UNITED STATES MONETARY POLICY: RECENT THINKING AND EXPERIENCE

HEARINGS

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

OF THE

JOINT COMMITTEE ON THE ECONOMIC REPORT

CONGRESS OF THE UNITED STATES

EIGHTY-THIRD CONGRESS

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UNITED STATES MONETARY POLICY: RECENT THINKING AND EXPERIENCE

MONDAY, DECEMBER 6, 1954

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON THE ECONOMIC REPORT,
SUBCOMMITTEE ON ECONOMIC STABILIZATION,
Washington, D. C.

The subcommittee met, pursuant to notice, at 10:05 a. m., in room 318, Senate Office Building, Senator Ralph E. Flanders (chairman of the subcommittee) presiding.

Present: Senators Flanders, Goldwater, Sparkman and Douglas; Representatives Talle, Patman, and Bolling.

Also present: Grover W. Ensley, staff director, and John W. Lehman, clerk.

Senator FLANDERS. I would like first to say I am glad to see you here. I am glad that our panel is here. I am glad that the attendance in the uncomfortable chairs in the rear of the room indicates a lively interest, and I am glad that there are other members of the Joint Committee on the Economic Report here besides the members of the subcommittee.

The Subcommittee on Economic Stabilization was appointed by Chairman Jesse P. Wolcott on April 16, 1954, pursuant to the report of the Joint Committee on the Economic Report filed with the Senate and House of Representatives on February 26, 1954 (H. Rept. 1256). The committee report set forth the functions of the Subcommittee on Economic Stabilization in the following words:

> *Subcommittee on Economic Stabilization.*—The economic situation is obviously very dynamic. The committee and staff will follow economic trends and developments from day to day to make sure that stabilizing action on the part of Government and business is effective. To facilitate expeditious study and action in this field the chairman will appoint a Subcommittee on Economic Stabilization. The subcommittee will hold hearings and conduct meetings as frequently as it deems necessary and desirable, and will report from time to time to the full committee on employment, production, and purchasing power trends. It will follow particularly the role of fiscal and monetary policy in dealing with the current recession.

The subcommittee and the committee staff have followed the current economic trends carefully during the past year. The staff has met frequently with economic analysts of the executive agencies, of business, labor, agriculture, and consumer groups, and the universities. Members of the committee have joined in a number of these meetings. As customary, the staff has reported these happenings and developments to all members of the committee. The subcommittee, in its executive meetings during the course of the past year, felt that recent economic developments did not warrant a material change in appraisal

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of the outlook from that presented by the witnesses at the committee's hearings last February, and set forth in the committee's report of February 26. We have consequently not seen the need for subcommittee hearings or special public reports during the recent session of the Congress. We have reported to the full committee.

During the last 3 years much reliance has been placed on monetary policy in carrying out the objectives of the Employment Act of 1946. The Joint Economic Committee has actively studied the objectives and workings of the United States monetary policy. Thorough studies were made by subcommittees in 1949–50 and again in 1951–52 under the chairmanships of Senator Paul Douglas and Representative Wright Patman, respectively.

Since the inquiry in 1951–52 there have been significant changes in the national economy and in the use of monetary instruments. It seems appropriate, therefore, and in compliance with announced intentions of the committee in its report to the Congress last February (H. Rept. 1256), to review recent thinking and experience with monetary policy. The use of the term "monetary policy" in this study is intended to include Federal debt management policy. The study will try to avoid covering the ground of the earlier committee studies, and will postpone discussion of the immediate economic outlook and the program to be submitted to the Congress by the President next January.

The subcommittee, in October, asked the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System to submit in writing their judgments relating to a number of questions by November 20 for review by the subcommittee, the committee staff, the panel participants, in advance of today's and tomorrow's hearings. I will insert at this point in the record the list of questions that were transmitted to Secretary Humphrey and Chairman Martin. We asked Secretary Humphrey to give his judgments on questions 1 and questions 6, 7, and 8; we asked Chairman Martin to comment on questions 1 through 5.

(The questions referred to above are as follows:)

1. What role did monetary policy play in the period of relative stability following the Treasury-Federal Reserve "accord" in 1951, in the months of boom late in 1952 and early 1953, and in the recession of 1953–54?

2. How has the emphasis in the use of monetary instruments changed during the period since mid-1952? For example, how have the various instruments—open market operations, discount rates and administration of discount operations, and reserve requirements—been used under varying conditions? Has there been any reliance on moral suasion during this period?

3. What is the practical significance of shifting policy emphasis from the view of "maintaining orderly conditions" to the view of "correcting disorderly situations" in the security market? What were the considerations leading the Open Market Committee to confine its operations to the short end of the market (not including correction of disorderly markets)? What has been the experience with operations under this decision?

4. What is the policy with respect to the volume of money?

5. Has monetary machinery (*a*) worked flexibly, and (*b*) has the market demonstrated flexibility in its responses to changes in policy? For example, how has the policy of "active ease" been reflected in the level and structure of interest rate, the volume of credit, and the [illegible]les of various types of lenders?

6. Has the debt management policy of the Treasury—both as to objectives and techniques—been consistent with the monetary policy of the Federal Reserve throughout the period since mid-1952?

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7. What considerations should dictate the maturity distribution schedule of the Federal debt, first, as to the long-run ideal to be pursued and, second, as a practical operating matter, giving weight to timing and contemporary conditions?

8. Are the benefits and costs to commercial banks of handling Government transactions clear enough, or can they be made clearer, to determine whether or not the banking system is being excessively compensated or undercompensated? What about the Treasury cash balance—its size and management? Should the Government receive interest on its deposits with commercial banks?

Senator FLANDERS. Without objection there will also be inserted in the record the replies of these two officials.

(The documents above referred to are as follows:)

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM,
Washington, November 26, 1954.

Hon. RALPH E. FLANDERS,
Chairman, Subcommittee on Economic Stabilization,
Joint Committee on the Economic Report, Washington, D. C.

DEAR SENATOR FLANDERS: In accordance with the request contained in your letter of October 26 and with subsequent conversations between members of your staff and the staff of the Board, there are attached copies of the Board's answers to questions 1 through 5 contained in your press release of November 12, 1954.

Sincerely yours,

WM. MCC. MARTIN, JR.

REPLIES OF THE CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM TO QUESTIONS SUBMITTED BY THE SUBCOMMITTEE ON ECONOMIC STABILIZATION OF THE JOINT COMMITTEE ON THE ECONOMIC REPORT IN CONNECTION WITH SUBCOMMITTEE HEARINGS OF DECEMBER 7, 1954

(1) What role did monetary policy play in the period of relative stability following the Treasury-Federal Reserve accord in 1951, in the months of boom late in 1952 and early 1953, and in the recession of 1953–54?

Inflationary dangers in prospect in 1951 made essential a shift in credit and monetary policies of the sort envisaged in the Treasury-Federal Reserve accord. Review of subsequent developments supports the conclusion that the policies pursued were helpful in bringing about and maintaining a reasonable degree of both stability and growth in the economy. The country encountered an economic problem of unprecedented nature, namely, carrying out, with no further price inflation after the 1950–51 spurt, a defense program of exceptional magnitude short of war while permitting moderate expansion in private expenditures. Private demands for goods and services were still in the process of overcoming the effects of war and postwar scarcities. Credit and monetary measures, together with fiscal and debt-management policies, helped to make it possible to cope with this situation through the mechanism of competitive markets and a free price system. As a result, the various direct controls imposed early in the defense period could be eliminated, thus relieving markets of the rigidities and inefficiencies inherent in such controls.

The Treasury-Federal Reserve accord was reached after an earlier inflationary outburst of overbuying, overborrowing, and overpricing in the private economy. In the first year after its adoption, private spending and borrowing moderated while the defense program expanded. In the second year, however, from the spring of 1952 to the late spring of 1953, there was a vigorous expansion in private spending and in private credit demands, just as defense expenditures were reaching a peak and the Federal Government faced the need for heavy borrowing to meet a deficit. Large capital expenditures, inventory accumulation, and heavy consumer purchases of durable goods—all financed to a large extent by credit—together with overtime operations in industry and exceptionally full utilization of resources generally, threatened to develop into an unsustainable boom. Credit restraints helped to keep total demands within the limits of the capacity of the economy to produce and to spread the volume of spending over a longer period.

The boom was checked without collapse and was followed by an orderly and moderate downward adjustment in activity. The adjustment was cushioned by progressive action to ease credit markets, as well as by tax reductions and other

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fiscal measures. It has not developed into a disastrous depression, as many quite reasonably feared.

The defense program has now been curtailed to a level more likely to be sustained over an extended period. Many of the more urgent domestic and foreign shortages resulting from war destruction and postwar reconstruction have been satisfied. Inventories have been reduced appreciably, and current production is more nearly in balance with demand. The problem of economic policy has thus become one of facilitating, yet keeping within sustainable bounds, the normal growth forces of a free enterprise, competitive economy.

In the remainder of this answer, credit and related economic developments in the 1951–54 period are described and analyzed in some detail.

Treasury-Federal Reserve accord

When the Korean outbreak occurred, the financial policies of this country were hampered by problems and methods of operation inherited from the Second World War and its aftermath. Federal Reserve credit policies for many years had been handicapped by trying to combine appropriate credit action with the support of Government securities prices. These practices, which were adopted to meet wartime conditions, contributed in the early postwar period to an inflation that had raised the price level to almost double the prewar average before it came to an end in 1949.

Following the Korean outbreak and adoption of a greatly enlarged defense program, inflation resumed. Various attempts to restrain credit expansion while continuing to support prices of Government securities had unsatisfactory and diminishing results as mounting sales of securities to the Federal Reserve by banks and other holders made funds abundantly and cheaply available for spending, investing, and speculation.

In a move to correct this situation, on March 4, 1951, the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System announced that "the Treasury and the Federal Reserve System have reached full accord with respect to debt management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt."

Following this accord, monetary policies were reoriented. Open market operations were altered over a period so as to adjust the supply of bank reserves to levels consistent with stable economic growth rather than to support prices of Government securities. The discount mechanism through which member commercial banks borrow from the Federal Reserve banks was gradually restored to an effective instrument of credit regulation. Various selective regulatory and voluntary means for restraining credit extensions in particular areas were utilized for a time, but to an increasing extent reliance came to be placed upon the more general measures that operate through the quantity of bank reserves and through flexible interest-rate movements.

Imposition of credit restraints—Spring of 1951 to spring of 1952

Following the accord, Federal Reserve operations in the short-term Government securities market, except for limited purchases during periods of Treasury refunding, were only for the purpose of influencing the volume of bank reserves in accordance with the broad objectives of Federal Reserve policy, namely, to contribute to stable economic growth. Purchases of long-term securities by the Federal Reserve were continued in diminishing volume for a number of weeks following the accord, but after mid-1951 the Federal Reserve bought practically no long-term bonds.

Under these policies, any bank or other investor wishing to sell Government securities generally had to depend on buyers in the market, and the free play of market forces resulted in some fluctuation as well as some rise in rates. Such price and interest-rate fluctuations perform important functions of a self-corrective and stabilizing nature, as is explained more fully in the answers to questions 3 and 5.

It had been widely feared that because of the magnitude of the public debt the removal of pegs on prices of Government securities would leave the market with insufficient buyers and holders to carry the debt, and thus would produce a catastrophic decline in bond values and panic conditions in the Government bond market. These fears proved unfounded. Would-be sellers either found buyers at prices they were willing to accept or refrained from selling. New issues were offered at yields which attracted sufficient buyers. Until late 1952, market yields on long-term bonds averaged less than 2¾ percent, with prices fluctuating

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between 95 and 99. The rate on Treasury bills gradually increased, but until 1952 remained generally below the Federal Reserve discount rate of 1¾ percent.

The Federal Reserve purchased short-term securities at times of Treasury refunding operations in order to steady the market. During periods of peak seasonal needs for reserves by the banking system, the Federal Reserve bought securities either outright in the market or from dealers under repurchase agreements for limited periods. At other times, however, System holdings of securities were reduced in order to absorb reserves in excess of current needs. For the year ending April 30, 1952, although there were wide variations during the period, total Federal Reserve holdings of United States Government securities declined slightly as shown in table I.

During this period banks were supplied with some reserves on balance by other factors, primarily a gold inflow, offset in part by a growing currency demand. To obtain additional reserves, banks resorted increasingly to borrowing at the Federal Reserve banks; these borrowings fluctuated considerably in response to temporary needs for reserves and showed a gradual rising tendency. This was the first time banks had had to borrow to any significant extent since the early thirties. Since banks are generally averse to borrowing steadily and the Federal Reserve banks endeavor to discourage continuous borrowing by individual members, the result of such a situation was to exert restraint on bank credit extension and thus on growth of deposits.

Federal Reserve credit and bank reserves, changes from April 1951 to April 1952 [1]

[In billions of dollars]

Federal Reserve credit:	
United States securities	−0.5
Discounts and advances	+.2
Other factors affecting reserves (sign indicates effect on reserves):	
Gold stock and foreign balances at Federal Reserve banks	+1.8
Currency in circulation	−1.3
Other, net	+.3
Member bank reserve balances, total	+.5
Required reserves	+.6
Excess reserves	−.2

[1] Changes derived from monthly averages of daily figures for the 2 months indicated. Figures may not balance because of rounding.

In addition to the adoption of more restrictive monetary measures following the Treasury-Federal Reserve accord, direct controls were imposed on prices early in 1951 and the allocation of materials in short supply was made more rigorous. A general reaction set in from the overbuying, overpricing, and overborrowing of the previous months. In the following 12 months, Government expenditures for defense increased sharply, but expansion in business and consumer expenditures for durable goods halted, and the rate of accumulation of business inventories was reduced. Consumer expenditures for nondurable goods and services continued to increase moderately. Private credit expansion slackened. Prices in general showed little change. Some prices that had previously risen most sharply declined, while some other prices advanced moderately.

Private credit expansion continued in this period, but the rate of growth was much slower than immediately after the outbreak in Korea. Commercial banks, while slowing down their loan increases, added somewhat to their holdings of short-term Government securities, being motivated to do so by the attraction of higher rates and by the fact that their longer-term holdings were less liquid than they had been under the bond support policy. Credit developments in this and other periods are indicated in table II, which shows changes in outstanding amounts of selected types of credit and also by selected groups of lenders or investors for years ending June 30, 1950 to 1954.

Although corporate security issues increased from mid-1951 to mid-1952, as a result especially of needs to finance expanding defense activities, the rate of expansion in bank loans to businesses and in mortgage credits slackened considerably. Increases in consumer credit and in borrowing by State and local governments were kept within moderate limits, notwithstanding continuing strong demands. The moderation in credit growth was due in part to regulation

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of consumer and mortgage credit terms and to the voluntary credit restraint program carried on by lending institutions. To a considerable extent, however, the slackened pace in making loans and investments resulted from the limitation on the availability of bank reserves, higher interest rates, and the reluctance of lenders and others to sell Government securities at the lower prices then prevailing.

TABLE II.--*Growth in major types of debt and equity financing*

[Net increase in amounts outstanding, in billions of dollars]

Distribution of growth by—	12 months ending June 30—			
	1954	1953	1952	1951
Major types:				
Federal cash borrowing	2.2	2.9	−0.5	−5.8
State and local government issues	5.5	3.1	2.6	2.8
Real-estate mortgages	9.9	9.4	8.2	11.3
Corporate bond and stock issues	6.7	7.7	7.3	4.7
Bank loans to business	−1.3	2.0	1.5	6.5
Consumer credit by banks and other lenders	.4	4.9	2.3	1.8
Bank credit not included above	2.4	.2	1.4	1.0
Total, major types of financing	25.8	30.2	22.8	22.3
Selected holders:				
Federal Reserve banks	.3	1.8	−.1	4.7
Commercial banking system	8.2	3.5	8.4	4.0
United States securities	4.9	−2.5	2.7	−7.2
Other loans and investments	3.3	6.0	5.7	11.2
Nonbank holders:				
Mutual savings banks	1.9	2.0	1.4	.9
Savings and loan associations	3.9	4.0	2.4	2.1
Life-insurance companies	4.5	5.2	3.7	3.7
Others, U. S. Government securities only:				
Individuals	0	1.5	−.9	−2.0
Corporations	−2.5	−.2	−1.1	1.6
Miscellaneous investors	.5	1.2	.9	1.0
Total holdings of above financing types accounted for by selected holders	17.5	19.0	14.7	16.0

NOTE.—Table shows net changes in selected types of loan extensions and new equity financing. Among types not included are trade credit other than consumer credit; interbank loans; security issues by foreign agencies, international organizations, nonprofit and eleemosynary institutions; nonbank loans for purchasing securities; and claims such as shares, passbooks, and insurance policies issued by financial organizations. Among holders, the most important exclusions are nonfinancial corporations, trusts, governments, and individuals, except for U. S. Government bonds.

These latter changes constituted in effect a decrease in liquidity and resulted in an increased demand for cash balances. The changed liquidity needs and the expanding volume of economic activity made possible a further substantial growth in bank credit and the money supply without generating inflationary pressures. Demand deposits and currency showed a further expansion of about $7 billion, or 6 percent, in the 12 months ending April 1952. Savings deposits, which had actually contracted following the Korean outbreak, increased substantially, as did savings in other forms.

In summary, it may be said that after the Treasury-Federal Reserve accord the Federal Reserve endeavored to adjust its policies so as to influence the level of bank reserves and the money supply in accordance with seasonal requirements, the capacity of the economy to produce goods and services, and sustainable economic growth in the economy. The discount function was restored as a means of supplying temporary needs for Federal Reserve credit in a manner that exerted restraint on unwarranted uses of such credit, thereby complementing open market operations in influencing the availability of credit at member banks. Discontinuation of rigid pegging of Government security prices removed the possibility of monetizing the public debt through sale to the Federal Reserve System at the initiative of the holders, nonbank as well as bank, and without loss to them. The excess liquidity of the economy was thereby removed.

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Resumption of expansionary tendencies—spring of 1952 to spring of 1953

Beginning in the spring of 1952 the rate of increase in defense spending slackened, but there was a renewed expansion of private expenditures and private credit demands became more vigorous. Around the middle of that year direct regulation of consumer installment and real-estate credit and the voluntary credit-restraint programs were discontinued. These actions increased the dependence on general credit measures for restraining excessive credit and monetary expansion. Total national product increased in the following year as a result of growing private expenditures both for consumption and investment, including a building up of inventories. By late 1952 the economy generally was operating on an overtime basis. Wage rates again rose substantially and consumer prices advanced slightly; at the same time, however, wholesale prices continued to show more declines than advances.

All major kinds of credit increased more sharply in the 12 months ending June 1953 than in the preceding 12 months, as shown in table II. The biggest change was in consumer credit, which increased $5 billion as compared with only little change during most of the previous year. The United States Government became a net borrower of about $3 billion from the public, as compared with a reduction in its indebtedness in the previous year. The volume of mortgage loans completed and of corporate and State and local government securities issued was moderately larger than in the preceding year. ank loans to businesses, reflecting inventory accumulation, expanded very sharply in late 1952 and failed to show the usual seasonal decline in early 1953.

A significant characteristic of this period was the amount of credit demands met from the genuine savings of the public. The net expansion in credit supplied by nonbank lenders was much greater than in the preceding year, while bank credit showed a smaller rate of increase. Furthermore, a larger portion of the bank credit represented the investment of savings deposits, which increased by 7 percent. Demand deposits and currency continued to expand but the annual rate of growth declined from 6 to 3 percent.

The Federal Reserve occasionally bought Government securities in this period but the objective of monetary policy continued to be restraint on undue credit and monetary expansion. Purchases were made at times of Treasury refundings during 1952 and subsequently offset in part by sales. Open market operations were also undertaken in response to seasonal influences affecting bank-reserve needs.

Over the whole period April 1952 to April 1953, as shown in table III, net purchases were less than enough to cover the drains on bank reserves resulting from gold outflow and larger currency demands. Banks had to borrow substantial amounts from the Federal Reserve in order to meet growing demands for credit. Discounts and advances at Federal Reserve banks generally exceeded a billion dollars from July 1952 to May 1953, and they averaged $1.6 billion in December 1952. This made banks much more restrained in their willingness to supply these demands. To make the policy of restraint more effective, the Federal Reserve discount rate was raised from 1¾ to 2 percent in January 1953.

TABLE III.—*Federal Reserve credit and bank reserves, changes from April 1952 to April 1953* [1]

[In billions of dollars]

Federal Reserve credit:	
United States securities	+1.4
Discounts and advances	+ .8
Other factors affecting reserves (sign indicates effect on reserves):	
Gold stock and foreign balances at Federal Reserve banks	— .7
Currency in circulation	—1.3
Other, net	+ .1
Member bank reserve balances, total	+ .2
Required reserves	+ .3
Excess reserves	— .1

[1] Changes derived from monthly averages of daily figures for the 2 months indicated. Figures may not balance because of rounding.

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The restraints did not stop credit and monetary growth. The growth that occurred apparently corresponded closely to the capacity of the economy to absorb more money without inflation. Since the resources of the economy were generally fully utilized, any more credit might have resulted in inflationary price rises and moreover might have built up an unsustainable debt structure. Inflation was prevented, notwithstanding strong pressures of demand for more credit, and prices remained relatively stable. In some lines, particularly installment loans to consumers and inventory loans to business, the rate of expansion was apparently more rapid than could be sustained.

The money market showed a marked response to the strong demand for credit and the restraints on its availability. Interest rates rose during the period, reflecting the pressures of credit demand in excess of the available supply. The rise in interest rates was particularly great in the spring of 1953 when yields on high-grade securities and loans generally reached the highest levels for 15 to 20 years. Treasury bill rates approached 2½ percent, the average yield on long-term Treasury bonds rose above 3 percent, and a small new issue of 30-year Treasury bonds bore a coupon rate of 3¼ percent. Rates on new issues of high-grade corporate bonds exceeded 3½ percent, and federally guaranteed mortgages sold at discounts in the secondary market.

By May 1953 the market developed a condition of tension that threatened to become unduly severe. This reflected a number of converging factors. Apprehension arose regarding the ability of the credit market to meet borrowing demands of the State and local governments, consumers, home buyers, and business corporations, together with rising Treasury financing needs. The combination of a Government deficit and large private credit demands is exceptional for a period other than one of active war and it was difficult to gage the problems that it might present. At that time the Treasury made its offer on a $1 billion issue of 30-year 3¼ percent bonds to raise new money from nonbank investors. This offering gave probably the first tangible evidence of a striking nature, not only of the fact that the Treasury had to borrow substantial amounts, but also that it had to compete against large private borrowing demands for the available supply of savings at competitive rates if resort to the creation of an undue volume of new money through the banking system were to be avoided.

In addition to Treasury borrowing, private credit demands of various sorts were exceptionally large. New security issues by corporations and State and local governments exceeded $7 billion in the first half of the year—larger than in any previous half-year, and the amount of future issues scheduled was still large. Some of this borrowing was in anticipation of further stringency. About this time, also, the ceiling rates on the FHA and VA mortgages were raised after months of consideration, and a large volume of mortgages which had been held back pending the authorization of higher rates suddenly came on the market. The new rates, however, proved low relative to the tight market at the time, and such mortgages sold at discounts in the secondary market.

The continued high level of member bank borrowing from the Federal Reserve and the limited availability of reserve funds were keeping banks under pressure. The effect on the money market was a marked rise in interest rates, which exerted a considerable amount of restraint on private credit demands. The heavy pressures on the market were due to the growing demand for credit. The supply of credit actually increased substantially but did not meet all demands.

Slackening of activity after spring of 1953

Early in May 1953 Federal Reserve officials recognized that as a result of a combination of circumstances, some of which were unexpected, undue tension was developing in the credit market. They concluded that steps should be taken to temper restraints curently imposed on member banks, particularly in view of prospective seasonal credit and currency demands.

The Open Market Committee began early in May to supply reserves by purchasing Government securities and by midyear about $1 billion of securities had been acquired. Early in July some $1.2 billion of reserves were released to the banking system by a reduction in member bank reserve requirements. These actions made it possible for banks to decrease their borrowings sharply and to subscribe for a new issue of short-term Government securities early in July, as well as to meet seasonal credit and currency demands around the midyear.

Inflationary forces abated after the spring of 1953 and economic activity commenced to recede from the all-time high level reached in the second quarter of that year. Business inventory expansion slackened and subsequently contraction

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in inventories set in. Home building plans were temporarily held up because of financing difficulties. Substantial cutbacks in defense expenditures began to be made by the Government.

As these evidences of business slackening became clearer, the Federal Reserve further eased credit conditions by purchasing additional securities in the market. Reserves thus made available were enough to cover the effects of a gold outflow and the customary seasonal rise in currency and credit demands, but the increases that actually occurred in currency and required reserves were smaller than expected. Member banks were thus able to use a part of the reserves made available to them to reduce their borrowings at the Federal Reserve banks. In February 1954 the Federal Reserve discount rate was reduced to 1¾ percent.

Developments for the first 12 months following the change in policy are summarized in table IV. In that period the reduction in reserve requirements of $1.2 billion and Federal Reserve purchases of securities of $1.3 billion enabled member banks to meet a small further gold outflow, to decrease appreciably their borrowings at the Reserve banks, and to obtain reserves needed to cover further deposit expansion.

TABLE IV.--*Federal reserve credit and bank reserves*

[Changes in billions of dollars [1]]

	April 1953 to April 1954	April 1954 to October 1954
Federal Reserve credit:		
United States securities	[2] +1.3	−0.2
Discounts and advances	−1.0	+.1
Other factors affecting reserves (sign indicates effect on reserves):		
Gold stock and foreign balances at Federal Reserve banks	−.5	−.2
Currency in circulation	0	−.3
Other	[2] −.4	0
Member bank reserve balances, total	−.6	−.5
Required reserves, due to—		
Reduction in requirements	−1.2	−1.6
Growth in deposits	+.4	+1.1
Excess reserves	+.2	0

[1] Changes derived from monthly averages of daily figures for the 2 months indicated. Figures may not balance because of rounding.

[2] Exclude effect of $500 million sale of Government securities to Treasury in exchange for free gold carried in Treasury cash balance.

Since April 1954 reserves needed for customary seasonal and other purposes have been supplied largely by a further reduction of about $1.6 billion in member bank reserve requirements. Reserves were supplied at times by Federal Reserve purchases of Treasury bills, while at other times to absorb redundant reserves bills were sold or not replaced at maturity. Thus banks have been able to meet seasonal credit and monetary demands and also to purchase new issues of Treasury securities with little borrowing.

Total credit demands, particularly for long-term purposes, continued substantial during the latter part of 1953 and in 1954, although less than in the preceding year. There was a decline in bank loans to business and consumer credit showed little increase from the middle of 1953 until recently. Mortgage lending began to pick up in the autumn of 1953 and has since been in record volume, stimulated in part by considerably liberalized downpayment and maturity terms, especially under Government mortgage programs. New security issues by corporations were slightly less than in the preceding year but those of State and local governments were much larger. The Federal Government remained a substantial net borrower.

Savings continued to meet a large portion of total credit demands as reflected in the figures of insurance companies, savings and loan associations, and mutual savings banks as well as in time deposits of commercial banks. The total of demand deposits and currency, which changed little from the spring of 1953 to the spring of 1954, except for normal seasonal movements, showed a more than seasonal increase after mid-1954.

As a result of the increased availability of funds and the slackened credit demands, yields on short-term Treasury securities declined by the summer of 1954 to the lowest level since 1949. Since the spring of 1954 yields on long-term Government securities and those on high-grade corporate bonds have been gen-

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erally at the lowest level since the Treasury-Federal Reserve accord. Rates charged by banks on customer loans remained at about last year's higher levels until mid-March, when the rate to prime borrowers was reduced. Mortgage interest rates declined somewhat and discounts on guaranteed and insured mortgages were reduced substantially, with small premiums appearing in some areas.

Summary and conclusion

The role and objective of the Federal Reserve in the defense-mobilization period have been to make possible the provision of adequate credit and money for full utilization of, and growth in, the country's economic resources. At the same time, policy endeavored to prevent excessive credit and monetary expansion beyond the limits of productive capacity that would lead to inflationary developments and threaten the maintenance of stable growth.

During the period of restraint in 1952–53, Federal Reserve policy looked toward the avoidance of credit excesses which could cause real trouble once a downturn had come. This policy sought to even out the flow of capital investment by fostering deferment of some projects until slack had developed in the economy. During the period of ease since May 1953, the major contribution has been to facilitate as large a volume of bank lending as the economy required, and to provide support for mortgage lending and utility and State and municipal financing which has had its counterpart in a high volume of construction of residential property, utilities installations, public buildings, and road construction. These activities have been a substantial offset to declines in defense expenditures and in business inventories.

(2) How has the emphasis in the use of monetary instruments changed during the period since mid-1952? For example, how have the various instruments—open-market operations, discount policy, and reserve-requirement changes—been used under varying conditions? Has there been any reliance on moral suasion during this period?

At any given time, the Federal Reserve System pursues the policy it believes appropriate for the credit and economic situation. It has three major instruments available for effectuating its policy—open-market operations, discount policy, and changes in reserve requirements. These instruments are complementary and mutually reenforcing. Extent of reliance on any one of the instruments depends upon the System's judgment as to what may be most appropriate under the circumstances to further the general credit policy being pursued.

Description of the instruments

Open-market operations are carried out at the initiative of the System by making purchases or sales of Government securities in the market. Purchases of securities supply reserves to member banks. Sales of securities absorb or extinguish member bank reserves. These operations can be used to offset losses or gains in reserves from changes in such factors as currency in circulation or gold stock or to expand or reduce the volume of bank reserves.

Discount policy relates to Federal Reserve bank lending to member banks. The initiative in such credit extensions is taken by individual member banks when it is necessary for them to build up their reserve positions to required levels. The discount rates at which the Federal Reserve banks will lend to member banks are established by each Reserve bank from time to time, subject to review and determination by the Board of Governors, in accordance with the credit and economic situation.

Member banks, as a matter of well-established banking practice, are generally reluctant to operate on borrowed funds, or to stay long in debt. Therefore, under ordinary circumstances, borrowing at the Federal Reserve by individual banks is usually on a temporary, short-term basis. In unusual or emergency situations, of course, Federal Reserve discount credit may be outstanding to individual banks for longer periods. The general principles governing Reserve bank administration of the discount window arise out of law, regulation, and Federal Reserve discount experience.

By raising or lowering reserve requirements of the various reserve classes of member banks—within specified limits for each class as permitted by law—the Federal Reserve at its initiative may diminish or enlarge the volume of funds which member banks have available for lending. Action of this type thus influences the liquidity position of banks and their ability to expand deposits in relation to their reserves. By their nature, changes in reserve requirements affect at the same time and to the same extent all member banks within each reserve class subject to the action.

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Interrelationship of the instruments

Although any one of these three major instruments will tighten or ease credit conditions, each of them has a somewhat unique role in carrying out System credit and monetary policy. Open-market operations have become the chief instrument by which the System influences on a current basis the volume of unborrowed reserves of member banks. Such operations are also actively used to exert important restrictive or expansive pressure on bank credit conditions when the economic situation calls for fundamental change in these conditions. Since a purchase or sale of Government securities by the System adds to or substracts from the reserves of the member banks, it will be reflected initially, other things unchanged, in the volume of excess reserves held by member banks or in the volume of reserves that member banks need to obtain by borrowing at the Federal Reserve banks. Reflecting the reluctance of member banks to incur indebtedness or remain long in debt, changes in the volume of member bank excess reserves or borrowing are promptly reflected in conditions of credit avail- the Federal Reserve banks. Rejecting the reluctance of member banks to incur become increasingly indebted and eased as the volume of that indebtedness is diminished or the amount of excess reserves is increased. Open-market operations are thus a flexible means for helping to achieve whatever condition of credit tightness, ease, or moderation may be appropriate.

The Federal Reserve discount rate is a pivotal interest rate in the credit market. In particular, short-term open-market rates tend to array themselves in relationship to the Federal Reserve discount rate, except in a period when the reserve positions of member banks are so easy as to obviate the need for borrowing at the Reserve banks. When through open-market operations bank reserve positions have been put under pressure (or have been allowed to get under pressure as bank credit and deposits expand), money rates will tend to range higher in their relationship to the discount rate. Conversely, as bank reserve positions ease, they will be lower in relation to that rate.

In a period, for example, when restraint on bank credit and monetary expansion is needed, open market operations and changes in the discount rate need to be used to reinforce each other. In the first instance, increasing pressure on bank reserve positions (increased need for borrowing) may be developed through use of the open-market instrument alone. At a point, however, it will become appropriate to support the effectiveness of this open-market action by an increase in the discount rate, strengthening the reluctance of member banks to remain indebted to the Federal Reserve by making borrowing more expensive as a means of adjusting bank reserve positions. Such discount rate adjustments tend to lag behind adjustments in market rates in a tightening credit situation. With an upward adjustment of the discount rate, market rates may shift further upward over a period of time as they re-form around the new and higher discount rate.

In a period when it is appropriate to ease credit conditions, open-market operations may be undertaken to supply reserve funds. Member banks may use these funds initially to reduce their borrowing. Since this action will put banks in a stronger position to increase their lending and investing activities, it will tend to be reflected in a stronger tone in money markets and in lower market rates in relation to the discount rate. To reinforce this credit-easing action, it may be appropriate at some stage to lower the discount rate, thereby keeping the cost of using this avenue for the temporary adjustment of bank reserve positions more nearly in line with the cost of making these adjustments through the sale and subsequent repurchase of market paper or securities.

Changes in reserve requirements can be used, like open-market operations, to tighten or ease bank reserve positions. As with open-market operations, the effect shows up initially in changes in the volume of member bank excess reserves and borrowing at the Reserve banks. Its impact on the money market and the availability of bank credit is, therefore, similar in many respects to that of a comparable open-market action.

The reserve-requirement instrument, however, is not interchangeable with the open-market instrument. Unlike open-market operations, the results affect immediately and simultaneously all banks in each reserve class. Changes in requirements, moreover, cannot be made frequently—especially on the up side—without unduly disturbing the operations of individual banks, since in our country adherence to reserve requirements is a basic rule to be observed in conducting a banking business. Changes in reserve requirements are, therefore, made infrequently and typically involve a fairly sizable volume of funds. The effects tend to be large and concentrated within a short period of time. The instrument

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is more appropriate for making a major change in the volume of available bank reserves than it is for short-run adjustments. It is not adaptable to affecting bank reserve positions on a day-to-day and week-to-week basis, as are open-market operations. Nor is the instrument as sensitive and flexible a means of affecting general credit conditions as is the combined use of open market and discount operations. In fact, it may be desirable to engage in partially offsetting open-market actions in order to cushion the impact of reserve requirement changes in credit markets.

Use of the instruments since mid-1952

In an appended tabulation, exhibit A, the various credit actions taken by the Federal Reserve after mid-1952 are set forth, together with a summary of the surrounding credit and economic circumstances. A chart, exhibit B, shows the interrelated effects of these actions on member bank borrowings and excess reserves. Examination of these measures will make clear the interaction and interrelation of the major instruments following a pattern similar to that described above. As may be seen from the accompanying chart, the System did not fully meet through open-market operations the heavy demands of banks for reserves in the fall of 1952, with the result that there was a buildup in the volume of discounts. This pressure on bank reserves was reflected in a rise in interest rates, particularly in the short-term sector. The restrictiveness of this development was reinforced in early 1953 by an increase in the discount rates of the Reserve banks from 1¾ to 2 percent. Restraint on bank reserve positions was maintained over the first several months of 1953. Reflecting the very strong demand for credit from a variety of sources, interest rates, both long- and short-term, rose further.

The revival in this period in the use of the discount instrument, little used since the early 1930's, raised some problems of discount administration for the System. Through a lapse of time some member banks had lost familiarity with the principles of law and regulation relating to the appropriate occasions for borrowing at the Reserve banks. Under the excess-profits-tax law then in effect, it was profitable for member banks in excess-profits-tax brackets to borrow to increase their tax base, and, in order to improve their tax situations, a few of these banks began to rely on borrowing at the Reserve bank rather than adjustments in asset positions in maintaining their reserve positions. Some other banks seemed willing to remain indebted at the Reserve banks for extended periods in order to profit from differentials between market rates of interest and the discount rate. As these developments became apparent, they were dealt with administratively by the Reserve banks on a case-by-case basis.

With signs of an abatement of the inflationary threat in the spring of 1953, the Federal Reserve modified its credit policy. Easing actions were first undertaken through the open-market purchases begun in early May and made on an increasing scale through June. These open-market purchases were supplemented at mid-1953 by a reduction in reserve requirements. Taken together these actions made available sufficient reserve funds to meet seasonal reserve drains and credit needs at the midyear, including large Treasury needs, and at the same time greatly to ease pressures on bank reserve positions and to reduce member bank borrowing needs.

Additional open-market actions were taken over the second half of 1953 to expand further the supply of reserves available to member banks in accordance with usual seasonal factors. Actual credit demands did not come up to seasonal expectations, however, and member banks used surplus reserve funds to reduce their borrowings at the Reserve banks. By early 1954 banks were largely out of debt to the Reserve banks and over the first half of the year excess reserves increased steadily, largely reflecting seasonal factors. Easing actions by the open-market instrument were supported by reductions in the discount rates of the Reserve banks first in February and again in April and May. Interest rates declined sharply over the period in response to this combination of actions and the reduced demand for short-term credit.

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In May of 1954 the Federal Reserve again began to supply bank reserves through open-market operations and around midyear reserve requirements of member banks were further reduced. This action was taken in order to promote further bank credit and monetary expansion and to make available funds to meet seasonal reserve drains and credit needs, including those of the Treasury. It was foreseen that the action would supply more reserves than were called for at the time and accordingly open-market sales were made to absorb a part of the funds. It was anticipated that these funds would be released to the market over the fall months as needed by open-market purchases and this was done. Then dovetailing of reserve requirements and open-market actions in the summer of 1954 illustrates how the impact of a change in reserve requirements may be cushioned and spread over time by temporarily offsetting open-market measures.

Selective credit actions [1]

In addition to its general credit instruments, the System had during this period one continuing instrument of selective credit action, namely, margin requirements on stock market credit. Margin requirements established by the Board of Governors limit the amount which brokers, dealers, and banks may lend to customers in order to purchase or carry securities. Their statutory purpose is to prevent undue use of credit for stock market transactions. From the standpoint of credit and monetary administration, margin requirement regulation serves to minimize the bearing that stock speculation might have on the use of the general instruments of System policy discussed above.

In February 1953 margin requirements on stock market credit were reduced from 75 to 50 percent. The 75 percent margin requirement had been set in January 1951 as a preventative measure during that inflationary period. The action in early 1953 was taken in the judgment that a 50 percent requirement would be adequate to prevent an excessive use of credit for purchasing and carrying securities.

Use of moral suasion

Moral suasion is generally taken to refer to oral or written statements, appeals, or warnings made by the banking and monetary authorities to all or special groups of lenders with the intent of influencing their credit extension activities. During the period under review only minor use was made of this instrument within the Federal Reserve System.[2]

The term "moral suasion" is sometimes given a broader meaning to include any public or private statements made by Federal Reserve officials in the discharge of their responsibilities. As so defined it would include statements made to promote awareness and understanding of current credit and monetary problems on the part of the public and the financial community. It would also include conferences with member banks, individually and in groups, and with others in connection with the administration of various System functions, including particularly the discount function. On the basis of this broader definition, it may be said that moral suasion is constantly being employed by the System to promote public understanding of System actions and to ensure compliance with the law and with regulations issued pursuant to the law.

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[1] At times during the past the Board has also had temporary authority to regulate the terms of consumer and real-estate credit. Most recently, for example, regulation of consumer credit was undertaken in the early fall of 1950 under temporary authority granted by the Defense Production Act. The Board suspended such regulation in May 1952, and in the Defense Production Act amendments approved June 30, 1952, Congress repealed the authority to regulate consumer credit. In the fall of 1950 the Board was also given temporary authority to regulate real-estate credit terms. Such regulation was begun in midfall of that year and suspended in September 1952 to conform with the provisions of the Defense Production Act as amended. That act continued the authority for real-estate credit regulation until mid-1953, but required that the regulation be relaxed earlier if the estimated number of dwelling units started in each of 3 successive months was below a seasonally adjusted annual rate of 1.2 million.

[2] For example, the Federal Reserve Bank of Boston, on May 15, 1953, addressed a letter to all commercial banks in the First Federal Reserve District calling attention to relaxation of credit standards taking place in the market for installment credit.

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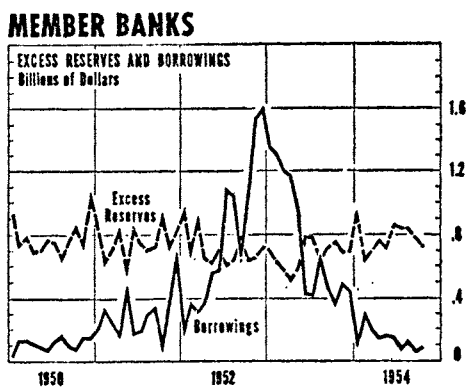
EXHIBIT A.—*Use of Federal reserve instruments, July 1952–October 1954*

Date	Action	Purpose of action	
		Intent with respect to effect on credit and money	Explanation
September 1952	Suspension of regulation of real-estate credit.	None	To conform with the terms of the Defense Production Act, as amended, requiring suspension of regulation if housing starts in each of 3 consecutive months fell short of an annual rate of 1,200,000 units, seasonally adjusted.
July–December 1952	Limited net purchases of U. S. Government securities in open market to $1.8 billion.	Restrictive	To meet seasonal and other reserve drains only in part, requiring banks to borrow some of the reserves needed so as to restrain bank credit and deposit expansion at a time when credit demand was very large and the economy was fully employed. Purchases in August and September were made primarily at times of Treasury refunding operations and were offset in part by subsequent sales.
January–April 1953	Sold or redeemed $800 million net of U. S. Government securities.	do	To offset seasonal changes in factors affecting reserves and thus to maintain pressure on member bank reserve positions.
January 1953	Raised discount rates from 1¾ to 2 percent and buying rates on 90-day bankers' acceptances from 1⅞ to 2⅛ percent.	do	To bring discount rates as well as buying rates on acceptances into closer alinement with open-market money rates and to provide an additional deterrent to member bank borrowing from the Reserve banks.
February 1953	Reduced margin requirements on loans for purchasing or carrying listed securities from 75 to 50 percent of market value of securities.	None	To reduce margin requirements from the high level imposed early in 1951, in the judgment that the lower requirement would be adequate to prevent excessive use of credit for purchasing and carrying stocks.
May–June 1953	Purchased in open market about $900 million U. S. Government securities.	Relief of credit market tensions.	To provide banks with reserves and to permit a reduction of member bank borrowing from the Reserve banks at a time when such borrowing was high, credit and capital markets were showing strain, and seasonal needs for funds were imminent.
July 1953	Reduced reserve requirements on net demand deposits by 2 percentage points at central Reserve city banks and by 1 percentage point at Reserve city and country banks, thus freeing an estimated 1.2 billion or reserves.	Expansive	To free additional bank reserves for meeting expected seasonal and growth credit demands, including Treasury financing needs, and to further reduce the pressure on member bank reserve positions.
July–December 1953	Made net purchases in open market of U. S. Government securities totaling $1.7 billion.	do	To provide banks with reserves to meet seasonal and growth needs and to offset a continuing gold outflow with little or no additional recourse to borrowing. This action and the one below were taken in pursuance of a policy of active ease adopted in view of the business downturn.
January–June 1954	Limited net sales to about $900 million of U. S. Government securities in open market.	do	To absorb only part of the reserves made available by the seasonal deposit contraction and return flow of currency thereby further easing bank reserve positions.
February 1954	Reduced discount rates from 2 to 1¾ percent and buying rates on 90-day bankers' acceptances from 2⅛ to 1¾ percent.	do	To bring discount rates as well as buying rates on bankers' acceptances into closer alinement with market rates of interest and to eliminate any undue deterrent to bank borrowing from the Reserve banks for making temporary reserve adjustments.
April–May 1954	Reduced discount rates from 1¾ to 1½ percent and buying rates on 90-day bankers' acceptances from 1¾ to 1½ percent.		

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EXHIBIT A.—*Use of Federal reserve instruments, July 1952–October 1954*—Con.

Date	Action	Purpose of action	
		Intent with respect to effect on credit and money	Explanation
June–October 1954..	Reduced reserve requirements on net demand deposits by 2 percentage points at central Reserve city banks and by 1 percentage point at Reserve city and country banks, and requirements on time deposits by 1 percentage point at all member banks, thus freeing about $1.5 billion of reserves in the period June 16–Aug. 1.	Expansive....	To supply the banking system with reserves to meet expected growth and seasonal demands for credit and money, including Treasury financing needs.
	Sold or redeemed U. S. Government securities totaling about $1 billion in July and August.	Cushioning...	
	Made net purchases in open market of about $400 million in September and October.	.....	Reductions in reserve requirements were offset in part by temporary sales of securities in order to prevent excess reserves from increasing unduly at the time, but security purchases were resumed as need for funds developed.



(3) What is the practical significance of shifting policy emphasis from the view of "maintaining orderly conditions" to the view of "correcting disorderly situations" in the security market? What were the considerations leading the Open Market Committee to confine its operations to the short end of the market (not including correction of disorderly markets)? What has been the experience with operations under this decision?

The matters referred to in this question relate to changes in techniques of System open market operations adopted in the spring of 1953. At that time, the full Federal Open Market Committee decided to amend its directive to the executive committee by dropping the clause authorizing operations to maintain orderly conditions in the market for United States securities and by substituting therefor a clause authorizing operations to correct a "disorderly situation" in the securities market. At the same time, the executive committee was instructed to confine its operations to the short end of the market. Closely associated was a decision taken earlier to discontinue direct supporting operations during periods of Treasury refinancing with respect both to maturing issues and to new issues being offered, as well as issues comparable to those being offered in exchange.

These three decisions did not change basic policy objectives. They were taken after intensive reexamination in 1952 of the techniques then employed in System

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open market operations with particular reference to the potential impact of such techniques on market behavior. Their purpose was to foster a stronger, more self-reliant market for Government securities. Improvement in this market was desired (1) in order that the Federal Reserve might better implement flexible monetary and credit policies, (2) to facilitate Treasury debt management operations, and (3) to encourage broader private investor participation in the Government securities market.

The decisions were taken to remove a disconcerting degree of uncertainty that existed at that time among market intermediaries and financial specialists. The market was uncertain, first, with respect to the limits the Federal Open Market Committee had in mind in its directive to "maintain an orderly market in Government securities." A second uncertainty pertained to the occasions when the System might decide to operate directly in the intermediate and long-term sectors of the market to further its basic monetary policy objectives, i. e., to ease intermediate and long-term interest rates in periods of economic slack or to firm these rates in periods of exuberance.

Both of these uncertainties related solely to transactions initiated by the System outside the short end of the market, transactions which had as their immediate objective results other than a desire to add to or absorb reserves from the market. The effect, however, was to limit significantly the disposition of market intermediaries and financial specialists to take positions, make continuous markets, or engage in arbitrage in issues outside the short end of the market.

The constant possibility of official action, which from the standpoint of investors and market intermediaries would often seem capricious, constituted a market risk which private investors could in no reasonable way anticipate and evaluate in formulating their advance judgment about market prospects. Even a financial intermediary who appraised correctly the emergence of a situation, where the Committee might decide to intervene, would have little basis for estimating the exact timing of that intervention, the issues in which it might be concentrated or the levels at which it might take place. Such estimates are important to the sensitive rapid trading at very small spreads that is characteristic of a self-reliant securities market. Inability to make them may add a degree of risk that is more than financial intermediaries are willing to accept.

It became apparent that these uncertainties, so long as they persisted, would tend to perpetuate a condition of thin markets and sluggish adjustment as between sectors of the market. This impaired the attraction of Government securities as a medium of investment, since their very high status with investors rests on ready salability as well as on credit quality. From the point of view of the Federal Reserve System, such uncertainties might increase the probabality of situations arising in which the Open Market Committee would be forced to intervene in various sectors of the market, either to prevent disorderly situations from arising or to see to it that funds it added to or absorbed from bank reserves in the pursuit of monetary policies found effective and appropriate response throughout the credit structure. In taking these decisions, the Federal Open Market Committee is not absolving itself from concern with developments in the longer-term sector of the market. It is particularly concerned that its policies shall be reflected in the cost and availability of credit in those markets.

In the case of all three decisions, subsequent experience with actual operating results has, on the whole, tended increasingly to substantiate the judgments that led to their adoption. This is particularly true of operating experience since June 1953. Wihout any intervention from the Federal Open Market account, except in the short end, the market for United States Government securities has become progressively broader, stronger, and more resilient throughout all maturity ranges. Experience during April and May 1953, just after the new techniques were adopted, and before their import was understood, is less clear. This was the period of mounting tension in the credit and capital markets analyzed in the answer to question 1.

In the 20 months' period of operations under these decisions, the economic climate has changed from one of boom to one of reduced levels of activity. Accordingly, Federal Reserve policies have been shifted from restraint against inflation to the active promotion of ease in the credit markets. Ease in the long-term markets, as well as the short-term money market, has been an important objective of these policies. Although all open-market operations, for technical reasons cited below, have been confined to the short end of the market, there appears to be no example that can be cited from Federal Reserve history where the cost and availability of credit in all sectors of the securities market has been

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more sensitively responsive to shifts in Federal Reserve policy than during these months. This applies as fully to the market for long-term funds as for short-term funds; to the market for mortgage money, for business and industrial, State, municipal and public financing.

It is important to keep in mind the scope of the decisions relating to the new open-market techniques. They are decisions of the full Open Market Committee adopted for the guidance of its executive committee and the manager of the open-market account. They do not mean that no operations wil be undertaken henceforth outside the short end of the market. They do mean, unless modified by the Committee, that operations in other than the short end of the market will have to be specifically authorized by the full Open Market Committee, except operations to correct a disorderly situation. In that case the executive committee, which can be convened quickly by telephone if necessary, is empowered to authorize such corrective operations.

Background of new techniques

These three interrelated decisions are designed to hold to a minimum the technical market repercussions that result in some degree from any operation on the part of the Federal open market account. In one sense it may be said that any purchase or sale in a market by any party, private as well as public, small as well as large, disturbs the market in that it results in a change in demand and supply conditions in that market. The new operating techniques are not designed to prevent this type of repercussion. Such market response is necessary and desirable if a market is to perform efficiently the function of continuously equilibrating changes in demand with changes in supply. On the contrary, it is the primary objective of the techniques to contribute, so far as possible, to the development of such responsiveness in the market for United States Government securities. For this end to be realized, the market must be able to translate swiftly an increase in the availability of funds in any one sector of the market to increased availability in all sectors, and to soften the impact of decreased availability of funds on any one sector by spreading that impact over other sectors of the market. In a well functioning market capable of such resilient response, Federal Reserve policies can make their greatest contribution to economic stability and growth.

Technical characteristics peculiar to system transactions.—The danger that operations by the Federal open market account may, if executed through faulty techniques, exert an unduly disturbing or even disruptive effect upon the market for United States Government securities arises from four characteristics of these operations by which they are differentiated from purchases and sales of securities for the account of private firms and individuals.

First, the dollar amounts of reserve funds that are required to be injected into or withdrawn from the markets in the course of ordinary day-to-day operations are likely to be quite large, much larger than the average amounts bought or sold in the course of a day for any individual private account. This naturally puts some strain on the market mechanism which is likely to function most effectively when the aggregate of its transactions is made up of numerous individual transactions of relatively small magnitude.

Second, the open market account deals in reserve funds which provide a basis for a multiple expansion of credit. This means that when it buys it does more than merely add to the demand side of the market, as do other purchasers. The account pays for its purchases with a check on the Reserve banks. Consequently, it simultaneously adds to the reserve base sufficient buying power to absorb a much larger volume of securities. Conversely, when the open market account sells a Government security, the problem of the market is more than finding a buyer for that issue, as it must in the case of sales of securities by others. The purchasers must simultaneously pay for the security with commercial bank reserve funds which will be subtracted from the reserve base. This withdrawal of reserve funds will affect positively the supply of securities offered for sale.

Third, transacrions by the open market account are not motivated by profit or loss considerations. They differ, consequently, from private purchases and sales which are so motivated. Private firms or individuals motivated by profit and loss considerations will not pursue purchases when prices rise or yields fall to levels that appear less remunerative than comparable alternative outlets for their funds, neither will they press sales and take losses with respect to either price or yield when alternative courses of action open to them appear less costly. The result of these motivations in a market with large numbers of participants is to generate forces that tend to slow down, or counteract, or limit

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movements in either direction. The importance of these counteracting forces was effectively illustrated after the accord when the unwillingness of investors to take losses reduced offerings in the market for United States securities. This restrained expenditures and helped materially to prevent a continuation or resumption of the Korean inflation. These same motives do not govern transactions initiated by the Federal open market account, which are undertaken for policy reasons, and pursued, until policy goals are achieved, without regard to their effect upon the earnings of the Reserve banks.

Fourth, the Federal open market account is the largest portfolio of United States securities under single control. Its holdings of marketable United States securities approximate $25 billion or nearly 1 out of 6 of all such securities outstanding with the public. Its potential buying power is also very large. Transactions initiated by the Federal open market account differ, therefore, from privately initiated transactions not only with respect to their motivation but also with respect to the potential financial power that lies back of them.

Role of financial intermediaries.—These four basic respects in which transactions in United States Government securities initiated by the Federal open market account differ from privately initiated transactions find a reflection in the technical organization of the market for United States securities. They are particularly important in circumscribing the role which primary dealers in United States Government securities and other professional intermediaries are willing to assume in that market.

In general, a market such as the market for United States Government securities achieves depth, breadth, and resiliency when there are active within it, at all times, professional and intermediaries alert and willing, on their own capital and risk, to make continuous markets and to engage in arbitrage. To make continuing markets, they must stand willing continuously to quote firm prices at which they will buy reasonably large quantities of securities from any and all sellers, including each other. They must be prepared, if necessary, to hold such securities in their portfolio, pending subsequent resale. Similarly, a professional intermediary must stand ready to quote firm prices at which he will sell securities in reasonably large quantities to any and all purchasers, and must be prepared to enter into such contracts for sale even if the particular issues in demand are not in his portfolio at the time but must subsequently be purchased from others.

To make continuous markets successfully with his own capital and at his own risk, the professional intermediary must be alert to possibilities for arbitrage, i. e., he must sense when various issues are offered for sale or sought for purchase at prices which are mutually inconsistent with each other in terms of price relationships which may be expected to prevail in the near future. In such cases, the professional intermediary seeks to sell the issue that is overvalued and simultaneously to purchase the issue for which there is momentarily less demand. This requires a keen sense of values, and has the effect of keeping market quotations for comparable values in close alinement with each other. The sensing of such minor inconsistencies is less difficult when the two issues are in the same maturity sector of the market. It requires great skill, however, when they lie in different maturity sectors, for then the professional intermediary must stake his capital on a judgment as to price and interest rate relationships that may be expected to emerge as between the various maturity sectors of the list. When the financial intermediary, alert to possibilities for arbitrage as between the various maturity sectors, is able to make such judgments successfully, and is willing to act on them aggressively, the effect is to impart continuity and responsiveness to the whole market. Continuity exists when variations in quotations as between successive transactions are minor. Responsiveness obtains when the impact of sales in any particular sector, instead of being concentrated in that sector, is cushioned and dispersed in greater or less degree throughout all maturity sectors.

Technical repercussions of transactions for system account.—These technical factors, taken in conjunction, pose the problem dealt with in the decisions discussed in this answer. Since transactions in United States securities initiated by the Federal open market account differ in important respects from similar transactions for private account, there is a danger that they may set off adverse repercussions that impair the efficiency of the market as an equilibrating factor in the economy. The nature of these repercussions may be illustrated by analysis of a sales transaction initiated by the Federal open market account.

In any market, a transaction initiated by the seller is likely to have as one effect a lowering of price for the commodity sold. In the market for Government

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securities, this means that sales initiated by any seller are likely to find their first expression in a softening of quotations for the particular security offered for sale. The softening is likely to be larger, the larger the amount that is offered. It is also likely to be larger if there is ground to expect that the specific offer for sale is only the first of a series of further offers. In the case of offers from the Federal open market account, these typical reactions and expectations are likely to be accentuated because such sales not only supply issues to the market for which purchasers must be found but also withdraw reserve funds from the market and diminish its ability to carry securities. They are made, furthermore, from the largest portfolio of the United States Government securities available for sale in the market. For all the market knows, they may be the forerunner of many more sales to come. Since they are not motivated by the twin incentives of maximizing gains or minimizing losses that motivate most other offers that appear in the market, but are made solely in the execution of monetary policy, they are properly regarded as a possible signal of the attitude of the monetary authorities with respect to the state of the economy. These reactions acquire peculiar significance when transactions are initiated outside the short end of the market because prices fluctuate most widely in these sectors in response to changes in the availability of securities relative to the demand for them.

This imposes a handicap upon private dealers and other professional intermediaries in the market whose function it is, first, to provide continuous markets by carrying portfolios and taking positions throughout all maturity sectors of the list, and, second, to maintain a consistent relationship between prices of different individual securities by being alert to possibilities for arbitrage. The gross operations of these professional elements are very large relative to their capital at risk. They maintain markets by trading at very small spreads. If they are alert, they can function effectively when variations in price from one transaction to the next are small, as they are likely to be when selling and buying is on private account, limited in volume by the needs of private investors for outlets for funds on the one hand, or for cash on the other.

Private professional intermediaries face a very different problem when prices in any group of securities vary sharply between transactions. Then the risk of making continuous markets and of engaging in arbitrage becomes too great. They tend to retire to the sidelines, so far as putting their own capital at risk is concerned. They cease, under these conditions, to make continuous markets, and confine their activities mainly to acting as brokers. As a result, the market for issues characterized by such risks becomes thin and moves over a relatively wider range between transactions. Such a market reacts sharply to relatively small bids or offers, and quotations that characterize an individual transaction become a poor guide to the values that would prevail on normal volume.

Technical advantages of operations in the short end of the market.—The danger that transactions initiated by the open market account may unduly disturb the efficient functioning of the market is much less acute when they are confined to the short end of the market. There are three main considerations which contribute to this result.

In the first place, the risk assumed by professional intermediaries when they trade in bills is much less than when they trade in longer term securities. Bills are traded on a discount basis, and the great preponderance of bills outstanding at any one time have a maturity of less than 3 months. This means they will always appreciate to par within that period. Bills are ideal collateral, furthermore, and can always be used as security for loans. It is not too difficult, therefore, to hold them to maturity. The main financial hazard attending professional operations in bills is that the holder will have to pay more in interest when he borrows to carry them than they gain in price as they approach maturity.

Another reason is that the bill market is accustomed to relatively large transactions such as the open market account must undertake in absorbing and releasing reserves. It is the market in which all financial institutions typically adjust their day-to-day positions. Trading is continuous and the market is accustomed to a large volume of individual transactions.

Finally, the financial markets do not attach the same significance to System operations when they are transacted in bills as they do to transactions in other sectors of the market. Financial experts know that the Federal Open-Market Committee is more or less continuously engaged in putting funds into or absorbing funds from this market as it compensates for large day-to-day fluctuations in the amount of float, in Treasury balances, in the demand for currency, and in other factors. The appearance in the bill market of purchase or sell orders initiated by

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the Federal open market account has no general long-term policy significance in the great majority of cases, and therefore does not so readily give rise to apprehensions that a change in policy is imminent.

Summary of technical considerations.—To summarize, transactions initiated by the Federal open market account, particularly transactions in intermediate and long-term issues, may seriously affect the efficiency of the market. The initial impact of such transactions falls first on the professional intermediaries of the market whose willingness to take positions gives continuity to the market and whose willingness to engage in arbitrage works to cushion a concentrated impact of such sales on part of the price structure by spreading their effect in greater or less degree throughout all maturity sectors.

These intermediaries confront great difficulty in estimating how large transactions for the Federal open market account may be, how long they may continue, or how large are the losses the seller may be willing to absorb. Such estimates, however, are essential to the efficient performance of the professional intermediary whose operations make continuous sensitive markets possible. Without them, dealers and other professional intermediaries have less basis for decision as to the amounts of securities they can afford to take into portfolio, or the points at which they can undertake an arbitrage operation. The ability to make such supply and demand estimates correctly on the average is a rare skill which a professional intermediary in the market must possess in high degree to survive.

When market conditions are such that approximate supply and demand estimates cannot be made, the continuity and sensitiveness of the market is seriously impaired. Dealers and other professional intermediaries in the market become reluctant to take positions and to undertake arbitrage. Instead, they tend to confine their role to that of brokers, operating mainly on a commission basis. In this role, they offer to find buyers for issues pressed for sale, and other sellers for issues in demand, but they do not themselves purchase or sell securities at their own risk. They do not, therefore, perform the function of giving breadth and continuity to the market by their willingness to take securities into position.

This situation presents a very real dilemma to the monetary authorities. Monetary policy is most effective and can make its maximum contribution to economic stability and growth without inflation at high levels of output and employment when the entire credit structure is sensitively responsive to its operations. Federal Reserve operations exert their constructive influence most effectively when they affect the cost and availability of credit throughout all sectors of the market. This is particularly true of the long-term market where the rate of saving and the cost and availability of funds register on capital formation. The effectiveness of monetary policies is definitely hampered when markets are thin.

Historical background of new techniques

Market conditions, adverse to the proper functioning of dealers and other professionals in the market for Government securities, were strongly in evidence during the period of pegging prior to the Treasury-Federal Reserve accord of March 1951. Dealers in United States Government securities tended to confine their operations to the broker function, coming to the Federal open market account for securities when they were in demand in the market and disposing of securities to the Federal open market account when they were in supply. Under these conditions, the account itself performed the function of making continuous markets for most maturity sectors even including the very short end of the market. It did so, of course, at the expense of monetary policies appropriate to the stability of the economy. The reserve funds that were made available almost automatically under the technique of pegging operated to augment the availability of credit and thus to increase the demand for commodities to a volume that was in excess of what could be supplied. The result was to incorporate into the base of the price structure a spiral of rising costs and prices.

This inflationary process was stopped early in 1951 when the Federal Open Market Committee discontinued pegging the prices of United States Government securities. Thereafter, as is brought out in the reply to question 1, the reserve funds released or absorbed through open-market operations were adjusted more closely to the needs of a growing economy operating without inflation at high levels of activity. The market for United States Government securities showed its basic strength at that time by adjusting to the new situation with much less disturbance than many close and informed observers had

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expected, and within a few months the operations of the open market account were almost wholly confined in practice to the short end of the market.

The Federal open market account continued during this period, however, to engage in operations in support of Treasury refinancing. The volume of reserve funds released in these supporting operations became, as time passed, a matter of increasing concern to the Federal Open Market Committee. They were large in volume and had later to be recovered by offsetting sales if the fueling of inflationary forces was to be avoided.

Concurrently, there was increasing concern at the failure of certain sectors of the market, particularly the long-term sectors, to develop the degree of depth, breadth, and resiliency that would be desirable from the point of view (1) of effective refinancing of the public debt, (2) of the effective execution of monetary policies, and (3) of the effective operation of the market in shifting or allocating funds among various users.

Specifically, following the accord, the long end of the market was described by competent observers as "thin." This was illustrated by the fact that prices of long-term Government bonds fluctuated over a relatively wide range in response to the appearance of relatively small buying or sales orders. It indicated that, so far as the longer sectors of the market were concerned, dealers and other professional intermediaries still tended, on the whole, to confine their operations to the broker function. Operations undertaken at their own risk, either to maintain continuous markets or for arbitrage, remained limited on the whole to relatively small commitments, too small to give the market a desirable degree of self-reliance.

It was in this setting that the Federal Open Market Committee undertook, in 1952, to reexamine intensively the techniques employed by the System itself in its contacts with the market for United States Government securities to see whether any changes could be made in those techniques that would contribute to a stronger, more smoothly functioning market. This examination led, among other things, to the three interrelated decisions that are dealt with in this reply. These decisions have fostered a more effective and efficient market for United States Government securities in two ways: First, by reducing to a minimum the direct disturbing or disruptive impacts on the market of transactions initiated by the System; and, second, by establishing a climate of expectations in the market that would encourage private operators to engage more actively in making continuous markets and in arbitrage.

The accomplishment of these results has had beneficial effects on System open-market operations from a monetary point of view. These operations are now confined to the amounts necessary to effectuate basic monetary policies—that is to say, they have come to be limited to providing or withdrawing reserve funds in amounts and at times appropriate to the general economic situation.

Decision to discontinue support of Treasury refinancing

The decision to discontinue support operations during periods of Treasury refinancing was mainly important in improving the timing, reducing the volume and minimizing the disturbing or disruptive effects of System operations on the market. Its importance in minimizing the volume of operations initiated by the open-market account and in improving their timing shows up strikingly in the record of System operations between July 1, 1951; i. e., after the market had adjusted itself to the accord; and September 30, 1952, the last month in which direct support was given to a Treasury refunding issue. During these 15 months, direct operations for System account put reserve funds into the market amounting to $2,418 million net, during periods when the Treasury was refinancing. During the same 15 months the net effect of all open-market operations initiated by the System in the intervals between these periods of refinancing was to withdraw $1,658 million. In other words, during those 15 months, a large volume of sales from System account were made solely to absorb reserve funds in excess of basic needs that had previously been put into the market to support Treasury refundings.

This phenomenon has entirely disappeared since the autumn of 1952 when the practice of giving direct support to Treasury refinancing was discontinued. At the same time, the rate of attrition incident to Treasury refunding operations, i. e., the relative proportion of maturing Treasury securities that have been presented for cash payment at maturity, has averaged lower than it did in the period when such direct support was given. This wholly satisfactory result reflects, of course, the nature and pricing of new securities offered by the Treasury since supporting operations were discontinued as well as improved performance on the part of the market under the new operating techniques.

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Decision to confine operations to the short end of the market

The technical considerations that account for the decision to confine operations to the short end of the market have already been discussed. The decision was taken to remove an obstacle that appeared to account, in part at least, for an undesirable degree of "thinness" in the intermediate and long-term sectors of the United States Government securities market after the accord. It was not taken without consideration of alternative techniques from the point of view both of the possible effects of these techniques on market behavior and of their implications in the development and effectuation of credit and monetary policy.

Alternative to operations at the short end of the market.—The problem of how to deal with the effects of central bank transactions on market behavior are not confined to this country. They are present in greater or less degree in all countries with highly developed credit structures where open market operations are used as a principal means of effectuating monetary policies. Some monetary authorities have tried to meet the problem by themselves assuming primary responsibility for making continuous markets and for arbitrage. They do this by being themselves prepared to buy or sell in all maturity sectors of the Government securities market. When a particular issue in demand is in relatively scarce supply in the market, the monetary authority is prepared to make the desired securities available from its own portfolio. It may then have to purchase other securities from other sectors of the list to offset the effect of the sale upon bank reserves, if the basic objectives of monetary policy do not justify an absorption of reserves from the credit base.

This procedure resembles in many respects that which was employed by the Federal Reserve System when it was engaged in pegging the prices of Government securities prior to the accord and for a period afterward during periods of Treasury refinancing. It has the important difference that no attempt is made to perpetuate any particular price level for Government securities. Rather, when this is done, the monetary authority comes to a judgment not only as to the general interest rate level but also as to what structure of rates would be most appropriate in the various maturity sectors of the market and is prepared in its operations to make these levels effective. As economic conditions change, requiring a different level of interest rates or a different structure of rates as between the various maturities, the monetary authority uses its own operations to move the prices of securities quoted in the market and market rates of interest to levels it regards as more appropriate to the new situation.

When monetary authorities adopt this technique, the problem of thin markets and sluggish arbitrage is in a sense eliminated, since the monetary authority is itself prepared to maintain continuous markets and to establish directly and to change from time to time the levels of prices and of interest rates which it regards as appropriate to the various maturity sectors of the market. The various securities in its portfolio become part of the potential market supply and it takes over the role of primary jobber to the market. At the same time, for reasons already noted, dealers and other professional middlemen operating on their own capital and at their own risk tend to confine their activities to that of brokerage.

It has been recognized within the Federal Reserve System since the accord that the technique described above not only had intrinsic defects but was inapplicable to the American economy. Considerable thought has, however, been given to a variant of this approach, namely, one in which the Federal Open Market Committee would normally permit the interplay of market forces to register on prices and rates in all the various maturity sectors of the market but would stand ready to intervene with direct purchases, sales, or swaps in any sector where market developments took a trend that the Committee considered was adverse to high level economic stability.

It will be readily appreciated that this variant differs decisively from that described above. Instead of taking affirmative responsibility to make continuous markets and to establish interest rates and prices in all the various sectors of the list, the Committee under this variant would operate normally in the short end of the market, absorbing or releasing reserve funds from day to day in accordance with general policy directives. It would stand continuously ready, however, to intervene in any sector of the list when it considered such intervention might further the objectives of monetary policy.

Such intervention would not necessarily have to be decisive. The fact that the Committee purchased or sold securities at any given quotation would not mean that it was prepared to engage in similar subsequent transactions to maintain the same price. Rather, it would seek, by occasional purchases and sales

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at the fringe of the market, to cushion or reverse declines or advances at some times and to accelerate them at others. In each case of intervention, the decision whether to accelerate or cushion would be based on an evaluation of what was considered most appropriate at the time to the achievement of the objectives of monetary policy.

This variant, which paralleled closely the actual pattern of System operations during the period following the accord up to the spring of 1953, was not adopted because it did not appear to offer real promise of removing obstacles to improvement in the technical behavior of the market.

System open market experience from the accord to March 1953.—During the greater part of the first 2 years after the accord, the great bulk of transactions actually undertaken by the System was confined, in fact, to the short end of the market. These included purchases to support Treasury refinancings, most of which were executed in the short end of the market. At the same time, the policy statement of the Federal Open Market Committee directed the executive committee to maintain orderly conditions in the market for United States Government securities. It was generally understood during this period, both within the System and in informed market quarters, that it was the policy and desire of the System that a free market for United States Government securities should develop and be permitted to make its maximum contribution to economic stability both in the sense of equating the demand for funds for investment with the supply of savings (with due allowance for the growth factor in the money supply) and of being permitted to allocate these demands and supplies as between the various sectors of the market. At the same time, it was understood that the System stood ready through open market operations, without restriction as to maturity, to check undesirable movements in prices and interest rates.

In comparison with the preceding period in which the practice of pegging prices and yields contributed to the inflationary potential, this shift in policy and technique was in the right direction. Despite the forebodings of many who prophesied that the dropping of the pegs would be followed by chaos, a free market did develop when the pegs were dropped and did play a major role in stopping the inflation and in sustaining the economy at high levels of activity. There was no catastrophic shift in prices of Government securities. There was no panic. Confidence in the stability of the dollar was restored. The results of the action in all major respects, except one, corroborated the judgment of those who took the responsibility for its initiation.

The exception, already noted, was the thinness that continued to characterize the intermediate sector and the long-end of the market for United States Government securities. At first, this was generally explained by the fact that a return to a free market after so long an interval would necessarily be accompanied by some frictions. It would necessarily take time, it was felt, for appropriate mechanisms to develop in the market before it could perform its normal functions at high efficiency. As time went on, however, these mechanisms failed to develop adequately and the problem of thin long-term markets continued to exist. It was in this setting and, in part, to consider how to deal with this problem, that the Federal Open Market Committee in 1952 undertook the studies that led to the three decisions treated in this question.

Decision to change directive with respect to orderly markets

During the period from the accord to March 1953 there was considerable misapprehension and confusion with respect to the interpretation of the phrase "orderly markets," a situation which in many respects was justified. The clause in the directive requiring the executive committee to maintain orderly markets was in the directive prior to the accord and was the authority under which many stabilizing operations were taken at that time. The fact that the phrase had not been changed after the accord but instead had been interpreted less restrictively left legitimate grounds for uncertainty with respect to the interpretation that might be placed upon it in future operations.

The decision to change the directive to the executive committee "to maintain orderly markets for United States Government securities" to read "to correct a disorderly situation in the Government securities market" was made to remedy this misapprehension and confusion. This gave notice that the Federal Open Market Committee would not intervene to prevent fluctuations of prices and yields such as normally and necessarily occur as markets seek to establish equilibrium between supply and demand factors and to allocate savings as between the different maturity sectors. Instead, it indicated that the market would have to be clearly disorderly before such intervention would occur.

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The primary aim of this shift in operating objectives was to foster in the market a climate of expectation with respect to System intervention that would encourage maximum private participation in market activities. In combination with confinement of operations to the short end of the market, the shift also contributed to minimizing the disturbing or disruptive effects of System operations.

Experience with the new techniques

These decisions were taken in March of 1953 in the hope and expectation that they would provide an environment in which professional intermediaries in the market would begin to broaden the scope of their operations in a way that would give greater depth, breadth, and resiliency to the intermediate and longer sectors. Specifically, it was hoped that these intermediaries, faced mainly by business and market risks which they were in a position to evaluate and freed from the risk of disturbing or disruptive repercussions arising from direct intervention by the Federal Open Market Committee, would begin to make more continuous markets and engage more promptly in arbitrage through all maturity sectors. It was hoped that they would sufficiently improve the market so as to minimize the occasions for direct System intervention in these sectors of the market, intervention either to correct the development of a disorderly situation or intervention to hasten the market's response to changes in credit and monetary policy. These expectations to date have been on the whole fulfilled, although, of course, it is recognized that this approach is still experimental and that insufficient time has elapsed to draw firm conclusions.

The first and most difficult test came in the spring of 1953, within a very short time after the new techniques were adopted, and before their impact had been evaluated or understood. This was the period described in the answer to question 1 when great tension developed in the long-term investment market, sufficient tension to require vigorous offsetting action by the Federal Reserve System. There were many at that time who felt that direct System intervention in the long-term money market was the only remedy that would relieve the situation. This view gained adherents when the first purchases of bills, initiated by the System early in May 1953, found relatively small immediate response in relieving tension in the long-term sector of the market even though the Treasury with its own funds made some purchases in that sector during this period. Finally, as the Treasury made larger purchases and the open-market account undertook to supply reserves in large volume through an aggresive purchase of bills, the tension began to subside.

Subsequently, all sectors of the market, long, intermediate, and short, have been characterized by great improvement with respect to their depth, breadth, and resiliency. Private arbitrage has brought about a sensitive response to the System's monetary policy in the long-term sectors of the market. The ease that for some time has pervaded the money and credit markets may account for part, but it does not by any means account for all, of these results.

It has been a primary objective of System credit and monetary policy during this period to encourage an expansion in private activity financed by long-term funds. This has also been a main objective of Treasury debt management policy which has refrained from competing with mortgage borrowers and other potential users of long-term savings. While, under the new techniques, open-market operations to help effectuate this policy objective have been confined entirely to putting reserves into the short market, the response in the form of increased availability of funds in the long-term capital markets, including even the semi-isolated mortgage market, has been gratifying.

The recession of industrial activity during this period has been exceptionally mild as compared to other periods, even milder than the recession of 1949 when United States security prices were pegged. It would be very difficult to make a case that direct intervention in the long-term markets during this period would have induced an even better response.

Such is the experience with the new techniques to date. As previously pointed out, it remains for them to be tested in other more normal periods of Federal Reserve operations. Only time and further experience will tell whether problems not now foreseen will or will not emerge. If they do, it will be the duty of the Federal Open Market Committee to deal with them in the light of its accumulated experience.

Conclusion

The formulation of appropriate credit and monetary policy is, at best, difficult. It requires, first, painstaking search for all the relevant facts that may bear on

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the economic and financial outlook; second, all the wisdom and insight that experience and operating contacts can bring to the interpretation of those facts, and, finally, and perhaps most important, humility with respect to any emerging situation. There are relatively few occasions when the meaning of developing events is so clear that the monetary authorities can say, "As of today, our policy should be changed from restraint to ease." A shift in policy emphasis more typically emerges from a succession of market developments and administrative decisions in which the range for variation needed in pursuit of any particular policy gradually shifts from the side of ease to the side of restraint or vice versa.

The various factors that exert an impact on bank reserve positions are at best difficult to forecast in advance. There is a considerable margin of uncertainty in any forecast of factors absorbing or supplying reserves. Yet these forecasts or projections must be made in planning open-market operations. In consequence, there is frequently much discussion, when prospective purchases or sales are authorized, of whether it would be wiser to deal with the area of uncertainty in the forecast in the direction of restraint or in the direction of ease. These changing shifts in emphasis do not necessarily mean that a new policy direction is emerging. Usually, however, by the time the facts of the economic situation are sufficiently clear to lead to the adoption of a changed policy directive, it will be found that these day-to-day allowances for uncertainties in the forecasts of reserve availabilities have begun to be increasingly resolved on the side later indicated by the new policy directive.

Such tentative testing and probing of the responsiveness of the economy to monetary actions would be much more difficult if the Federal Reserve were to make itself responsible not only for adding to and withdrawing marginal amounts of reserve funds from the money market but also for making continuous markets and establishing interest rates and prices prevailing in all sectors of the security markets. Then any changes in such interest rates and prices could result only from direct administrative decisions. Such decisions would carry considerable significance in themselves and would require adequate justification.

Such justification might not be too difficult to find if the American economy customarily relied on the import of capital for its development. In that case, the necessary signals would usually be furnished by movements of prices and interest rates in the various sectors of the foreign financial market from which the capital was imported. In fact, however, the American economy is a high-saving economy that exports rather than imports capital. In this country if the structure of interest rates were too closely controlled, it would be difficult to tell from the character of the market response whether and when new trends were developing within the economy. The allocation functions of the market place in determining relationships between the cost and availability of funds in the various sectors of the market, short-term, intermediate, and long-term, would be in abeyance, and responsibility for efficient performance of these important economic functions would be transferred to the area of official discretionary action.

In conclusion, it needs to be emphasized once more that it is not contemplated that these new techniques will never be changed. The Federal open-market committee must always be prepared to tailor the techniques of its operations to the requirements of the economy. In the development of those techniques, situations may well arise when the Federal Open Market Committee will want to operate directly outside the short end of the market.

It must also be emphasized that the new techniques do not imply that the Federal Open Market Committee is unconcerned about developments throughout the securities market or that it is committed to dealing only in the short end of the market whatever may happen to prices and yields of long-term securities. The Federal Open Market Committee directive specifically and positively enjoins the executive committee to operate to correct a disorderly situation in the market for United States Government securities if one develops. Such situations rarely do develop in efficiently functioning markets. History indicates, however, that there are occasions when a market becomes clearly disorderly and in itself threatens economic stability. This happens when a selling or buying movement feeds on itself so rapidly and so menacingly as to prevent counteracting forces from developing within the market mechanism. Usually, these situations reflect a serious deficiency or excess of reserve funds and can be corrected by

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operating to adjust the volume of reserves to the requirements of the economy. Sometimes, however, they occur in response to other factors. Under the Federal Open Market Committee's present directive, the executive committee is responsible for diagnosing such a situation if one develops and for dealing with it decisively without any restriction whatever as to sectors of the market in which transactions are initiated.

(4) What is the policy with respect to volume of money?

The policy of the Federal Reserve System with respect to the volume of money is to provide as nearly as possible a money supply which is neither so large that it will induce inflationary pressure nor so small that it will stifle initiative and growth. Put another way, the policy is to help maintain a volume of money sufficient to facilitate the consumption and investment outlays necessary to sustain a high level of production and employment, without leading to spending and investing at a rate which would outstrip the supply of available goods at prevailing prices and generate speculative conditions. Judged from this standpoint, the amount of money required varies with such factors as: the productive capacity of the economy; the state of business expectations; economic dislocations of various kinds; seasonal fluctuations; and changes in money turnover or velocity reflecting variations in liquidity and the demand for liquidity on the part of businesses and consumers.

In the past, the monetary supply has shown considerable fluctuation over the course of business cycles. It is the policy of the Federal Reserve System to counteract, insofar as possible, the tendency for excessive cyclical swings in the volume of money.

An economy which is expanding requires an increasing supply of money to facilitate its growing volume of transactions. Additions to population and productive capacity and a growing complexity of economic organization give rise to increased needs for cash balances. It is the policy of the Federal Reserve System to foster growth in the money supply in accordance with these needs.

Like any other modern monetary system, the monetary system of the United States is complex. In view of its complexities, it is not feasible to rely upon any mechanical formula for the determination of the volume of money appropriate to a given economic situation. This subject is one requiring continuous examination and study—historically, currently, and prospectively—of the various changing forces affecting the economy's need for money.

Our monetary organization and its complexities were discussed at considerable length in the reply of the Chairman of the Board of Governors to question 28 of the questionnaire addressed to him in 1951 by the Subcommittee on General Credit Control and Debt Management, under the chairmanship of Representative Patman. They were also treated again in an article under the title "The Monetary System of the United States" published in the Federal Reserve Bulletin for February 1953.

(5) Has monetary machinery (a) worked flexibly, and (b) has the market demonstrated flexibility in its responses to changes in policy? For example, how has the policy of "active ease" been reflected in the level and structure of interest rates, the volume of credit, and the roles of various types of lenders?

The monetary machinery since mid-1952 has worked flexibly, and the market has responded flexibly to changes in credit and monetary policy. The effectiveness of credit and monetary policy is due in part to its adaptability to changing economic circumstances. During late 1952 and early 1953, inventories were rising, the Federal cash deficit was increasing sharply, consumer installment indebtedness was growing rapidly, capital outlays were being made on a large scale, credit demands generally were very strong, and forward commitments were taking on a speculative hue. With the economy already operating at virtually full capacity and producing in excess of final takings from the market, these developments constituted a threat to long-term stability and growth. Accordingly, Federal Reserve policy from mid-1952, to late spring 1953 was directed toward restraint of further increases in spending financed by bank credit. With abatement of inflationary pressures in the late spring of 1953, the Federal Reserve readapted its policies to promote orderly realinement of activities and to foster a climate favorable to resumption of economic growth.

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The influence of credit and monetary policy can be traced through observations of changes in five interrelated factors: the availability of credit relative to demand, the volume of money, the cost of borrowing, capital values, and the general liquidity of the economy. Examination of each of these factors helps to illustrate the points of "flexibility" and "responsiveness" raised in this question.

In considering these factors it is important to keep in mind that credit and monetary action is only one of the many factors, although an important one, affecting the general level of economic activity. The influence of credit and monetary policy in any period is necessarily conditioned by various other policies and programs of the Federal Government, by economic and political developments abroad, and by public responses to a variety of unpredictable events. Also, the effectiveness of credit and monetary policy in a particular period needs to be judged in the light of broad experience and observation. One of the difficulties with such judgments is that financial and institutional practices are constantly changing so that close comparison with past periods may not be entirely appropriate. These changes result in financial adjustments which differ in responsiveness and degree of lag from one period to another.

Availability of credit

Changes in the availability of credit, while not subject to statistical documentation, may be observed in a general way from the terms and conditions which lenders require in granting credit, from their passivity or aggressiveness in seeking out new outlets for loan funds, and by the response that borrowers experience to their applications for credit. During the period of credit tightening through late spring of 1953, for example, the very large demands for credit exceeded the substantial volume of funds available for lending and lenders had to adjust their operations to this fact. Some lenders, particularly banks, tended to favor short-term credits and reduced their longer term lending.

Other actions to discourage undue borrowing were adopted by various lenders. Commercial banks tended to require larger minimum deposit balances from borrowers. Insurance companies tended to write more restrictive call provisions and other features into their private-placement agreements. Mortgage lenders generally tended to favor paper with shorter terms and to require larger downpayments. Also, lenders cut back their activities for developing new credit outlets, became reluctant in many cases to accept new borrowing customers, and reduced the volume of their lending to borrowers who were marginal in terms of risk and longrun profitability. These tendencies became more pronounced as the tightening movement progressed.

With credit easing after the late spring of 1953, these developments were reversed. In general, lenders found themselves with more funds available relative to the demand than earlier, and were under pressure to keep such funds fully invested. As a result, uses of credit were promoted that under tighter money conditions had been postponed or curtailed. The volume of new security issues was maintained at a very high level throughout the period of business decline, and a number of these issues, particularly State and local government revenue issues, were of a type that would not have been brought out in the earlier period of restraint. Mortgage credit became available on more liberal terms with respect to downpayment and maturity, and lending commitments to builders again came to be readily arranged. Consumer credit standards and terms also eased, although with more lag than in the case of mortgage credit. Commercial banks, moreover, became more aggressive in term lending and tended to lengthen somewhat the maturities of their investment portfolios as well as to widen the area of their investment interest. In some cases these liberalizations went further than had been attained in the preceding period of credit ease.

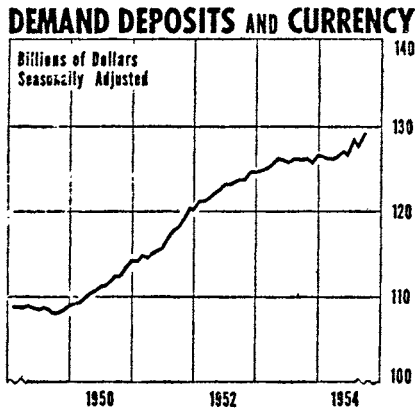
Volume of money

The accompanying chart shows the movement in demand deposits adjusted plus currency in circulation, seasonally adjusted, since mid-1952. Federal Reserve restraints on the expansion of bank credit during the period of inflationary threat from mid-1952 to late spring of 1953 were effective in curbing growth in the money supply at a time when pressures for bank credit and monetary expansion were very strong. During this period, the demand deposit and currency holdings

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of individuals and businesses increased by $3 billion, or about 2½ percent. This compares with a growth of over 6 percent in each of the preceding 2 years.

Over the past year and a half, the money supply increased further even though business activity declined over the first half of that period. Demand deposits and currency of businesses and individuals leveled off during the second and third quarters of 1953, after allowances for usual seasonal movement, rose moderately thereafter through mid-1954, and subsequently increased sharply. Over the year ending September 1954, the money supply expanded by $3 billion, or approximately 2½ percent. This expansion, which reflected primarily an increase in bank holdings of Government securities, is in contrast to the behavior of the money supply in most previous periods of business decline. In some previous recession periods the money supply contracted, reflecting a significant liquidation of bank credit as a factor of economic recession. Under such circumstances, curtailed liquidity put consumers and businesses under pressure to reduce their spending, thus contributing to further recession in activity.



Cost of borrowing

The accompanying table of selected market interest rates since mid-1952 shows the changes that have taken place in the cost of borrowing. Reflecting the combined influence of heavy credit demands and restrictive Federal Reserve policy, interest rates began a general advance in the second half of 1952. The advance accelerated in early 1953, with peaks for this movement reached in June. Thereafter, the interest rate movement was reversed as Federal Reserve policy shifted from one of restraint to one of actively fostering credit ease. Market interest rates declined appreciably through the early part of 1954 and subsequently have shown little change.

The movement in interest rates spread throughout the credit market, affecting all types of credit paper and securities, although in different degree. For example, rates charged by banks on customer loans were more sluggish in their response on the downside than were open market rates. However, the responsiveness of market interest rates to the policy of "active ease" was very marked; the decline in money and capital market rates after mid-1953 was as sharp and widespread as in the comparable phase of any other business downturn since World War I.

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Selected money rates

[Monthly averages]

	U. S. Government securities			Prime commercial paper	Bank rates to customers	Corporate bonds			Municipal bonds
	Bills	3 to 5 years	Long-term old series			Aaa	A	Baa	
1952—June	1.700	2.04	2.61	2.31	3.51	2.94	3.20	3.50	2.10
July	1.824	2.14	2.61	2.31		2.95	3.19	3.50	2.12
August	1.876	2.29	2.70	2.31		2.94	3.21	3.51	2.22
September	1.786	2.28	2.71	2.31	3.49	2.95	3.22	3.52	2.33
October	1.783	2.26	2.74	2.31		3.01	3.24	3.54	2.42
November	1.862	2.25	2.71	2.31		2.98	3.24	3.53	2.40
December	2.126	2.30	2.75	2.31	3.51	2.97	3.22	3.51	2.40
1953—January	2.042	2.39	2.80	2.31		3.02	3.25	3.51	2.47
February	2.018	2.42	2.83	2.31		3.07	3.30	3.53	2.54
March	2.082	2.46	2.89	2.36	3.54	3.12	3.36	3.57	2.61
April	2.177	2.61	2.97	2.44		3.23	3.44	3.65	2.63
May	2.200	2.86	3.09	2.67		3.34	3.58	3.78	2.73
June	2.231	2.92	3.09	2.75	3.73	3.40	3.67	3.86	2.99
Change: June 1952 to June 1953	+.531	+.88	+.48	+.44	+.22	+.46	+.47	+.37	+.89
1953—July	2.101	2.72	2.99	2.75		3.28	3.62	3.86	2.99
August	2.088	2.77	3.00	2.75		3.24	3.56	3.85	2.88
September	1.876	2.69	2.97	2.74	3.74	3.29	3.56	3.88	2.88
October	1.402	2.36	2.83	2.55		3.16	3.47	3.82	2.72
November	1.427	2.36	2.85	2.31		3.11	3.40	3.75	2.62
December	1.630	2.22	2.79	2.25	3.76	3.13	3.40	3.74	2.59
1954—January	1.214	2.04	2.68	2.11		3.06	3.35	3.71	2.50
February	.984	1.84	2.60	2.00		2.95	3.25	3.61	2.39
March	1.053	1.80	2.51	2.00	3.72	2.86	3.16	3.51	2.38
April	1.011	1.71	2.47	1.76		2.85	3.15	3.47	2.47
May	.782	1.78	2.52	1.58		2.88	3.15	3.47	2.49
June	.650	1.79	2.54	1.56	3.60	2.90	3.18	3.49	2.48
July	.710	1.69	2.47	1.45		2.89	3.17	3.50	2.31
August	.892	1.74	2.48	1.33		2.87	3.15	3.49	2.23
September	1.007	1.80	2.51	1.31	3.56	2.89	3.13	3.47	2.29
October	.987	1.85	2.52	1.31		2.87	3.14	3.46	2.32
Change: June 1953 to October 1954	−1.244	−1.07	−.57	−1.44	−.17	−.53	−.53	−.40	−.67

Capital values

Changing interest rates have also affected the economy through the recapitalization of future income, that is, through lowering or raising the dollar value of existing capital assets, particularly long-lived assets. This response has been especially noteworthy in the securities markets where prices of outstanding bonds and investment-type stocks have registered the influence of interest rate movements as well as, of course, of other factors. The attached table shows the percentage changes in values in selected types of capital asset over the past 2½ years.

From mid-1952 to mid-1953, the increase in yields and consequent decline in prices of United States Government securities and corporate and municipal bonds reduced significantly the market value of investors' portfolios of such securities. Stock prices also showed moderate decline over this period despite prosperous business conditions. These developments were an influence helping to damp down the boom in capital outlays in this period.

Since mid-1953, rising prices of bonds and stocks have reflected in part the influence of falling interest rates. This movement in values has tended to help sustain private capital expenditures during the period when business activity in other lines was receding somewhat in consequence of the work-off of excess inventories and reduced defense expenditures following the settlement in Korea.

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In some investment areas, such as the farm and existing residential real estate areas, values declined somewhat despite falling interest rates. These declines reflected the overriding effect of other factors, for example, the reduction in agricultural income in the case of farm real estate values and the increasing supply of new homes in the case of residential real estate values. Even in these areas, however, there is reason to believe that the higher capitalization factor helped to cushion the decline in market values.

Percentage changes in selected capital values

	June 1952–June 1953	June 1953–October 1954
Government bonds (long-term)	−7	+9
Corporate bonds (high-grade)	−6	+8
Municipal bonds (high-grade)	−12	+10
Preferred stocks (high-grade)	−9	+14
Common stocks [1] (Standard & Poor's series)	−3	+33

[1] Values of common stocks are, of course, particularly affected by important variables other than the capitalization factor. These include, for example, changes in earnings and dividends and changes in expectations as to general business developments.

General liquidity of the economy

Changes in the volume of money and other highly liquid assets and in the value of existing assets affect the liquidity of businesses and individuals and influence their willingness to spend and invest. They also affect the liquidity of financial institutions and their willingness to lend and invest.

The restrictive credit policy from mid-1952 to last spring 1953 caused existing assets to decline in liquidity. This development influenced consumers and businesses to screen expenditures more carefully either because they were reluctant to dispose of interest-bearing securities at the prices currently prevailing, or because they were encouraged by rising yields to save and invest in securities or other savings forms. Also, the desire for liquidity was heightened by the fact that access to credit was not as assured as it had been earlier. This put a greater premium on holding cash balances and other liquid assets rather than spending. The relative stability of prices over this period, moreover, fostered confidence in the value of the dollar so that holders of deposits and currency did not feel pressed to make expenditures immediately in anticipation of higher prices.

In contrast, falling interest rates in the recent period of monetary ease tended to make individuals and businesses, as well as financial institutions, more liquid and increased the proportion of their assets that could be sold at cost or profit. This is particularly true of investment portfolios where the rise in prices of marketable United States Government bonds, corporate bonds, State and local government bonds, and corporate stocks made holders more willing to lend and to spend. The fact of ready availability of credit, furthermore, reduced the requirements of businesses and individuals generally for liquidity.

Concluding comment

Viewed as a whole it appears that credit and monetary policy exerted a wholesome restrictive influence in the 1952–53 period of boom and a desirable cushioning and sustaining influence in the economic decline which followed. In so doing, it made a necessary and positive contribution to stable economic growth.

UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS,
Washington, November 26, 1954.

HON. RALPH E. FLANDERS,
Chairman, Subcommittee on Economic Stabilization of the Joint Committee on the Economic Report, Congress of the United States, Washington, D. C.

MY DEAR MR. CHAIRMAN: For Secretary Humphrey, I am transmitting the Treasury's replies to the questions your subcommittee directed to us on October 26, 1954, with respect to United States monetary policy and debt management in recent periods.

Both Secretary Humphrey and I are pleased to participate in your subcommittee's review of recent thinking and experience in this important field. The

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past 2 years have given us our first real test in a long time of the contribution that a flexible money and credit policy can make to economic stability and growth.

As you know, the Secretary is currently attending the Conference of Ministers of Finance or Economy in Rio de Janeiro, but he still hopes to attend your subcommittee's hearings on December 7. In any event, I shall be there.

Sincerely yours,

W. RANDOLPH BURGESS,
Under Secretary for Monetary Affairs.

Enclosures.

MONETARY POLICY AND DEBT MANAGEMENT

REPLIES BY THE TREASURY DEPARTMENT TO QUESTIONS SUBMITTED BY THE SUBCOMMITTEE ON ECONOMIC STABILIZATION OF THE JOINT COMMITTEE ON THE ECONOMIC REPORT, NOVEMBER 1954

Question 1. What role did monetary policy play in the period of relative stability following the Treasury-Federal Reserve accord in 1951, in the months of boom late in 1952 and early 1953, and in the recession of 1953–54?

This question is being answered fully by Chairman Martin of the Federal Reserve Board, in his reply to the same inquiry. On the debt-management aspect of your question, however, we are glad to add a few comments from our own experience since this is the area where final responsibility lies with the Treasury, rather than with the Federal Reserve.

Early 1953

When we came to the Treasury in January 1953, we were faced with the problem of developing a constructive program for the effective management of a public debt of more than $265 billion in an economic environment during the early months of 1953 where inflationary pressures were still running high.

Production was at a record high in the spring of 1953 and was exceeding sales, causing a threatening accumulation of inventories in the hands of manufacturers and distributors. Defense expenditures were high and plant and equipment expenditures were setting new records. Unemployment was at extremely low levels and industry was spending large amounts for overtime employment.

The Nation's resources were fully utilized and any further sizable expansion of credit could result only in uneconomic competition for scarce labor and materials at the risk of further price rises. At this time, consumer credit was expanding rapidly and business loans were continuing to increase as compared with the normal expectation of seasonal contraction. New corporate and municipal security issues were at a record high and new mortgage financing was running ahead of previous years.

Together with the prospect of a large Federal deficit, all of these factors created inflationary pressures. In addition, controls over prices and wages had just been lifted. This was a situation that called for monetary and credit restraint, and that is exactly what the Federal Reserve was applying.

Treasury action in debt management in the first half of 1953 was carefully planned so as to tie in with a Federal Reserve monetary policy of credit restraint. Debt-management decisions in this period were geared to a program designed to offer securities attractive to nonbank investors and by so doing avoid the inflationary potential of increased bank ownership of Government securities. In February, instead of offering investors who held a maturing certificate merely an exchange into another 1-year certificate, the Treasury gave investors the opportunity to go into a 5-year 10-month bond. The market response to the bond offering was encouraging and indicated that there was demand for securities beyond the 1-year area.

As the Treasury approached its spring financing and realized that more money was needed than had previously been expected, the Treasury offered a billion dollars of 3¼-percent 25- to 30-year marketable bonds for cash—the first long-term marketable securities issued since the end of World War II financing. In addition, close to half a billion dollars of the 3¼'s were issued in exchange for those series F and G savings bonds which matured in the calendar year 1953.

The Federal Reserve policy of credit restraint, together with these debt-management actions, permitted the heavy credit demands in the market to make a natural correction through the operation of a rising level of interest rates, continuing the trend of 1951 and 1952. The Treasury, in doing its borrowing, paid the rates required by the market in recognition of the principle that the Federal Reserve should be free to exercise appropriate monetary and credit policy.

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Monetary and debt-management policy in the first part of 1953 played an important part in checking the inflationary ground swell.

The period since May 1953

By the early summer of 1953 the situation changed. Business demand for funds lessened and inflationary pressures receded. There were some evidences of slowing business activity. In this new environment monetary and debt-management policies were directed toward increased availability of credit for appropriate business demands. As a result of the successful use of these policies, inventory liquidation was able to proceed in an orderly fashion without fear of a tightening up on loans and capital expansion was encouraged. Interest rates fell and the path of legitimate credit growth was smoothed.

In its refunding operations in June, and again in August, the Treasury issued only 1-year certificates in exchange for maturing issues to avoid any tightening effect on the money market as it adjusted to its new environment. The only major Treasury cash financing in that period was an offering of $5.9 billion 8-month tax-anticipation certificates to cover the seasonal low in Treasury receipts during the second half of the calendar year.

Monetary policy during the late months of 1953 and during 1954 has stressed active ease in the money market. The Treasury, therefore, has refrained in the past year and a half from issuing long-term securities. It has purposely done its financing so as not to compete for or reduce the long-term money available for private capital investment or for State and local highway, school, and other construction projects. This policy has contributed appreciably to maintaining a high level of economic activity during the last year or so.

Treasury debt management policy, therefore, has been tied in very closely with monetary policy throughout the last 2 years, first in helping to restrain inflation and then in helping to avoid deflation. The successful restraint of inflationary forces eased the task of monetary and debt management policy in avoiding deflation.

The Federal Reserve and Treasury actions of these past 2 years have conformed to the principles stated by your own Joint Committee on the Economic Report, through Senator Douglas' subcommittee in 1950 and Representative Patman's subcommittee in 1952, which concluded that "* * * we believe that the advantages of avoiding inflation are so great and that a restrictive monetary policy can contribute so much to this end that the freedom of the Federal Reserve to restrict credit and raise interest rates for general stabilization purposes should be restored even if the cost should prove to be a significant increase in service charges on the Federal debt and a greater inconvenience to the Treasury in its sale of securities for new financing and refunding purposes."

That freedom has been restored, just as President Eisenhower promised it would be in his first state of the Union message in early 1953:

"Past differences in policy between the Treasury and the Federal Reserve Board have helped to encourage inflation. Henceforth, I expect that their single purpose shall be to serve the whole Nation by policies designed to stabilize the economy and encourage the free play of our people's genius for individual initiative."

Long-run debt management objectives

In the same date of the Union message, President Eisenhower also suggested that the long-run objective of Treasury debt-management policy was to "properly handle the burden of our inheritance of debt and obligations." At the same time that we have been working closely with the Federal Reserve in pursuing policies which would lean against inflation or deflation, the Treasury has also made progress toward its long-term objective of working toward a better balanced maturity structure of the public debt—one that will contribute, along with budgetary and monetary policies, to high employment, rising production, and a stable dollar.

When the present administration came to the Treasury in January 1953, the debt was too heavily weighted in the short-term area. Short-term securities tend, by their very nature, to be very liquid—almost like money. When they are relied upon too heavily, they can add substantially to inflationary pressures.

A large volume of short-term debt also means that the Treasury has to be almost continuously in the market refunding short-term securities. When the Treasury has to engage in so many financings every year, it means that the Treasury's impact on the money market is almost continuous, either through the

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planning of a new financing, the financing itself, or the secondary market response to it. This tends to limit the effectiveness of Federal Reserve credit control operations. The greater the space between Treasury financings, the less will be the likelihood of this sort of interference.

In addition, Federal debt ownership should be broadly distributed among the various investor groups in the economy—and within those groups as well. In a democracy like ours, it is important that citizens participate in its responsibilities as well as its benefits. With a direct stake in their Government's financial operations, either through individual or group investments in Government securities, they will tend to take a more active part in seeing that the Nation's affairs are managed in their best interests. That is one of the most valuable functions that the Treasury savings bond program is performing today.

A widespread debt—in terms of maturities as well as holders—contributes to the effectiveness of monetary policy aimed at promoting economic stability. When the Federal debt is widely distributed, action taken by the Federal Reserve to tighten credit during inflationary periods or to ease credit during deflationary periods will tend to be more effective as its impact is transmitted through all parts of the money market.

Improvement in debt structure

The Treasury has made progress in improving the structure of the debt during the past 2 years, although improvement has at times been slow because of the need for adjusting our financing to the economic situation of the moment.

The first step in spreading out the debt was taken in the February 1953 refunding, but a more important step was the issuance of the 3¼ percent long-term bond in May. Treasury debt extension was postponed temporarily in the summer of 1953 as the market was unreceptive and short-term bank financing contributed to maintaining the volume of money. In the later months of 1953, however, the Treasury was able to make several modest moves toward lengthening the debt. On three occasions securities were offered which were attractive principally to commercial banks who were interested in lengthening out their own portfolios of intermediate-term Government securities. In this way, $7 billion of the debt was extended for periods ranging from 3½ to nearly 8 years.

Debt extension of this type was neutral with respect to Federal Reserve monetary policy. No useful purpose would have been served in flooding the commercial banks with more short-term securities than they wanted. Yet through issuance of intermediate-term securities, the Treasury was able to improve the maturity structure of the debt without competing directly in the long-term market for funds that were needed to support a high level of capital expansion in the economy.

The record of debt management in 1954 follows essentially this same pattern. Commercial banks again expressed interest in lengthening out their portfolios and this gave the Treasury the opportunity to spread the debt further through the use of intermediate-term securities.

In February 1954 investors exchanged $11 billion of maturing issues into 7-year-9-month bonds. In May, August, and October, a total of $13 billion more intermediate-term bonds and notes were issued—partly for cash and partly in exchange for maturing securities. The Treasury's latest refunding offer of 8-year-8-month bonds in its December financing has just been announced (November 18) and we have every reason to expect that the new bond will be well received. This is the longest bond offered since the 3¼'s in the spring of 1953. Even before we include the new December bond, the Treasury has issued $33½ billion of securities in 1953 and 1954 which were beyond the 1-year area.

As a result of these operations from January 1953 through November 1954, the Treasury reduced the amount of marketable debt maturing or callable within 1 year from $74 billion to $63 billion—a decline of $11 billion. The Treasury debt in the over-5-year category rose by about $8½ billion during this period, and will increase again in December. Furthermore, the average length of the marketable debt has risen in 1954, marking the end of a steady 6-year decline which virtually ended in 1952 and leveled out in 1953.

It is also significant that during 10 out of 12 major financings during 1953 and 1954 (excluding seasonal borrowing in anticipation of tax receipts), the Treasury offered investors securities longer than 1-year certificates. This is quite a contrast to the 2 preceding years, when on only 2 occasions out of 13 were marketable issues offered outside the 1-year area.

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Question 6. Has the debt management policy of the Treasury—both as to objectives and techniques—been consistent with the monetary policy of the Federal Reserve throughout the period since mid-1952?

In the reply to question 1, we have already discussed the role that debt management has played in the past 2 years to complement monetary and credit-control action taken by the Federal Reserve, first in the period through the spring of 1953—when inflationary pressures were still running strong and credit restraint was appropriate—and then later as the inflationary tide turned and an easier Federal Reserve money policy encouraged the free availability of credit for legitimate needs.

Fiscal and monetary policy—with an independent Federal Reserve working in harmony with effective budgetary, tax, and debt policy—is the mainstay of our program for sound money in America. This is a major plank in the program of the Eisenhower administration. It is not surprising that it was also a major plank in the reports of both of your predecessor subcommittees studying these matters. It is a fundamental of good government.

In 1950 your Subcommittee on Monetary, Credit, and Fiscal Policies, headed by Senator Douglas, concluded that—

"We recommend not only that appropriate, vigorous, and coordinated monetary, credit, and fiscal policies be employed to promote the purposes of the Employment Act, but also that such policies constitute the Governments primary and principal method of promoting those purposes."

And again in 1952 your Subcommittee on General Credit Control and Debt Management, headed by Representative Patman, agreed in these words:

"We believe that general monetary, credit, and fiscal policies should be the Government's primary and principal means of promoting the ends of price stability and high-level employment and that whenever possible reliance should be placed on these means in preference to devices such as price, wage, and allocation controls and, to a lesser extent, selective credit controls—all of which involve intervention in particular markets * * *."

We believe in this policy. Under the present administration, the Federal Reserve has been free to pursue a flexible credit policy conducive to stability and economic growth.

Independence does not mean isolation. We have worked very closely with the Federal Reserve Board, with the Federal Reserve bank officials, and with their staffs all along the line. We know of no occasion in the past 2 years when debt management decisions were not completely consistent with Federal Reserve monetary policy.

Question 7. What considerations should dictate the maturity distribution schedule of the Federal debt, first, as to the long-run ideal to be pursued and, second, as a practical operating matter, giving weight to timing and contemporary conditions?

In the reply to question 1, we discussed our long-term objectives of gradually moving more of the debt out of short-term securities into the hands of long-term savers. In the same reply, we also discussed our shorter-run objectives in terms of managing the debt in a way that was consistent with monetary policy. A few additional comments here are in order.

The Treasury's long-term objective of achieving a better debt distribution cannot—and should not—be defined in terms of any specific maturity pattern. Changing economic conditions require changing perspectives, and debt-management policies, like budgetary and monetary policies, can best serve the Nation's interests if they are flexible.

An ideal maturity structure of the debt cannot be suddenly achieved or rigidly maintained. Improvement in the maturity structure of the debt is the composite result of a multitude of financing decisions over the years. We are working with a complicated debt structure which is already in existence. We do not have the opportunity to set up an entirely new debt structure, so progress must necessarily seem slow at times. As President Woodrow Wilson said in his first inaugural address:

"We shall deal with our economic system as it is and as it may be modified, not as it might be if we had a clean sheet of paper to write upon; and step by step we shall make it what it should be * * *"

In the attainment of an improved debt structure, the Treasury cannot arbitrarily set the maturity distribution of the debt by dictating the terms under which it will borrow. The market for Government securities is to a large extent compartmentalized. Many investors are interested only in short-term securities,

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others prefer long-term securities, and still others want a more diversified portfolio. The market expression of demand for various types of securities from a wide variety of buyers has a powerful effect on the maturity structure of the debt.

Like other borrowers, the Treasury must meet the test of a free money market. The success of Treasury financings is dependent on its ability to offer attractive securities at those times and in those areas where market demand exists. The Treasury may be able to encourage investors to lengthen or to shorten their portfolios by offering them a choice of two issues, one of which may be a little more attractive to some investors than the other. But it is the investor who makes the ultimate decision as to which security he will take. He may decide not to take either one.

There are many ways in which the problem of improving the structure of the debt may be approached. For example, the average maturity of the debt can be lengthened by the same amount by putting out a billion dollars of a 30-year bond or a larger amount of a shorter bond. Yet the particular economic circumstances of the moment may make the shorter alternative an obvious choice if the long bond would work against Federal Reserve monetary policy rather than complement it.

The experience of the last year and a half is again a case in point. During the transition to a lower level of Government spending, it has been important to economic stability that the Treasury not put out any long-term bonds which would interfere with the availability of long-term funds for capital investment. Under circumstances such as these, improvement of the structure of the debt may be slowed temporarily.

Obviously, an ideal debt structure must achieve proper balance between short, intermediate, and long-term debt. A certain amount of short-term debt is necessary and desirable to meet basic liquidity needs of commercial banks and for nonfinancial corporations, who are building up reserves for taxes and other short-term needs. But the amount of short-term debt should be kept low enough so that it does not undermine action taken by the monetary authorities to restrain undue credit expansion.

Furthermore, a high level of short-term debt already outstanding could create difficulties for the Treasury in an emergency requiring a substantial expansion of short-term debt.

Question 8. Are the benefits and costs to commercial banks of handling Government transactions clear enough, or can they be made clearer, to determine whether or not the banking system is being excessively compensated or undercompensated? What about the Treasury cash balance—its size and management? Should the Government receive interest on its deposits with commercial banks?

This question calls for a brief description of the Treasury depositary system.

The Treasury doesn't make deposits in its tax and loan accounts in commercial banks in the same way that the individual goes into a bank and deposits money. What the Treasury does is to authorize the banks to act on its behalf as a system of pipelines through which taxpayments and the proceeds from the sale of Government securities flow from the public on their way to Treasury accounts at the Federal Reserve banks, against which checks are drawn to meet Government expenses.

Most of the money that follows this route starts as a deposit in the commercial banks in their customers' accounts. The payment of taxes or the purchase of Government securities thus involves the transfer of a deposit from the account of an individual or corporation to a Government account.

Some Treasury deposits in the banks are new deposits, which are created when a bank buys Government securities from the Treasury and pays for them by giving the Treasury a deposit in the bank. But the newly created deposits don't stay in the banks very long, because the Treasury begins to draw them out after a few days to pay its bills. When the Treasury pays its bills, the people and business concerns who get the checks deposit them in their banks and thus restore to the bankings system the funds withdrawn by the Treasury. The round trip is completed.

Treasury deposits in commercial banks from these two sources are almost continually on the move. Semiweekly calls for withdrawal of Treasury balances in the larger accounts, for example, frequently run 25 percent to 50 percent of the outstanding balance. The average balance of almost $4 billion in these tax and loan accounts last year looks like a great deal of money—and it is. But it doesn't

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seem quite as big when you compare it with the more than $5 billion of budget expenditures the Treasury has to meet each month.

The extensive use of this commercial bank pipeline system provides the most effective method yet devised for maintaining a smooth flow of funds from the public to the Treasury and back again into the channels of trade through Government disbursements with a minimum of economic disturbance.

Whenever the Treasury calls in money from the commercial banks and puts it in the Federal Reserve banks, bank reserves are reduced. Then as the Treasury spends the money, the disbursement out of the Federal Reserve causes bank reserves to go up again. By leaving most of our money on deposit in commercial banks rather than at the Federal Reserve, the amount of time between the withdrawal and the restoring of bank reserves is narrowed to a practical minimum. If the uneven flow of Treasury receipts were permitted to go directly to the Federal Reserve, the banks would have to maintain enough idle reserves to stand the load of these heavy withdrawals. Their lending capacity would, therefore, be reduced and interest rates would tend to rise. As it is, the general public and the whole economy benefit from the more efficient use of these Government funds.

The principal reason, therefore, why the Treasury carries deposits in commercial banks is to assure an orderly flow of funds through the financial community and avoid jolts and jars. It is in the public interest.

Bank services

The banks perform a great many services for the Treasury. They sell a large proportion of Treasury savings bonds; they service many of the E-bond payroll savings plans; they receive subscriptions for marketable Government securities and handle maturing issues presented for redemption or exchange. Banks participate in the weekly sale and distribution of short-term Treasury bills.

In fact, the banks are the principal salesmen for all the vast billions of Treasury securities. The deposits they thus retain (even briefly) are their incentive for a vigorous sales effort. Without this arrangement the Treasury could have to pay commissions for selling its securities. Banks also handle remittances accompanying employers' withheld tax receipts when they are deposited in the Government's account.

These and many other services are performed by the banks without compensation other than the value of the Treasury deposit. It should be emphasized that the size of the Treasury's deposit in any given bank is the result of that bank's own activities in selling and buying Treasury bonds, handling the flow of taxes, etc.

Interest on demand deposits

The question whether or not the Government should receive interest on its demand deposits with commercial banks is related to the broader question of interest on all demand deposits. The payment of interest on demand deposits was specifically prohibited by the Banking Act of 1933. This applies to Federal Government tax and loan deposits, which average around $4 billion, and to the $½ billion balances that the Treasury carries in general bank depositaries. It also applies to the $10 billion of State and local government demand deposits, and to the $100 billion demand deposits of individuals and businesses.

The prohibition of payment of interest on demand deposits was partly due to the belief that some of the serious bank failures of the twenties and early thirties resulted to a considerable extent from the weakening effect of excessive interest payments by banks for competitive reasons. At the time of the Banking Act of 1933, an added burden was also being placed on the banks in the form of assessments for Federal deposit insurance. More important still, interest payments on deposits forced the banks to charge higher rates for loans in order to cover their costs. A resumption of interest on demand deposits would exert pressure on banks to charge higher loan rates.

It is almost impossible to make a useful analysis of the cost and income of the banks attributable to Government operations; they fluctuate widely, differ from bank to bank, and involve such a large part of bank activities. Bank profits have not been high, however, compared with other kinds of business and compared with the need to build up capital funds to protect their customers' funds.

Senator FLANDERS. Following the announcement of these hearings on November 12, the subcommittee was asked as to whether or not the Council of Economic Advisers had been given an opportunity to

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present its views on this important subject. The Council was given an opportunity, but declined at this time. In order that the record may be clear on this subject, however, I will insert at this point, without objection, correspondence between the staff director of the Joint Committee on the Economic Report and the Chairman of the Council of Economic Advisers.

Without objection, that will be inserted.

(The correspondence above referred to is as follows:)

OCTOBER 1, 1954.

Dr. ARTHUR F. BURNS,
Chairman, Council of Economic Advisers, Washington 25, D. C.

DEAR ARTHUR: Before Senator Flanders left for California last week he asked me to explore the possibilities of 2 or 3 days of hearings in early December on United States monetary policy—recent thinking and experience. There has been a desire on the part of some members of the subcommittee to meet with the Federal Reserve Board of Governors and the Federal Reserve bank presidents more or less informally to discuss monetary policy. This could be arranged with convenience in early December during the fourth quarterly meeting of the Board and bank presidents here in Washington.

I have prepared the attached very preliminary and very confidential plan for 3 days of hearings along the lines expressed to me by Senator Flanders. As always on such studies we like to give the Council of Economic Advisers an opportunity to be heard either in executive or open session on the subject under consideration. You will note that on the attached plan we have tentatively reserved time to hear from you. We would, of course, like to hear you but will be guided by your wishes as to (1) whether you appear or not and (2) whether you wish a closed session or an open session.

In addition to your letting me know your desires in this connection as soon as possible, we would appreciate any suggestions or observations which you may have at this time with respect to the questions that will be considered in the study and the first-day panel participants. We will welcome any and all of your suggestions.

With best regards.

Sincerely yours,

GROVER W. ENSLEY, *Staff Director.*

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS,
Washington, October 11, 1954.

Mr. GROVER W. ENSLEY,
Staff Director, Joint Committee on the Economic Report,
Congress of the United States, Washington 25, D. C.

DEAR GROVER: Thank you for your letter of October 1, in which you set out tentative plans for hearings by the joint committee, to be held early in December, on recent monetary happenings and policies in the United States.

I appreciate the position taken by the joint committee in leaving it up to the Council to decide whether or not to testify.

The month of December is going to be an especially busy time for the Council, and after weighing all sides of the question I have reached the conclusion that it would be best for me not to appear during the December hearings. My conclusion is reinforced by two facts: First, that the Economic Report is likely to convey the Council's general thinking on monetary policy; second, that any questions that members of the joint committee may have about the Council's stand could be cleared up if I testify next year, as I did this year, at the hearings dealing with the Economic Report.

Sincerely yours,

ARTHUR F. BURNS.

Senator FLANDERS. I regret that Congressman Richard M. Simpson, a member of this subcommittee, is unable to attend these hearings; he is in Geneva participating in the General Agreement on Tariffs and Trade Conference. Senator Fulbright, another member of this

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subcommittee, also is participating in international discussions at the United Nations in New York and it is unfortunate that he, too, can't be with us. They both have expressed interest in the subcommittee's inquiry, however, and I am sure will look forward to reading the hearings and the summary of this proceeding.

I do not view these hearings as resulting in a special subcommittee report but subject to the will of the subcommittee will view them as part of the educational functions of this committee. The hearings will be published, and I am sure will take the same place on this subject of monetary policies and debt control that the previous hearings have taken in colleges, on the shelves of economists, on the shelves of others who are technically interested and technically concerned with the problems that we are discussing today.

I am sure that these hearings also will assist the committee in the formulation of the committee's annual report to the Congress which is due on March 1.

The plan of the hearings was set forth in the announcement of November 12. It includes a panel discussion today composed of recognized monetary technicians and, I might add, of widely varying points of view, from universities and from financial institutions.

Tomorrow morning we will hear from Secretary of the Treasury Humphrey and W. Randolph Burgess, Deputy to the Secretary of the Treasury. Tomorrow afternoon we will have a roundtable discussion on monetary policy questions with the six members of the Board of Governors of the Federal Reserve System and the presidents of the 12 Federal Reserve banks participating.

They are holding their regular fourth quarterly meeting in Washington the first part of this week, and it seemed advisable, in view of the interest we have in getting their opinions, not to ask them to make a separate trip to Washington when they were coming anyway, at a time which seemed convenient to the members of the committee.

Before getting into the panel discussion this morning, I wonder if other members of the subcommittee wish to make any introductory remarks.

There is one other matter before I ask for preliminary comments from other members of the committee. With the approval of the subcommittee it would be my plan, unless other plans and better plans are suggested, to hold this session until 12:30, to meet again at 2 and continue in session until about 4. I would hope that the presentations of the panel could be completed this morning, with perhaps a little time left for discussion, and that we could spend the afternoon in discussion, particularly of the members of the panel with each other with such observation, comment, and questioning as the members of the committee, both the subcommittee and the main committee, may see fit to interpose.

Is there any suggestion from other members of the committee or the subcommittee with regard to the procedure or by way of introductory remarks?

Representative PATMAN. May I say a word, Mr. Chairman?

Senator FLANDERS. Yes.

Representative PATMAN. First, I commend the chairman for calling this meeting. I think it is a very fine thing. I think it is well arranged, and I am particularly glad that the Open Market Committee will be with us tomorrow afternoon.

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I assume that is what he had in mind in suggesting that all the presidents of the Federal Reserve banks be here along with the members of the Federal Reserve Board. All the presidents are either now or have been or will soon be members of the Open Market Committee, and for all practical purpose they are functioning as members of the Open Market Committee.

Senator FLANDERS. That is true.

Representative PATMAN. And I assume that we will be privileged to ask these distinguished gentlemen questions after they have finished, and that they will return this afternoon for any further questioning that we desire.

Senator FLANDERS. That is the plan. The plan is to have the Treasury represented tomorrow morning, and in the afternoon we will have as long a session as may be necessary. I wouldn't call it off at 4 o'clock if the discussion is still lively. Let's keep going tomorrow afternoon until we have made a good try at clearing up the various points of interest in open market operations.

Representative PATMAN. Tomorrow seems to be a very crowded day, with Mr. Burgess and Mr. Humphrey being heard in the morning. If we are crowded in the afternoon, will there be an opportunity to have the members of the Open Market Committee back on Wednesday?

Senator FLANDERS. I think we might even run through into the evening if that seems necessary.

Representative PATMAN. Mr. Chairman, I ask unanimous consent at this point to put in the record excerpts from our hearings in the past in which I have made request, representing the Democratic members, for the personal appearance of the Open Market Committee before the Joint Committee on the Economic Report.

Senator FLANDERS. That we will be glad to do.

(The documents above referred to are as follows:)

BACKGROUND INFORMATION ON THE APPEARANCE OF THE OPEN MARKET COMMITTEE OF THE FEDERAL RESERVE SYSTEM BEFORE THE JOINT COMMITTEE ON THE ECONOMIC REPORT, SENATE OFFICE BUILDING, WASHINGTON, D. C., DECEMBER 7, 1954

JANUARY 1954 ECONOMIC REPORT OF THE PRESIDENT

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Tuesday, February 2, 1954, Washington, D. C.

The joint committee met, pursuant to notice, at 10:20 a. m., in room 1301, New House Office Building, Representative Jesse P. Wolcott (chairman), presiding.

Present: Representative Wolcott (chairman), Senators Flanders (vice chairman), Carlson, Sparkman, Douglas, Fulbright; Representatives Simpson (Pennsylvania), Talle, Bender, Patman, and Bolling.

Also present: Grover W. Ensley, staff director; John W. Lehman, clerk.

* * * * * * *

STATEMENT OF HON. GEORGE M. HUMPHREY, SECRETARY OF THE TREASURY, ACCOMPANIED BY HON. MARION B. FOLSOM, THE UNDER SECRETARY OF THE TREASURY; AND HON. W. RANDOLPH BURGESS, DEPUTY TO THE SECRETARY

* * * * * * *

Representative PATMAN. Now, then, Mr. Chairman, I want to make a request that we invite the entire Open Market Committee before this committee. Tomorrow, I understand from the agenda, we have Mr. Martin. Of course, Mr. Martin

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is the Chairman of the Federal Reserve Board. But Mr. Martin is just the head of one group that is part of the Open Market Committee. The Open Market Committee, under the laws passed by Congress, has tremendous power. It is composed of the Board members of the Federal Reserve System, and five Presidents of Federal Reserve banks. I believe that this is worthy of the serious consideration by the chairman and should be granted for several reasons.

No. 1, the five Federal Reserve bank presidents that are on this Committee are selected by the private banks. They are not directly under obligation to the Government at all. They are constituents, we can almost say, of the private bankers in the district where they operate. There are five of them. To have just the Chairman of the Federal Reserve Board here, I think is incomplete. I do not think that he is in a position to answer. Particularly is that true now when the Board has only six members.

Chairman WOLCOTT. Mr. Patman, I wonder if you would withhold your request until you have heard Mr. Martin tomorrow, and ask the chairman of the committee to give further consideration to your request, following that, if you still think it is necessary.

Representative PATMAN. I shall be very glad to yield to the request of the chairman, but I know now, Mr. Chairman, that he cannot speak for the five presidents of the Federal Reserve banks. He does not have the power to do so. And since we know that he does not have this power, I would just suggest that it might be a fine thing to have all the members of the Board of Governors and the five presidents of the bank here for a panel discussion.

Chairman WOLCOTT. Would it not be better if we delayed any decision in that matter until after he testifies?

Representative PATMAN. Certainly. Thank you very much, Mr. Chairman. I will propound the other questions to him in writing.

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Wednesday, February 3, 1954.

Chairman WOLCOTT. The committee will come to order.

We have with us this morning William McChesney Martin, the Chairman of the Board of Governors of the Federal Reserve System, and with him are Mr. Young and Counselor Cherry.

* * * * * * *

Representative PATMAN. I will defer as usual to the judgment of the chairman.

Now, one other line of questioning which I hope will be brief, and I will be through.

I notice you state here on page 11 that—

"It is and must be closely coordinated with debt management. * * *

"But, so far as credit and monetary policy is concerned, we are on our own in the Federal Reserve System."

What do you mean there, that you are on your own? That you are kind of footloose and fancy free and the System can do anything it wants to do, and nobody is the master except the Federal Reserve System? Is that the reasoning, Mr. Martin?

Mr. MARTIN. No. That is what I commented on earlier. I think that we have the sole responsibility for monetary and credit policy, and we have to exercise our own judgment.

Now, the monetary function is like the function of the judiciary, as I answered at the time of your questionnaire, Mr. Patman, and I could do no better than at that time. It requires objective judgment free of private pressures and free of political pressures.

Representative PATMAN. Or presidential pressure or congressional pressure?

Mr. MARTIN. Exactly.

Representative PATMAN. All of them?

Mr. MARTIN. All of them.

Representative PATMAN. In other words, you are free, almost another branch of the Government?

Mr. MARTIN. No. You have delegated to us——

Representative PATMAN. The Congress has.

Mr. MARTIN. The Congress has delegated this to us.

Representative PATMAN. That is the reason I asked the chairman yesterday, and I hope he does not talk me out of this one—I asked that the Open Market

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Committee appear before our committee, because we ought to be able to see one time in our lives the people who are actually running the monetary credit policy of the Government.

Chairman WOLCOTT. I am afraid I am going to have to——

Representative PATMAN. The Congress has delegated the power to the Open Market Committee, which you state here, and correctly so. Since we have delegated that power, which the one-hundred-and-sixty-million-and-some-odd people gave to the 531 Members of Congress, to 12 people, I would just kind of like to see them at one time.

I make the request, Mr. Chairman, again, that we call them before this committee.

Chairman WOLCOTT. You said you would like to see them at one time.

Representative PATMAN. I would like to see them before this committee.

Chairman WOLCOTT. We have a problem with respect to the witnesses. We have a tentative program right up through the 16th and then the staff and the members are going to have a terrific job to do to get this report out by March 1. That is what has been bothering me.

Representative PATMAN. Don't you think this is more important than everything?

Chairman WOLCOTT. I do not agree with you that the presence of the Open Market Committee is more important than the present study during which we will have other witnesses on the economic report. As I see it now, we would have to cancel some of these very important panel discussions which we are going to have next week to make room for the Open Market Committee. I think that perhaps the presence of these panels representing labor and agriculture and business and industry and finance generally—I thought, anyway, that their presence would be of more help to us than the Open Market Committee. That is what is bothering me right now. As for myself, I have not made any definite commitment.

Representative PATMAN. All right. I will not insist on it now, but I do want you to consider it, because they are "it."

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Friday, February 5, 1954.

Chairman WOLCOTT. The committee will come to order.

Representative PATMAN. Mr. Chairman, may I make a request at this time?

On behalf of the Democratic members of the Joint Committee on the Economic Report, Senators Sparkman, Douglas, Fulbright, and Representatives Hart, Bolling, and myself, it is requested that the chairman call before this group the Open Market Committee of the Federal Reserve System for questioning.

Chairman WOLCOTT. Well, the chairman will give consideration to the request.

Senator DOUGLAS. The chairman will, of course, with his customary fairness, hold a meeting of the committee to decide?

Chairman WOLCOTT. I do not see any reason why we should not hold any meetings. If we can get the committee together for that purpose, I don't see any reason why we should not hold a meeting. But today, you know, we are running a little short because of the committee hearings in the Senate on several matters before committees of which members of this committee are members.

Banking and Currency, for example, in the Senate this morning, is working on confirmation of members of the President's Advisory Council.

Representative PATMAN. May I supplement that, Mr. Chairman, with one brief statement: Mr. Sproul, in making a speech last Monday a week, I believe it was January 25, emphasized the fact that the Open Market Committee of the Federal Reserve System are on their own; that they are almost a separate branch of Government; that they are entitled to any credit for good that is done, and they should be charged with the responsibility of anything that is not good.

He made a very courageous statement of his viewpoint, and on the day before yesterday, when Mr. Martin was before this group, he stated emphatically that the Open Market Committee was responsible for anything that has happened; in other words, and with reference to any change of hard money and high interest policy, they accepted all responsibility for it.

Since they consider themselves kind of off to themselves they have complete charge, according to their own statements, of the financial and monetary policy of our Government, we are just spinning our wheels talking to anybody else. They are the people we should talk to.

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Chairman WOLCOTT. I want to say that there is perhaps no reason why the Open Market Committee should not come before this committee. But, as I said the other day, I do not want that subject to get to be a disproportionate problem before the committee in the study that we making.

Now, we are up against time. We are expecting to devote the next 2 weeks to open hearings, principally panel discussions, on these problems that the President has raised in his economic report.

There will be then not more than a week in which the staff of this committee will have to get to do some very intensive work on the report if we are going to meet the deadline by March 1, and I hope we can meet that deadline.

Now, I am certain that there will be no opportunity in the mornings to get the Open Market Committee or any other witnesses, in addition to those which we have set out in the agenda, to appear before this committee. I thought that, perhaps, if it was convenient to the committee, if we could work it in on an afternoon, that we might try to do it. But we have got to take into consideration, of course, the fact that the House and the Senate will be in session in the afternoon. I, frankly, do not look forward with any pleasure to evening sessions, and I am going to try to avoid as many evening sessions as I can before this committee at all times.

Now, if we can get a reasonable number of members of the committee here on some afternoon, as far as it is convenient, where it does not interfere with their work on the floors, then we can give consideration to it. But I think it would be a grave mistake to interrupt the continuity of this schedule that has been set up, with the hope of an entire morning, as we would have to give to the Open Market Committee, because I think you would put a disproportionate weight on the testimony that they would give.

I think we all know about what they would testify to anyway. But that is a matter that the committee can decide when we have a substantial number of the committee here, and I will be very glad to take it up then and see what they want to do.

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Thursday, February 18, 1954.

Chairman WOLCOTT. The committee will come to order. We are continuing the discussion of the President's economic message, and this morning, as a summary, we have with us three outstanding economists: Edwin G. Nourse, Martin Gainsbrugh, and Alvin H. Hansen.

Representative PATMAN. Mr. Chairman, may I propound a parliamentary inquiry?

Chairman WOLCOTT. Mr. Patman.

Representative PATMAN. In behalf of the Democratic members, I wanted to ask the chairman if he could give us an idea about our request to have the Open Market Committee before this committee.

Chairman WOLCOTT. As far as the chairman is concerned, he has not changed his mind with respect to it. He still has the same doubts that he has already expressed.

I shall put it this way: The question of open-market operations seems to me a little disproportionate for us to devote an entire day or 2 days to that question. We have to get this report out by March 1. We have to do a very quick job if we are going to do it. Personally, it is my ambition that in this respect we break precedent, or set a record. As far as I know, this committee has never gotten out its report by March 1 even though the statute requires it. I though that possibly we might be able to establish precedent this year for future reports and get it out by March 1. We have made such good progress so far toward that end that I would be reluctant to suggest that we devote another 2 days to a subject which, as I said, has become disproportionate to the whole subject.

So, I would prefer that we wait until such time as we can take a little time with them. I might say to members of the committee that whatever loose ends there are which we will not be able to pick up in working on this report, we might as well continue with a subcommittee. If such a subcommittee thinks it is advisable or essential that we have the Open Market Committee before us, then they may do so.

We know also that the makeup of the Open Market Committee will change materially on March 1. I don't know whether we should have the present Open

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Market Committee down here only to have a new committee come in on March 1 or whether we should wait until March 1 to have the new committee.

Representative PATMAN. May I suggest that I am in accord with the chairman's views on getting out the report, and I shall not do anything to deter him in that respect. I know that I am speaking the wishes and will of the other Democratic members in saying that.

But at the same time, it is not necessary that we hear from the Open Market Committee before we get out the report. We shall have a reasonable time after we get out the report. I am not suggesting that it is necessary to have them to get out this report.

Chairman WOLCOTT. I might suggest, Mr. Patman, that a very short time after we get out this report, you and I are going to be busy with the Commodity Credit Corporation and the new housing bill. We have hearings on the Credit Corporation bill next Wednesday and immediately following that, hearings on the housing bill.

Representative PATMAN. I realize that, Mr. Chairman.

Chairman WOLCOTT. So, I wonder if you and I want to devote that much time to the Open Market Committee during the House committee hearings on commodity credit and housing.

Representative PATMAN. I think the Open Market Committee has much to do with the credit situation. In other words, the Congress has delegated to them important powers, and I do not believe it would be bad to have them appear at least once before a congressional committee that has never seen them to my knowledge.

Chairman WOLCOTT. May we leave it this way, that at the first opportunity when the committee thinks it advisable we will have the Open Market Committee down here.

Representative PATMAN. Does that mean within the next month or so, or something like that?

Chairman WOLCOTT. If we were to set up a subcommittee following these hearings to pick up what loose ends we have, then the subcommittee can have them before them.

Representative PATMAN. We do not want to withdraw our request. We still want to urge the chairman at the earliest opportunity to have the Open Market Committee before this committee.

Chairman WOLCOTT. Do you not think perhaps it might be better to await the new board?

Representative PATMAN. That new board, Mr. Chairman, is somewhat of a fiction. It is kind of one-third of a member each time.

Chairman WOLCOTT. Maybe it is an important one-third.

Senator FLANDERS. This morning we have eight economists drawn from universities and financial institutions. They were supplied a week ago with the Treasury and Federal Reserve replies to our questions. We would like each member of the panel to give a summary of his views on monetary policy during the past 3 years, this summary not to exceed 10 minutes.

Now, there are 8 of you—8 times 10 is 80 minutes or an hour and 20 minutes. Two of these documents are a little lengthy. They cannot be disposed of in 10 minutes, and I am wondering whether the members of the committee present would feel like going through with these, even the longer ones, without much interruption, so that we can have the documents all presented during this morning's time. I will leave that to the desires of the committee.

Representative PATMAN. We will leave it to the chairman.

Senator FLANDERS. I think, then, perhaps we might well do that. And if either of those with the two longer documents feel that they can shorten them in any way by giving a synopsis of certain paragraphs or pages, it may leave time for discussion this morning.

Following the opening presentation, we will proceed more informally, giving individual panelists an opportunity to expand their

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remarks or to raise questions with respect to other views and to give subcommittee members an opportunity to question the panel.

I may say that individual members of the panel may insert in the record that portion of their prepared statements which they did not have time to present orally today.

Now these panel members will be called on alphabetically. I don't know of any fairer way to arrange that, whether it will present the proper contrasts or opinion, I am not sure, but we will proceed alphabetically. I will list them first and then call on them in turn.

The first is Mr. Lester V. Chandler, professor of economics at Princeton University, in Princeton. I may say parenthetically that he was the economist for the Douglas subcommittee.

John D. Clark, director of the American National Bank, Cheyenne, Wyo., former member of the Council of Economic Advisers.

Seymour Harris, professor of economics, Harvard University, Cambridge.

James N. Land, senior vice president, Mellon National Bank & Trust Co., Pittsburgh.

C. Clyde Mitchell, Jr., chairman, department of agricultural economics, University of Nebraska, at Lincoln.

Edward S. Shaw, economist, the Brookings Institution, Washington, D. C., on leave from Stanford University, Palo Alto.

Rudolf Smutny, senior partner, Salomon Bros. & Hutzler, New York.

Frazar B. Wilde, president, Connecticut General Life Insurance Co., Hartford.

Now, bearing in mind the desirability of getting this all in during this morning's session, and hoping to have a little time to spare for discussion, I would urge those reading their documents to take advantage of the provision for putting the whole statement in the record, and where it seems possible, summarizing passages or pages.

The first one in the list alphabetically is Prof. Lester V. Chandler, professor of economics at Princeton.

STATEMENT OF LESTER V. CHANDLER, PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY

Mr. CHANDLER. Monetary and debt management policies since the Federal Reserve-Treasury accord of March 1951, may be evaluated on two different planes. One plane might be called that of "grand strategy"—the selection of major objectives and the formulation of general programs of action for the attainment of those objectives. The other plane would be that of "tactics"; this would call for an evaluation of the many individaul actions taken—the accuracy of the analysis of current economic conditions, the accuracy of economic forecasts, and the timeliness and appropriateness of each policy action. In the short time available for this opening presentation, I shall confine my remarks to a few aspects of what I have called the grand strategy level.

As is well known, the outstanding event during this period was a change in monetary objectives, which necessitated the development of new action programs appropriate to the new objectives. For nearly a decade prior to March 1951, the dominant objective of our national monetary policy had been to stabilize interest rates, or at

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least to hold their fluctuations within very narrow limits. This was a demanding objective which at times forced the neglect of all others. Any tendency toward higher interest rates forced the Federal Reserve to create enough new money to prevent the rise, no matter how inflationary the injection of the new money and loan funds might be. Conversely, this objective called for a reduction of the money supply whenever interest rates tended to decline, whatever might be the effects on employment, production, and price levels.

The most important thing that has happened since March 1951, has been that considerations relating to the behavior of employment, production, and price levels have replaced interest rate stability as the dominant determinants of monetary and debt management policy. This does not mean that the behavior of interest rates is unimportant; it means only that interest rates should be allowed to change—and be forced by a positive monetary policy to behave—in a way that will contribute most to attaining the desired behavior of employment, production, and price levels.

It follows, of course, that the monetary and debt management policies followed since the "accord" must be disapproved by those who believe that the dominant objective of monetary policy should be stability of interest rates, whatever else may be happening in the economy. Their criticisms need not be based on any real or alleged errors in tactics by the Federal Reserve or the Treasury; these critics must necessarily disapprove the shift of basic objectives. Those who insist on desirability of perpetually low interest rates must disapprove of all restrictive policies, no matter how well justified by other considerations. And those who advocate stable interest rates at a high level must surely disapprove of the actively easy money policy which has been in effect for well over a year.

For my part, I approve of the shift of objectives that has occurred since March 1951. This is not because I believe that monetary and debt-management policies can alone assure the attainment and maintenance of a satisfactory behavior of the economy. It is only because I think that flexible monetary policies can make important contributions, whereas a policy dominated by the objective of stabilizing interest rates will often, if not usually, accentuate instability of business activity and prices.

It may be in order to make a few comments concerning the types of policies that would be appropriate to the new objectives. A shift to the objective of promoting economic stability and growth does not imply any decrease in Federal Reserve responsibility for developments in the money market; nor does it imply that Federal Reserve policies should be any less active. It is necessary to make this point because of some puzzling official statements during the period which created confusion and left the impression that the official policy was to be one of passivity—of allowing the forces of private supply and private demand to determine conditions in the money market.

High officials in the Treasury Department have at times suggested that interest rates should be determined by the market forces of demand and supply, and the Chairman of the Board of Governors made a memorable speech describing the transition to "free markets," which was to include a "free money market." This was, in my opinion, an unfortunate choice of words. There are some respects in which the money market should probably be largely free of continuing official

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control. For example, most of us would prefer to rely largely on competitive market processes to ration and allocate the supply of credit among the various competing demanders. But to allow the total supply of money and loans, and the price of loans, to be determined by private demand and private supply would negate the very idea of central banking. Central banks exist because we are not willing to allow the total supply of money and credit, and the cost of credit, to be determined by the unregulated forces of private supply and demand. The basic function of a central bank is to regulate the total supply of money and credit and the terms on which they are made available. It should be clear that the Federal Reserve can make its maximum contribution to economic stability and growth only by recognizing its continuous responsibility for money market conditions, and by taking whatever positive actions that may appear conducive to the attainment of its objectives. There will, of course, be times when the forces of private demand and private supply will produce in the money market exactly those conditions that seem most desirable, and when no current Federal Reserve action will be required. But there will probably be many more occasions when the forces of private demand and supply will produce inappropriate conditions so that an active, and perhaps even an aggressive, Federal Reserve policy will be required. A successful policy of economic stabilization cannot be a passive policy.

It also needs to be emphasized that a shift to the objective of promoting economic stability and growth does not mean that the Federal Reserve should cease to be concerned about the behavior of interest rates, nor that its control of interest rates should be any less precise than was its control during the pegging period. The Federal Reserve's mistake during the pegging period was not that it controlled interest rates; the mistake was in stabilizing interest rates—in making stability of interest rates an overriding objective and in sacrificing all other objectives. To be successful in promoting economic stability and growth the Federal Reserve should use its power to control interest rates, but use the power to bring about those changes in interest rates which will best promote its purposes.

Chairman Martin quite properly emphasized, in his answer to your questionnaire, that the effectiveness of Federal Reserve policy does not rely solely on interest rate behavior. When the Federal Reserve increases or decreases the free reserves of the banking system, the supply of money may be increased or decreased in many ways other than by a reduction or rise of interest rates—by more restrictive or less restrictive rationing of credit by lenders, by changing standards of creditworthiness, and so on. Yet, interest rate behavior is important, and the Federal Reserve should take the responsibility of forcing the interest rates to behave in a desirable way. In some cases it may succeed in doing this solely by regulating the volume and cost of bank reserves; in others it may need to exert a direct effect on the prices and yields of long-term securities by purchasing or selling them. For example, there may be times when long-term yields remain undesirably high despite large excess reserves in the banking system. At such times the Federal Reserve may usefully buy long-term bonds, thereby tending directly to drive their prices up and their yields down.

Chairman Martin may be right in arguing that technical considerations relating to the broadening and deepening of the long-term market for Government securities justified the policy of confining

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open-market operations to the short maturities during the transition period. It was, however, reassuring to note in his answer to your questions that this is not necessarily a permanent policy, and that we may hope that in the future the Federal Reserve will feel free to buy and sell long-term governments when such operations promise to be useful in promoting economic stabilization.

Senator FLANDERS. Thank you, Professor Chandler.

The next on the list is our old friend, Dr. John D. Clark, who was a former member of the Council of Economic Advisers, and appeared many times before us in that capacity.

Dr. Clark.

STATEMENT OF JOHN D. CLARK, DIRECTOR, AMERICAN NATIONAL BANK, CHEYENNE, WYO.; FORMER MEMBER OF COUNCIL OF ECONOMIC ADVISERS

Mr. CLARK. Thank you, Mr. Chairman.

We now have three official descriptions of the economic situation when our monetary authorities undertook their unhappy experiment with a repressive monetary policy in the spring of 1953. Two come to this committee from the Treasury Department and the Federal Reserve Board. The third is the statement of the President himself, in the White House release of August 12.

The Treasury says that in the early months of 1953 inflationary pressures were "running high." In the next paragraph it says that production was exceeding sales, a condition which hardly fits into the description of inflation. Otherwise, in its reply to the committee as well as in the many self-approving statements issued by the Secretary, the Treasury sticks to its story that in the first quarter of 1953 we faced inflation pressures serious enough to require the action which halted economic expansion.

The Federal Reserve Board gives only faltering support to this rationalization of fiscal and monetary policy in the spring of 1953. It opens its response with the statement that a series of circumstances "threatened to develop into an unsustainable boom." This is indeed a new standard of an economic situation requiring rigorous anti-inflationary action.

Later in its report, the Federal Reserve discredits its own speculative fears about economic stability early in 1953. Reviewing conditions in the period April 1952 to April 1953, the Board finds that credit and monetary growth "corresponded closely to the capacity of the economy to absorb more money without inflation." Then comes the flat statement that "inflation was prevented" and that "prices remained relatively stable." So there was neither monetary inflation nor price inflation in the spring of 1953, according to the Federal Reserve, but only a fear that things were too good to last.

To the President, the first half of 1953 represents "the greatest prosperity we have yet known," and he does not conceal his yearning for a return to the happy economic conditions to which he fell heir. Neither the Treasury's sense of present danger nor the Federal Reserve pessimism about a coming storm clouded his assurance that our prosperity was real.

These conflicting evaluations of economic conditions in early 1953 fail to explain why our new fiscal managers set out to upset the

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business boom as soon as they entered office in January 1953. An extraordinarily stable price level certified to the soundness of a condition of rising employment, production, and consumer buying. Yet men who 2 months before Inauguration Day were advertising their intention to use fiscal and monetary policies as antiinflationary instruments would not look at the real economic facts when they came to power.

They found eager collaborators in the Federal Reserve Board, which had read the election reports. Never since the war, and for a long time before, had the Federal Reserve failed to assist an important Treasury offering by supporting the market. This continued to be its policy even after it had discontinued steady pegging of the market price of Government bonds in 1951. But November 1952 changed all that. The large refunding operation on December 1 was given no support.

The market, thus advised that the monetary authorities were not averse to and would not act to halt the rise in interest rates for which the financial district had long hungered, promptly started the upward rush of rates which did not end until the crisis in the following June. To keep it going until the new team taking over the Treasury could swing into action, the Federal Reserve raised discount rates in January. The tiny increase of one-fourth of 1 percent could itself have little effect upon credit. Its purpose was to show that the Federal Reserve intended to follow the market, not lead it as it had been doing for years.

Experience with fiscal and monetary policy in the last 2 years has not taught us much that we did not know. The tightening of credit and increasing interest rates smothered a business boom, as such policy is intended and expected to do. The quick reversal of that policy and the return to one of low interest failed to forestall the induced recession. For a long time cheap and easy credit has had no effect in inducing economic expansion, as the Federal Reserve learned 20 years ago, and so reported.

The fundamental issue between the supporters of monetary policy as a prime anti-inflationary instrument and the old Council of Economic Advisers still remains. In November 1950, we placed before the joint committee our view, in which President Truman concurred, that an important inflationary movement should be met by increasing the facilities and volume of production. This process requires cheap and ample credit, and until the volume of output increases, inflationary pressure will increase and must be curbed by other than monetary measures of the kind which increase the cost of capital.

Our objection to the use of monetary policy was, of course, that the one and only way it reduces prices is by bringing about less employment, less output, and less demand for goods and services than would otherwise exist.

This characteristic of monetary policy as an anti-inflationary instrument can hardly be denied, but advocates of that policy believe that the monetary authorities can use their power with such finesse that the inflationary movement is stopped but no real damage is done. Our view was that gentle measures are futile, and strong action is dangerous.

Very great damage has been done this time, and it is clear that the President is unhappy over the economic decline, quite apart from the fact that it has cost his party the control of Congress. But the Treas-

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ury and the Federal Reserve seem to be complacent. They do not quite subject us to the stupid and once common argument that the recession is a "healthy corrective movement," but they seem to feel that way and they constantly compliment themselves that they have done well in not bringing on a real depression.

It seems that no lessons have been learned by the monetary authorities and that we must expect that unless the Congress intervenes they will continue to yield to the obsession with the danger of inflation which sticks out of this and every other Federal Reserve report and is shared by the officers currently in control of the Treasury.

They have shown a willingness to bring economic expansion to an end when there is no inflation and they only fear inflation may be coming. But even when they acknowledge that business needs to be invigorated, they are willing to engage in only meager action because they are forever beset by the fear that they will find inflation creeping into the economy.

This haunting fear of inflation will foreclose resort by them to the only remaining recovery action in the field of monetary policy—a return to the normal legal requirements for bank reserves. The recent grudging decreases even when all public officials were eager to induce greater economic activity illustrate the deep reluctance of the Board to restore the normal legal reserve requirements and its determination to hang on to the extra requirements despite the passing of all circumstances which would justify their imposition. The Board is not even moved by the fact that if normal reserve requirements are restored, the Board will have a much wider margin within which to maneuver whenever the new inflation it is always expecting does arrive.

I do not know whether restoring normal legal reserve limits and the freeing of 40 percent of the large sums now in reserves would furnish the extra push to the economy which has been needed since the business slide-off ended 10 months ago. But the other possible sources of a major and quick-acting push upon the economy require legislative action in the very fields where legislation moves most slowly. Restoration of normal legal reserve requirements is the only program which can be adopted overnight. It is the one program in the field of monetary policy which can add to the fresh stimulus to economic expansion which is coming right now from the resumption of full-scale automobile production and the collateral improvement in the steel industry.

Above all, it is a program which can bring trouble only if it first produces great benefit, and if inflationary trouble does then develop, the program can be quickly reversed. By this I mean that reducing reserve requirements can bring inflation only if it first brings about larger employment, higher personal income, and greater demand for goods. Even then, there need be no increase in price levels if freer and cheaper credit has induced the necessary increase in the output of goods.

A final word about recent developments which indicate the passing of the illusion that the Federal Reserve and other so-called independent commissions are not subject to executive control. If orders can be given to the Tennessee Valley Authority and the Atomic Energy Commission, even to the point of forcing reversal of commission action, we may be sure that the Federal Reserve Board will be forced, if necessary, to fall in line with any national economic policy

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which the President determines upon. It may be, Mr. Chairman, that with a little urging from this committee he will tell the Federal Reserve to give the economy a real shot in the arm, and he will take his chance with a little inflation for a change.

Representative PATMAN. Mr. Chairman, I ask unanimous consent to insert in the record at this point a letter from Dr. Clark that was published in the Washington Post this morning.

Senator FLANDERS. Without objection, it is so ordered.

(The letter above referred to is as follows:)

STIMULUS TO ECONOMIC GROWTH

For the fifth time in a few years, the Joint Congressional Committee on the Economic Report is today beginning an inquiry into the usefulness of monetary policy as a method to stabilize the economy.

This indicates a precarious status for a policy which only a few years ago seemed to be thoroughly accredited, and less than 2 years ago was the most loudly proclaimed of all of the policies of the new team then taking over the Treasury.

The joint committee has become increasingly cool to the idea that the way to halt inflation is to choke off a business boom by making credit tight and costly. The study by the Douglas subcommittee led to a unanimous recommendation in January 1950 that vigorous use of monetary policy should be "the Government's primary and principal method of promoting" the economic stabilization which is the purpose of the Employment Act of 1946.

The more ambitious inquiry by the Patman subcommittee, with much the same membership, brought a divided report in June 1952 with the majority nodding approval of monetary policy in theory, but sharply criticizing its practical operation.

When the full committee concluded its study in February 1954 of the actual use of restrictive monetary policy to smother the fine business boom which the new administration inherited in the first quarter of 1953, the majority report did not have one word to say about monetary policy or about the most dramatic and important economic experiment of the preceding year. In separate statements, several of the minority members challenged Treasury and Federal Reserve policies.

Now that unemployment, the normal result of the successful use of monetary policy as an anti-inflationary instrument, has brought about the loss of administration control of the Congress, it will be interesting to observe where the joint committee goes.

It will be unfortunate if the new subcommittee holds to its agenda and postpones discussion of the current economic situation and of appropriate recovery programs until after the annual economic report of the President has been received late in January. The historical survey it proposes is important, because history is being distorted, but of far greater immediate importance is the problem of getting the economy off the dead center upon which it has stuck since last January.

In the 1949 recession, the downward slide of industrial production from October 1948 to July 1949 was immediately followed by a recovery movement which with almost no hesitation persisted until industrial production reached a new postwar high in June 1950, before the Korean outbreak. In the current recession, the drop in industrial production continued from July 1953 to January 1954. The January 1954 index figure was 125, in October last it was 125, and in the intervening months it was either 125 or slightly lower.

Why this difference in the course of the economy, and what does it portend? May we, like the Government officials who each month assure us that recovery is just around the corner, be complacent, confident that, if we are patient the normal and powerful forces of expansion which are inherent in our economy will sooner or later carry us off the economic plateau and in the right direction? Or should we fear that the stalemate is permitting the process of progressive deterioration which used to turn recession into depression to overcome the potency of the new stabilization policies which have twice since the war sustained the economy against forces of deflation?

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Experience in the postwar economy is too limited to enable the joint committee to find wholly satisfactory answers to these questions, but the committee can reach a conclusion about the wisdom of national action without further delay.

For the third time this year, a powerful stimulus to economic expansion has appeared. Neither the substantial reduction in personal income taxes nor the extraordinarily liberal credit program for housing proved to be strong enough, by itself, to give the economy the necessary push. We did not supplement either of these stimuli, when it was new and most powerful, with additional impulses toward recovery. Now we have the entire automobile industry joining in a full production program, with a corollary expansion of steel production and with three weeks of Christmas shopping upon us.

We cannot know whether this combination of powerful forces will itself get the economy into forward stride again. That depends largely upon the consumer, and his verdict on the strange new car models has not yet been given. But we do know that this is the last occasion for months to come, when private enterprise will be developing powerful new stimuli to economic activity. After 3 weeks of Christmas shopping we will face a season of declining employment, of heavy tax payments, of decreasing money supply, and of declining business borrowing. The Federal Government will then have to carry the full burden of formulating and supporting recovery programs, if recovery is still around the corner.

Surely, it is the part of wisdom and prudence to exploit the fine opportunity we now have to join the impetus arising from potent Government action to powerful forces of recovery in the private economy. That opportunity will be lost if we await the annual economic report of the President.

JOHN D. CLARK, *Washington.*

(Mr. Clark formerly was vice chairman of the Council of Economic Advisers.)

Senator FLANDERS. The next speaker is Prof. Seymour Harris of Harvard. Mr. Harris.

STATEMENT OF SEYMOUR HARRIS, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MASS.

Mr. HARRIS. Mr. Chairman, since my paper is one of the longer ones, I shall spare you the dull period of listening to it. I would like to summarize my position and save you some time, if that is agreeable, and put my paper into the record. Is that agreeable, Mr. Chairman?

Senator FLANDERS. I am very glad that you feel able to do that, Professor Harris.

Mr. HARRIS. Let me begin by saying that in the last few years it seems to me that the Federal Reserve has had inflationary jitters, the Treasury has had a strong inflationary neurosis. Now, I say that this is true, both in 1952–53, and 1953–54.

In the first place, there was no price decline in 1951, 1952, 1953, after March 1951, and therefore one could very well argue that there was no case for an anti-inflationary policy. In the first half of 1953 there was a cash surplus for the Government. There was no evidence at all of inflationary pressures, with the possible exception of the rise in inventories.

Despite that fact, in the first half of 1953 the Treasury raised its rates to such an extent that within a period of 5 months the rate of interest rose on long-term Government securities as much as they had risen in the preceding 7 years.

Now, I will say possibly the Federal Reserve's bark is worse than its bite. If you look at the total policy, there were a number of anti-inflationary policies during this period. For example, they related on borrowing by the Federal Reserve on securities and real estate credit, and they did not reduce the excess reserves of member banks, and

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for this reason, though the Federal Reserves were claiming a strong anti-inflationary policy, actually it wasn't quite so strong as claimed and did less damage, therefore.

Now, when we look at the antirecession policy which began in about May 1953, what do we find? We find that there was a reversal of policy, and for this both the Treasury Reserve and the Federal Reserve deserve credit. They acknowledged their sins and are ready to give us an expansionary policy; but unfortunately again they are too fearful of inflation.

For example, in the year ending September 1953 there was a rise of deposits of $1 billion, or less than 1 percent, in the period when the GNP dropped by 3 percent, and relative to a full employment economy by 6 percent. During this same period we had a fall in the annual rate of Government spending of $9 billion, and we have also since the peak had a fall in private investment of $10 billion. To offset that, we have a reduction of taxes with a lag at an annual rate of about $9 billion.

In March 1954 we reached a peak of 3.7 million unemployed, which is roughly equivalent to 5 million in my own accounting of unemployment.

Now, during this period of inclusion of hourly cuts and those unemployed but not so counted concern about the economic situation, the Federal Reserve gave us an average excess reserve in 1954 of $700 million. I would like to compare this figure with the more than 5 billions of excess reserves in 1939, when required reserves were only one-third as large. In other words, relatively speaking, the Federal Reserve gave us one-twentieth as large excess reserves as compared to the 1939 situation.

Now, some may say, of course, that monetary policy doesn't do much good in recession, and I think that there is probably a good deal of truth to this, but the Federal Reserve makes no such claim, and if they are really using monetary policy, why don't they give us a couple billion dollars of excess reserves.

Again the chairman made a point that I would also like to make very strongly, namely, there is an awful lot of nonsense in the Treasury and Federal Reserve statements about the free market. There is no such thing as a free market in money. As a matter of fact, where would our monetary system be without the $24 billion of earning assets of the Federal Reserve.

Total member bank reserves are only $19 billion. You can imagine where our monetary system would be without the $24 billion of earning assets of our central bank.

Now, you may ask: Why does the System fear to such an extent controlling the rate of interest? Because actually this seems to be their great fear. They are afraid to control the rate of interest. Note their statement on intermediaries when they seem so willing to relinquish much of their control over the rate of interest.

Modern theory of employment and output holds that above all the authorities should control the rate of interest, and by controlling that they control, to some extent, the total amount of investment, and if the authorities control the total amount of investment, to that extent they stabilize the economy and allow it to grow, and if they do not do this, then they endanger all other markets, and if we want freedom

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in all markets we don't want freedom in the rate of interest, the money market.

In relation to this point, there seems to be a general view in recent years that the main objective of controlling the price of Government securities has been to maintain the price of Government securities. Now, this, to some extent, has been true and particularly from 1945 on we experienced some inflation that we might not have had if this policy had not been carried through.

But I think it is a great mistake to assume that our major objective was to control the price of Government securities. The major objective was to control the rate of interest, and the way to control the rate of interest was to control the Government security market, and if you control the rate of interest then, of course, you also to some extent control investments.

It is a great mistake also to assume that there was a miraculous change in policy in 1951, because, as a matter of fact, in the preceding year the Government was just as much interested in employment and output as was any other government.

I am not trying to make this a political speech. The only point I am trying to make is that Government also, for many years, had been interested in employment and output, and we might criticize the administration on the grounds that before 1953 they gave us a little more inflation than we might have had, but not on the grounds that they were not interested in maintaining employment and output.

I am very much surprised to hear the Federal Reserve announce that they are no longer interested in the long-term rate of interest. At least, what they are telling us is that what they are really trying to do is to control the short term of interest, and hoping that this will in turn control the long rate of interest and that they do not generally intend to deal in long-term Government securities any more.

This is a surprising position. I am very much pleased that Mr. Smutny also made a point of the difficulties involved for the dealers of Government securities resulting from the concentration on the short-term rate.

There also seems to be a theory held by these authorities that it is almost immoral for banks to hold Government securities. This is certainly not my theory, and anybody who has studied American economic history knows this is the most absurd theory, because if you go back, for example, to the 1940's and take the situation in the early 1950's, you would find there has been a tremendous increase in the supply of money. That has made a rise possible and was a condition for the national income of 8 times and real national economic income of 4 to 5 times.

Now, what made this possible? What made this possible was the purchase of Government securities by the banks, because of the total rise of earning assets by banks during this period, two-thirds were in public securities.

And I would also like to point out that there it is not immoral for the banks to hold short-term issues or is it unwise to allow a large amount of short-term issues to be outstanding because, as a matter of fact, one of the great revolutions in the Government market has been the increase in short-term issues, which has been going on ever since the twenties, and this has been one of the great contributions to bring-

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ing the rate of interest down from 4 percent in the twenties to 3 percent in the thirties and 2 percent in the forties.

This also has been a revolution and has had a great effect on our economy, and I think has made capitalism stronger since it reduced what Lord Keynes used to call the dead hand of debt.

When we consider the objectives of the authorities, the Treasury objectives, for example, what were they going to do early in 1953?

Actually what these people were trying to do was to get Government bonds out of the banks, and I would like to suggest this is a silly policy. At any rate, what did they accomplish?

From 1945 to 1952 Government bonds held by banks declined by 30 percent. From the end of 1952 to the latest month that I could get figures for, the amount of Government bonds in the banks increased by 6 percent, so they obviously failed here.

The Treasury also wanted to lengthen the average maturity of debt. I don't have the latest figures, but I wanted to point out that, as a matter of fact, the short-term securities held by the banks are as large, that is, securities less than 1 year, than they were at the end of 1952, and the average maturity of the entire debt actually increased in 1953, though there might have been some reduction in 1954.

So, in a general way, Mr. Chairman, may I conclude, and within 10 minutes, may I say that I believe that to some extent the Treasury was responsible for our recession. To a smaller extent, the Federal Reserve was.

Now, I think there are some extenuating circumstances. The Treasury was new at this job, and I think they were a little too anxious and ambitious to bring us back to a free market.

I do hope that they will learn their lesson and learn this is not a free market.

I also want to agree with the point that somebody else is going to make presently, namely, that the Treasury policy is going to increase the cost of financing the debt, and this is a dubious policy for a Treasury that is so strong for balancing the budget.

And one final point, namely, when you look at the total volume of earning assets for 1952 to 1953, for example (fiscal year), you find actually the Federal Reserve, and luckily, policy failed because of an increase in earning assets of $30 billion, only $3 billion were commercial bank assets, and this suggests the Federal Reserve has a job to do in trying to control the policies of noncommercial banks.

(The prepared statement submitted by Mr. Harris is as follows:)

SUMMARY STATEMENT OF SEYMOUR E. HARRIS, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, ON MONETARY AND FISCAL POLICY SINCE THE MIDDLE OF 1952

(Comments on the statements of Secretary Humphrey and the Federal Reserve Board)

SUMMARY OF SUMMARY

Whereas, in the first half of 1953, the Federal Reserve suffered from inflationary jitters, the Treasury seems to have contracted a genuine inflationary neurosis. Whereas the Federal Reserve attacked the mythical inflation with a scalpel, the Treasury used a sledge hammer. Whereas the Reserve authorities neutralized their anti-inflationary policies to some extent by recourse to modest inflationary policies, the Treasury within a period of less than 6 months raised the rate of interest by as much as it has risen in the preceding 7 years. Whereas throughout the years 1953 and 1954 the Reserve authorities carried through their

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policies with due humility and expression of the uncertainty of results, the Treasury expressed no such doubts.

The Treasury, much more than the Reserve, can therefore be held responsible for the rise of rates in 1953, for the imposition of an anti-inflationary policy in the midst of a period of price stability and even price declines, in a period of Treasury cash surpluses, and hence can be blamed to some extent for the insuing recession.

In the period of antirecession policy beginning in May 1953, both the Reserve authorities and the Treasury wisely reversed their policies. And they deserve credit for doing so. But their policies were not sufficiently bold. By March 1954, the official unemployment had reached 3.7 millions and an accurate estimate of total unemployment would be at least 5 millions. Yet the Reserve authorities provided an increase of excess reserves of but a few hundred million dollars, and excess reserves averaged but $700 million in the first 10 months of 1954. What danger would be involved in raising the excess even to $2 billion? (Compare the excess reserves of $5.2 billion in 1939, when required reserves were but one-third those of 1953–54 and hence relatively the excess reserves were 20 times as large as in 1954. Commercial bank deposits in the year ending September 1954 had increased by but $1 billion, or less than 1 percent, and GNP had fallen by 3 percent in the first 9 months of 1954. Yet here where a sledge hammer should have been used, a scalpel was applied. There was still too much fear of inflation. With GNP 5 to 6 percent ($18 to $21 billion) below the full employment level, the authorities provided us with $1 billion more of bank deposits. Fortunately a reduction of $3 billion in personal taxes in 9 months (annual rate) prevented a more serious drop. The reduced taxes at least in part offset a decline of $9 billion in Government purchases (annual rates).

In part the trouble seems to lie in a fear on the part of the Federal Reserve (and Treasury) to control the rate of interest aggressively. Rather the Reserve authorities insist that they merely offset undesirable movements in rates; and they restrict themselves even within these narrow limits to influencing the short-term rate. Modern developments in the theory of money and output seem largely to have escaped those responsible for monetary and debt policy. They seem to consider the control of the rate of interest on Government securities merely as an attempt to raise artificially the price of these assets rather than (as they should) consider the control on this rate as a means of determining the rate of interest generally and hence influencing investment and output and thus increasing the probability of freedom in all markets.

The Treasury started with a bang. They were going to reintroduce the free market; to raise interest rates so that banks would dispose of securities and other purchasers would be attracted; and they would increase the maturities of securities. There seemed to be no realization in their repeated statements of the association of bank purchases of Government securities and the required provision of adequate supplies of money. For example from 1914 to 1951, issues of $66 billion of Government securities to the banks were twice as important as new loans in contributing towards a rise of $132 billion in bank deposits, in turn contributing toward a rise of national income of 8.6 times (4 times in real income).[1]

At any rate the policies of the Treasury failed. There is no evidence that the higher rates increased the market for Government securities net. (The reduced income accompanying higher rates would tend ultimately to have the opposite effect.) Whereas banks disposed of 30 percent of these Government securities from 1945 to 1952, from 1952 to 1954 they actually increased their holdings. Even the program of converting short-term into long-term securities was not clearly successful. The percentage of issues maturing in 1 year actually rose. Unfortunately the Treasury does not seem to be aware of the revolutionary changes in rates, with their significance for economic output and Government finance—a decline from 4 percent in the twenties, to 3 percent in the thirties and 2 percent in the forties. This is intimately tied to increased needs of liquidity and the great rise in popularity of short-term issues.

I. ROLE OF MONETARY POLICY SINCE BOOM OF 1952

July 1952–April 1953

The Federal Reserve claims that its policy was a restrictive one from the middle of 1952 to April 1953. Evidence of restrictive policies is to be found, according

[1] See my statement in the 1952 hearings on Monetary Policy and the Management of the Public Debt, pp. 380–389.

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to the Reserve authorities (statement of November 26), in the limitation of open market purchases of Government securities to $1.8 billion in the second half of 1952 to meet seasonal needs of banks; the sale of $800 million net of United States Government securities in January–April 1953 to keep member banks in debt to reserve banks and hence force banks to be more cautious in lending; and a rise in discount rates and buying rates on bankers' acceptances in January 1952.

This policy of the Federal Reserve raises certain questions.

One, was there a boom the premise upon which this policy was based? In 1951, the wholesale price level was 114.8; in June 1952, 111.2; by April 1953, 109.4. The cost of living, was also remarkably stable. In fiscal year 1952 (ending June 30), the Government's operations were not inflationary. Its cash budget was in balance; and in the first half of calendar year 1953 there was a cash surplus of $2 billion. There was also little evidence of inflation on the stock market. Then where was the boom? Indeed, the index of industrial production had risen from a low of 193 in July 1952 to 235 in December 1952 and 243 in March 1953. But surely a rise of output accompanied by stable or declining prices is no evidence of a boom. The Federal Reserve and the Treasury seemed to have had inflationary jitters.

Second, fortunately despite its large claims of an antiboom policy, it is not at all clear that Reserve policy conformed to its professions. Perhaps the best test of effectiveness of Federal Reserve policy lies in its effects on member bank reserves and notably on excess reserves. Excess reserves in June 1952 amounted to minus $192 million (deficiency of reserves), but ranged (average daily figures) from a minimum of $535 million (April 1952) to a maximum of $778 million (September 1952) from July 1952 to April 1953. That the policy (fortunately) was not as restrictive as claimed is evident in the continued rise of bank deposits (demand), a rise of $7 billion in the second half of 1952. A seasonal decline followed in the first half of 1953. It is also of some interest that in September 1952 the Board suspended regulation of real-estate credit and in February 1953 reduced margin requirements for purchasing or carrying securities from 75 to 50 percent—these are scarcely restrictive policies.

May 1953–October 1954

In this period the Federal Reserve's objective was to treat an expected recession by introducing monetary ease. In May–June 1953, the System purchased $900 million United States securities and in July–December 1953, $1.7 billion; in July 1953, through a reduction of reserve requirements, the Reserve authorities freed an estimated $1.2 billion of reserves and in the summer of 1954, an additional $1.5 billion of reserves were freed. (Though the latter was offset to some extent by sales of securities.)

Clearly the policy of the Reserve System was in the right direction at this time and carried through with adequate humility and admission of uncertainties of effects of policies. The only criticism I can make at this time is, was it enough? By March 1954, unemployment had risen to 3.7 million (more than 2 millions above the 1952 minimum); and if allowance were made for cuts in hours, the partially unemployed, those with jobs but unemployed (not counted as unemployed), the total might well be over 5 million.

Member bank reserves were allowed to decline during most of 1953, though this was offset by relaxation of reserve requirements; and after a rise of reserves in the latter part of 1953 they moved downward again in 1954. The important variable to watch is excess reserves. They fluctuated very little from May 1953 to October 1954 ($591 million in May 1953 to a peak of $936 million in January 1954 and generally around $700 million; $705 million average in first 10 months of 1954). Indeed, member banks' borrowing declined to some extent, though this writer believes the Federal Reserve exaggerates the significance of this factor as a contractionist force. Total Federal Reserve credit changed insignificantly net over the 16 months ending October 1954. It is well to compare the excess reserves of $700 million in 1954 with the $5.2 billion in 1939, the $3.1 billion in 1941, and amounts substantially in excess of $1 billion during the war. Was not the Federal Reserve again excessively fearful of inflation and, therefore, inadequately concerned with unemployment?

II. POLICY RESPECTING VOLUME OF MONEY

In the opening paragraph of its reply to question 4 (Memo of November 23, 1954), the Federal Reserve presents an admirable statement of the objectives of monetary policy: to provide a supply of money "which is neither so large that it will induce inflationary pressure nor so small that it will stifle initiative and

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growth * * * sufficient to facilitate * * * outlays necessary to sustain a high level of production and employment * * *." This statement marks a great advance over the theory upon which the System was established, namely, accommodate credit to the needs of trade or even over the objective of the 1920's, (though not often publicly admitted) of stabilizing prices.[2]

But some questions may be raised concerning policies pursued or even avowed in the light of this admirable objective. Thus in the year ending September 30, 1954, demand deposits rose by but $1 billion, or less than 1 percent. Is this sufficient to match expected annual growth of 3 percent? That GNP declined by 3 percent in the first three quarters of 1954 vis-a-vis the corresponding period in 1953, is all the more reason for making the most effective use of monetary policy. Would it hurt to raise excess reserves to $2 billion?

Control the rate of interest? The Federal Reserve response to question 3 (why the shift of emphasis "from maintaining orderly conditions to the view of correcting disorderly situations?") is disturbing to this reviewer of Federal Reserve policy.

It is a widely accepted view today that the fundamental job of the central banking system is to influence the total supply of money as a means of determining the rate of interest. Moreover, this indirect method of control should be implemented by direct purchase and sales of long-term Government securities—we cannot depend merely on the interrelations of short- and long-term rates to accomplish our objectives.

Then here are our objections to the Federal Reserve policy as suggested by the reply to question 3:

1. The Reserve wrongly fears a control by the monetary authority in cooperation with the Treasury of the return on Government securities (question 3, pp. 1–3, 22–24). They seem to lose sight of the fact that control of the return on Government securities is not only a means of pegging the price of these assets but, more important, it is a means of controlling prices of all long-term assets and hence influencing investment and contributing toward freedom in all other markets. Free markets are not likely to persist without adequate output, in turn dependent on rates of interest and investment. The primary objective is to control the rate of interest, not to depress rates of interest on Government securities. But I hasten to add that the monetary authority also has some responsibility for maintaining prices of Government securities in a world where Government finance is of first-rate importance—though this objective should be related to other objectives of monetary policy.

2. It is absurd to assume that the money market is a free market. The Federal Reserve has created $24 billion of reserves primarily through the purchase of securities. This has provided not only the cash required to put money into circulation but has contributed in an important way toward the $19 billion of member-bank reserves which are the basis of the deposits of the country. Where would we be without the Federal Reserve and without the Federal Reserve determination of monetary supplies?

3. It is difficult to understand why, out of deference to the intermediaries in the Government security market who are supposed to give the market breath and stability and who through arbitage operations are supposed to assure a consistency of prices of different issues of Government securities, the Federal Reserve should sacrifice its initiative and control of the market. The major objective is to determine interest rates, not merely offset undesirable changes in rates as is proposed at one point (question 4, pp. 20–21), and the way to do this is through Federal Reserve operations.

4. At least we can say for the Federal Reserve that, though it disclaims any intention to take the initiative, nevertheless through purchases and sales it sometimes does. Moreover, in its statement of policy with respect to the volume of money, the authorities say they take into account such factors as productive capacity, state of business expectations, and "changes in money turnover or velocity reflecting variations in liquidity and the demand for liquidity on the part of business and consumers" (question 4, p. 1). No better intent to influence the rate of interest could be found than a determination to offset increased liquidity by the creation of additional money.

III. TREASURY DEBT FINANCING

Apparently the Treasury moved in at the beginning of 1953 even more convinced than the Federal Reserve that inflation was the great danger. It made

[2] See my Twenty Years of Federal Reseve Policy, 1933, especially vol. 1.

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clear its objectives at the outset: (1) Free the Government bond market, with rates of interest to be determined by the free market; (2) the resultant higher rates would move securities out of the banks into the hands of the public and thus destroy deposits and cut inflationary pressures; (3) there would follow a great lengthening in the maturity of the Federal debt.

The Treasury showed little of the humility of the Federal Reserve. At the very outset a spectacular rise in short-term rates was put into effect. The famous April 3¼-percent bond issue followed, an issue which for a while demoralized the bond market. Indeed, whereas the Federal Reserve used a scalpel, the Treasury had produced a sledge hammer. The resultant rise in interest rates contributed to the recession which followed. (A supplementary statement to be submitted to the Joint Committee of announced objectives of the Treasury should be compared with Secretary Humphrey's statement of November 1954.)

Treasury policy was based on certain misapprehensions.

First, the threat of inflation was not serious if present at all; and hence the economy should not have been jeopardized by a sudden major rise in rates.

Second, the response of additional purchases of securities to any practical rise of rates is not likely to be large. (Purchases depend on alternative attractions, for example, the pull of the stock market, which the authorities stimulated by reducing margins and, in 1954, by reducing interest rates; and purchases seem to depend on income even more than upon rates of interest. But higher rates cut income.)

Third, the vogue of short-term securities is explained by the vast expansion of deposits, the need of tax anticipation securities, etc. Though at one point the Treasury pays lip service to this need of tailoring securities to market needs, the general meaning gleaned from Treasury statement of policy is that short-term issues are dangerous. The fact is that, in the last generation, adapting securities to market needs has brought a large rise in the proportion of short-term securities and contributed greatly toward reducing rates of interest from the 4 percent level in the twenties, to 3 percent in the thirties, and to 2 percent in the forties. The resultant savings on Federal Government interest payments are about $3 billion yearly.

Let us see how much the Treasury has accomplished.

1. Has the Treasury succeeded in forcing Government securities out of the banks (and thus deflating deposits)? The answer is no. In fact the record from 1952 to 1954 is much worse than from 1945 through 1952.

U. S. Government securities held by commercial banks

[Billion dollars]

		Change	Percent change
End 1945, 90.8	End 1952, 63.4	−27.4	−30
End 1952, 63.4	August 1954, 67.0	+3.6	+6

Source: Federal Reserve Bulletin, November 1954.

What is more, other borrowers were apparently not influenced greatly by higher rates. For example, here is the percentage of Government securities held by insurance companies and savings and loan associations (latest figures available, Federal Reserve Bulletin, November 1954):

Securities held as percent of assets

	December 1952	June 1953	August 1954
Life-insurance companies	14.0	13.3	11.2
Savings and loan associations	7.9	8.1	6.8

2. Has the Treasury succeeded in achieving substantial lengthening of maturities? The answer is "No." (Again, I rely on the last published figures, exclusive of the late November refunding.)

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Major changes in Federal securities, 1945–54

[Billion dollars]

	December 1945–December 1952		December 1952–October 1954	
		Percent change		*Percent change*
Short-term bills and certificates	−16.7	−30.0	−0.8	−2
Intermediate notes	+7.5	+33.0	+5.9	+20
Marketable bonds	−40.7	−37.4	+4.4	+6
Nonmarketable bonds	+9.1	+16.0	−.9	−1
Special issues	+19.15	+96.0	+3.1	+8

Source: Federal Reserve Bulletin, November 1954.

In making this comparison we should allow for the fact that the first period covers 7 years, the second only 21 months (one-quarter as long). But it is clear that the Treasury in reducing short-term issues has not been as successful as the previous administration. In fact the short-term issues were 19.8 percent of the debt outstanding in 1945, 14.4 percent at the end of 1952, and 13.5 percent at the end of October 1954. Against this it should be noted in favor of the Treasury that there was a rise in the marketable bonds outstanding (but contrary to objectives, in the hands of banks). But also note the large rise in notes outstanding. The average maturity, however, declined from 10.77 years in 1946 to 6.77 years in 1953; but there was no improvement in 1953.[3]

Finally, the Treasury had to yield on its objective of raising rates. Here it had a large success in the first half of 1953, though unfortunately a success in a mistaken policy; but it had to retrace its steps and help depress rates in 1954. Instead of seeking to issue long-term securities at higher rates of interest, the Treasury now introduced a new policy, and a much improved one: they would not issue long-term securities which might compete with the long-term private issues.

Before the issue of April 1953 of 3¼-percent 30-year bonds, the Treasury had issued a 6-year 2⅜-percent bond in July 1952 and a 5-year 2½-percent bond. The 3¼-percent issue marked a dramatic rise in rates.

Interest rates moved as follows:

	Taxable Treasury bonds		Moody's AAA corporate bonds
Average 1945	2.37		2.83
December 1952	2.75		2.97
	(*a*) 12–20 years	(*b*) 20 years and after	
June 1953	3.09	3.29	3.40

Source: Treasury Bulletin.

It will be noted that whereas the yield of taxable Treasury bonds rose by 0.38 percent in 7 years, 1945 to 1952, aside from the additional rise associated with the rate on long-term bonds, the rise in the 6 months, December 1952 to June 1953, was 0.34 percent, or almost as much as in the preceding 7 years. The later rise in corporate bonds was even more spectacular.

(The following statement was submitted in response to the chairman's invitation to the panelists to extend their remarks in the record.)

SUPPLEMENTARY STATEMENT BY SEYMOUR E. HARRIS

On the invitation of Senator Flanders, I make the following comments (unfortunately, I have not had the time to prepare an additional statement promised in my written evidence):

1. I emphasize again that what monetary policy can do in a depression is distinctly limited. But in a boom more may be attained. Hence I suggest that

[3] CED, Managing the Federal Debt, 1954, p. 10.

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excess reserves should be increased. Not as much as Dr. Clark proposed, but at least enough to increase purchases of assets. If the banks then purchase more Government securities, they will then move on to other assets as the price of Government securities rises; that is, the return declines. But what of the stock market? asks Senator Goldwater. The market may be rising too much. If this is so by all means deal with the market directly. Why are margins 50 percent now?

2. I stress again the point that continued rises of output are likely to mean some inflation. Bottlenecks, wage inflation, other factors raising short-period real costs are relevant. In periods of 15 million unemployed or even 4 million, the effect of rising output is likely to be some increase of prices—more in the latter condition. Those responsible for policy have to weigh the gains against the losses. Our objective should be growth and stability; but we are likely to be confronted with some inflation as we grow. I doubt that any fiscal or monetary policy of 1955 vintage will stop the small but steady inflation except at the expense of material unemployment. Is it worth the risk?

3. Then note that the major expansion of loaning assets by far in 1952–53 and 1953–54 (fiscal years) was made by noncommercial banks—not really under Federal Reserve control. They saved us from a much greater recession—and saved us from excessive caution of the monetary and Treasury authorities.

4. Much was said about the importance of the rate of interest. Mr. Wilde argued it did not matter; Mr. Smutny that it did. In my opinion, it depends. It is important for long-term contracts (e. g., housing) and can be decisive when there is not too much pessimism around (e. g., 1954–55).

5. Indeed, as Professor Chandler says, monetary policy should not be used to correct structural maladjustments. But it is also well to remember that structural maladjustments are associated with price-cost relationships. And when prices exceed costs (in, say, slightly inflationary periods) the same industries that would have been considered structurally maladjusted now become adjusted.

Senator FLANDERS. You did well, Professor Harris, and we appreciate it.

The next speaker is Mr. James Land, senior vice president of the Mellon National Bank & Trust Co. of Pittsburgh.

Mr. Land.

STATEMENT OF JAMES N. LAND, SENIOR VICE PRESIDENT, MELLON NATIONAL BANK & TRUST CO., PITTSBURGH, PA.

Mr. LAND. Monetary policy since mid-1952 has made significant contributions to economic stability.

It is clear that the measures of monetary restraint taken in the latter part of 1952 and the first part of 1953 had a retarding effect on the volume of residential construction, and it is equally clear that the policy of active ease in the money market which was initiated in June 1953 has stimulated residential construction.

In the field of State and local public construction, there have been somewhat similar results. Some projects were postponed or delayed during the period of relatively tight money because of the difficulty of financing under the conditions then prevailing. The advent of easier and more readily available money turned the tide the other way and the volume of State and local public construction is now rising at a faster rate.

Money conditions also probably influenced the timing of business expenditures for new plant and equipment, although to a lesser extent than in the case of residential and public construction.

In these various areas of the economy, particularly in residential construction, monetary regulations cut something off the peak of the boom which culminated in the spring of 1953 and helped to some extent to fill in the succeeding valley.

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Twenty years ago easy money was largely ineffective in stimulating business. Water was put before the horse, but the horse would not drink.

This time the horse has been drinking.

Throughout the recent period of changing business conditions, commodity prices on the whole have been unusually stable. Monetary regulation undoubtedly contributed to this stability.

Those who are directing monetary and related fiscal policy are entitled to a large measure of satisfaction over the results they have been able to achieve through the application of such policy.

From the standpoint of the future, however, there is cause for grave concern in some of the difficulties which were encountered in applying a policy of monetary restraint.

In its efforts to acquire greater freedom to restrain monetary expansion, the Federal Reserve, late in 1952 and during the first several months of 1953, modified its policies with respect to United States Government securities, seeking only to prevent disorderly markets rather than to maintain orderly markets. Among other things, it abandoned the practice it had previously followed of assisting in the United States Treasury's refunding operations by bidding a small premium in the market for each maturing issue (other than bills) and exchanging all of the securities so purchased for the new refunding issue.

The Treasury was confronted with several large refunding operations in the latter part of 1952 and the first part of 1953 and in addition it had to raise a considerable amount of cash. This financing was accomplished under increasingly difficult conditions, reflected in declining prices for Government securities, including new issues.

The relative aloofness of the Federal Reserve, the record over several months of new issues successively selling below their issue prices and the prospect of heavy seasonal deficit financing by the Treasury combined to produce on the 1st day of June 1953 a near panic in the Government securities market. It was only with considerable difficulty that the Treasury was able to sell an issue of bills on that date. In part the market disturbance was an overreaction by the public to various policy statements made by Federal Reserve and Treasury officials in preceding months. The public would have had a better balanced viewpoint if it had attached more importance to the fact that the Federal Reserve had begun to buy moderate amounts of Government securities in May 1953.

The unfortunate events of June 1, 1953, made drastic action necessary, and this took the form of heavy open-market purchases of Treasury bills by the Federal Reserve during June, followed in July by reductions in the percentage reserve requirements of member banks. In early July the Treasury was able to sell quite successfully a certificate issue of nearly $6 billion.

The change in Federal Reserve policy which was made largely under the compulsion of the crisis of June 1, 1953, coincided fairly closely with a downturn in business, and this made continuation of an easy money policy appropriate.

But suppose the boom had gone on unabated. Would the Federal Reserve have been able to reinstate an adequately effective policy of monetary restraint? I doubt that it would, in view of the con-

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tinuing large financing needs of the Treasury. In my opinion, the events which culminated on June 1, 1953, indicate that monetary regulation by the Federal Reserve must be to a very substantial extent the prisoner of the Treasury's necessities when the Treasury is compelled to engage in large and frequent operations to refund maturities and finance deficits.

It is cause for satisfaction that the present Treasury administration regards lengthening of the debt as one of its primary objectives. The issues which it has put out for this purpose have been limited largely to the 2½- to 9-year range, but refundings of this character can accomplish a great deal in the way of reducing the number of maturities per annum.

We have apparently learned to use the accelerator of easy money quite successfully. What we now need to do is to create the conditions under which the brake of monetary restraint can be more successfully applied in the future when appropriate.

If we use the accelerator too much, and the brake not enough, we shall drift into renewed inflation.

Senator FLANDERS. Thank you, Mr. Land.

Now we have C. Clyde Mitchell, Jr., chairman of the department of agricultural economics at the University of Nebraska, in Lincoln.

I may remark that the University of Nebraska has a wonderful collection of elephant fossils, and if anyone is driving through Lincoln, Nebr., I urge them to stop and see two things:

One is the wonderful State capitol, built without debt, and the other is that marvelous collection of elephant fossils.

They show the growth of the elephants in the first period of a kind of a long-nosed thing which apparently grubbed in the mud in the Nile Delta, up to the present magnificent specimens which now roam the earth.

Now we will return to our order of the day.

Senator DOUGLAS. Mr. Chairman, would you forgive a question. I have not had the privilege of inspecting this collection of elephant fossils, but do they show the reason for the decline and disappearance of the elephant from North America?

Senator FLANDERS. They, sir, give no untrue record of history.

Mr. MITCHELL. We suspect it is the Nebraska winter, Senator Douglas.

Senator FLANDERS. Now, Mr. Mitchell.

STATEMENT OF C. CLYDE MITCHELL, JR., CHAIRMAN, DEPARTMENT OF AGRICULTURAL ECONOMICS, UNIVERSITY OF NEBRASKA, LINCOLN, NEBR.

Mr. MITCHELL. In agriculture the American ideal of the expanding, prosperous economy is failing in the most obvious fashion. Monetary policy of the past 3 years must bear a great deal of the blame. While objecting to the restrictive monetary policy of the immediate past, however, I desire to expand my objections to a broader subject—the economic theory of which monetary policy is only a part——

Senator FLANDERS. Excuse me just a moment. I note that yours is one of the longer presentations.

Mr. MITCHELL. You can trust me, Senator, to keep it to 10 minutes.

Senator FLANDERS. I am sure I can trust anyone from Nebraska.

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Mr. MITCHELL. Thank you.

Continuing my statement: I desire to expand my objections to a broader subject—the economic theory of which monetary policy is only a part—concepts accepted by the Federal Reserve Board and the administration—concepts of capital formation and economic growth which are entirely unsuited to our Nation.

If America intends to make a national policy of full-employment work, we are going to have to revise some widely accepted but highly unrealistic ideas about our economic system. One of them is a belief that underlies all the opinions presented by the Federal Reserve and Treasury officials, a belief that something called the free market rate of interest should be a major factor in determining when and how much our Nation should expand its economic growth.

Monetary policy is too important to be entrusted to the market. There are three good reasons for this statement, either one of which would be sufficient to justify it. In the first place, it is quite certain that the real world does not fulfill the conditions necessary to create the type of free market in which the traditional economic theory would have meaning; the theory, that is, of capital formation through prior saving and its regulation through the interest rate. There is thus no valid justification in economics for preferring the so-called free price rather than a controlled price for capital funds.

In the second place, the traditional idea that a modern nation's capital-goods expansion is brought about through prior saving is incorrect, both in theory and in the actual history of modern civilization. In truth, for society to plan and govern its capital formation in essential lines, and to set whatever rates of rental it desires for such funds, are completely sensible politico-economic behavior.

Third, we have discovered, particularly since 1951, that whenever we attempt to use the so-called indirect methods of control on capital formation, they either do not work or work badly. This is particularly true with regard to agriculture. National welfare demands that there be made available to agriculture within the next few years, at low interest rates, very large increments of capital funds. Other industries whose rapid capital growth is also essential are in the same position. These essential industries should not have been penalized with higher interest and curtailed fund availability in the past 3 years, and should not in the foreseeable future.

To develop these arguments in any detail would require far more time than is at my disposal. In this brief argument and in the longer paper you have before you, therefore, I am devoting major attention to arguments that seem to me to have been not so often presented.

Last February, before this committee, I objected to the administration's proposal for agriculture on the grounds that it was based on unrealistic economic theory and that it was not designed to fulfill the responsibilities placed upon the administration by the term of section 2 of the Employment Act of 1946.

My criticism of our Nation's monetary policy since the accord of 1951 follows identical lines. This policy has been based on the same incorrect economic reasoning and likewise is not consistent with the aims of an expanding economy.

The accord of 1951 placed the power of decision over an important factor of economic growth in the hands of men and institutions

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devoted to the belief that there is something deeply significant and valuable in the way the price of rented money is set in the market. This belief led these men and these institutions to take action which struck hard at two classes of citizens—farmers, and low- to middle-income home builders. The excuse for this widely advertised hard money policy was twofold: (1) that we were in an inflationary period, (2) that the so-called indirect methods, particularly those resulting in across-the-board curtailment of investment funds and in higher interest, are the best way to slow down inflation. Underlying these two was the implicit assumption that inflation is unquestionably something we must prevent.

I should like to object to these two excuses and to the underlying assumption:

(1) Whether we were in an inflationary period or merely a period of healthy prosperity consistent with reasonably full employment is a highly debatable subject. The definition of the terms "prosperity" and "controlled inflation" are practically indentical. People who would benefit from a stable or falling price level considered the situation inflationary, whereas people who would benefit from reasonably full employment and a generally bullish economy considered it healthy prosperity. Certainly for agriculture, the past 3 years have brought severe losses. Farmers will never agree with administration spokesmen that we have, to use their words "shifted from unsustainable inflation to stability." For farmers, the shift has been from moderate prosperity to depression. There is no other word that can describe a drop of 14 percent in net income from 1951 to 1954 (from 14.5 to 12.5 billion dollars).

(2) My objection to the second excuse (that "indirect methods" should be used) is one with which your committee is familiar; I shall merely summarize it. Indirect methods to control capital formation work badly, bearing particularly hard upon some of the most essential and "conservative" industries in society, for example, farming and home construction. For our Nation to follow an expanding-economy goal and carry out the ambitious terms of the Employment Act demands that interest rates for capital-goods formation in worthy industries remain at low level, preferably trending downward, but certainly never rising.

If speculative and too-rapid capital formation in certain lines ever needs to be curbed, for example, the building of race tracks, Mr. Chairman, let it be curbed by direct means, such as materials rationing, instalment-credit curbs, and other selective controls. On the developmental side, capital funds for the things which America urgently needs may often have to be directed positively and selectively. This is consistent with the social and economic planning which is normal in our complex society. That capital funds for such essential purposes should be rationed through the supposed impersonal operation of something called the free-price system is not an inevitable, nor even a necessary rule of our society. Yet our present national monetary policy assumes, first, that ours is a free-price regulated economy and, second, that interest, the price for which money is rented, must be set by the impersonal market.

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I suggest that we look at the world around us—that we recognize that through political action our society itself decides (or condones the decision by various private groups) upon many prices and production decisions—perhaps most of them. Our general policy—if there be one—is something like this: We leave many decisions to private interests, of course, but we do so not because of any basic trust in the "natural laws" which force private interests to decide correctly. We do so mainly because most of these decisions left to private interests do not impress us as being important enough, or the private controls obnoxious enough, to warrant intervention.

Whenever society decides that intervention is necessary in any case, there is no valid appeal from this decision, certainly not to anybody of absolute principles with which economics can supply us.

Whenever we are faced with a serious situation that demands the creation of new capital goods, we create those goods. Whenever institutional rearrangements are necessary, to print money or expand credit to aid in construction, we make them. Because our Nation, and indeed all modern technological civilizations, always have a great deal of underutilized capacity within them, even in wartime, this can customarily be done with little or no increase in prices.

In the material in appendix I, below, I suggest that the process of capital growth in our economy, and particularly in agriculture, needs to be understood and used in the national interest to achieve planned expansion of our economy.

I object also to the underlying assumption that inflation must always be prevented. There are two main types of inflation: (1) That with rather full employment, as in the United States during recent periods, and (2) that with unemployment—like the Chinese type. I take it for granted that most economists now recognize that the only type we could have in this country is the former, the best answer to which always lies in increasing production, and in increasing capital funds available to the specific lines in which production must be most rapidly increased.

It is unfortunate that the same word, "inflation," is also used to describe the wild price flight that takes place when the technological productive capacity of a country has been wrecked by physical means. Most economic textbooks, failing to recognize the reasons for the Chinese type, imply that it will come about as an inevitable result of letting the United States type "go too far." Nothing could be further from the truth.

The only plausible objection to the full-employment type of inflation in this country is that it can bring about changes in the distributive shares going to various classes of our people, particularly upsetting to persons and institutions on pensions and other fixed incomes. I have discussed this problem at greater length in appendix II, below. I can summarize by saying that our society, if it decides that mild, controlled inflation is a safer policy for implementing the Employment Act than rigid price stability, is perfectly capable of handling the problems such a policy creates, including the problems that prosperity creates for fixed-income classes.

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(The unread portion of the statement submitted by Mr. Mitchell is as follows:)

APPENDIX I. THE ROLE OF CREDIT IN AN EXPANDING ECONOMY, WITH PARTICULAR REFERENCE TO AGRICULTURAL CREDIT

I. SUMMARY OF THIS APPENDIX

1. Economic progress in welfare terms (goods and services), is assumed to be the goal toward which social planning is directed. The United States has expressed in the Employment Act of 1946 the intention to pursue a course of economic progress in an expanding economy.

2. Such progress will continue to result, as it has in the past, mainly from the association of more (and more efficient) capital equipment with the factors of labor and management.

3. Productive credit assists in bringing about that association (of more capital equipment with the labor and management factors). Availability and use of credit which facilitates the creation of more capital equipment is therefore a condition of progress.

4. Serious deficiency in credit availability to various people engaged in agriculture is one important factor standing in the way of efficient production. If the United States is successfully to maintain an expanding economy, these deficiencies must be made up rather rapidly.

5. Tentative suggestions are made in this article that new and different methods of supplying credit to agricultural producers will be needed in the next few years. These methods at first glance appear to be radically different from those employed by agricultural credit institutions, particularly before 1933. They are different from those envisioned in traditional economic theory which frowns on capital goods accretion in the absence of prior moneysaving. However, a closer examination indicates that with regard to capital goods formation: (1) the areas of the American economy which have made the most progress have benefited from considerable cultural fiat and social action with regard to production credit, and (2) the traditional theory of capital goods formation contains basic logical faults and probably never deserved the adherence of economists in the first place. In short, it is possible that these suggestions are realistic rather than radical and involve only the extension to agriculture of ideas long accepted in industrial production.

6. More rapid progress in the field of agricultural capital formation will probably result from social action programs additional to and of a more comprehensive nature than have been tried in the past 20 years. Methods should be found to establish competent farm producers in a well-equipped productive operation at the time in their lives at which it is most likely that they will be able to produce efficiently.

7. If plans along the lines of these suggestions are put into effect, they will change the nature of the obligations which the farm producer owes to the rest of the community. A tentative exploration is made in this article into the nature of these changes.

II. A SHORT EXCURSION INTO TRADITIONAL IDEAS OF CAPITAL GOODS FORMATION

A. Robinson Crusoe and his fish net

The earliest economic thinkers were impressed with the way in which division of labor and specialization could increase the production of any group of workers dramatically, beyond that amount the workers might contrive without specialization. These theorists recognized the influence of capital goods upon increased productive efficiency, and correctly reasoned that an increase in the production of capital goods was a necessary condition of economic progress. For various reasons, the fathers of economic thought devoted far less attention to the technological conditions of capital goods creation than they did to economic conditions, rather narrowly defined. In the famous story of Robinson Crusoe, who built a fish net to increase his haul of fish beyond the amounts he could catch with his bare hands, theory took what is perhaps a wrong turn. In order to feed himself while he spent 2 or 3 weeks weaving the net, Crusoe first needed a supply of food. He saved berries. Saving thus appeared to the theorists to be necessary prior to the construction of capital goods.

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B. Capital goods formation limited by savings

From this interpretation of fishing technology grew the idea that capital goods formation is limited by money savings. Basic to the theory of capital goods formation are the assumptions of the logical system in which capital goods formation is only one part: The laissez-faire system of distribution, in which prices serve as the directing force for economic decisions and bring about both efficiency in production and equity in distribution of the products of man's work. These assumptions can be summarized in the phrase "perfect competition in a perfect market," and include, subsidiarily, mobility of factors of production, and the economic man.

Given these assumptions, in a free society, full and efficient employment of all factors of production would be assured as if by an unseen hand. For society to progress, new capital goods needed to be introduced into the system. Such introductions could be made only by those who could save money. Capital goods formation was therefore conceived to be limited by moneysaving. Moneysavers were changed from the usurious devils of a slightly earlier age into benefactors of society, by the writings of Adam Smith and his followers.

C. Forced savings

If money means benefaction, then could a ruler, by printing a great deal of money, become a great benefactor? For a long time the people in charge of printing paper money have been intrigued by the tremendous power in the finger with which they push the starting button of the printing press. It appeared that at a motion of this finger they could bring into being great warships, buildings, dams, highways, and national monuments. But simple intelligence convinced almost everyone that such magic could not possibly be true; that these impressive accomplishments were the product of artisans and laborers and engineers rather than the button-pushers in the printshop.

In fact, the button-pushers, toiling not and sweating not, were deemed to be a rather irresponsible crew in aspiring to perform magic feats. Economic logicians took pains to point out the danger of letting the printing-press operators direct such important human activities as calling forth warships and buildings. Given the assumptions of the economic system which the theoreticians believed described our world, of course, the printing-press operators were positively dangerous. Although they might print money which called forth in the construction of capital goods, their action took the entire matter of saving out of the hands of those fortunate members of society who could save, and forced everyone, particularly the poor people, to save whether they wanted to or not, or whether they could spare anything from their meager existence or not. The printing-press money forced savings by pushing prices up, particularly of the things that the poor people have to buy. This early discovery that money printing might get new industries built was therefore never given adequate study because it was almost from the start believed to be irresponsible and sinful.

D. Capital goods formation in an underemployed economy

However, the theoreticians discovered that in the real world, money can sometimes be printed and put into circulation to build new capital equipment without raising prices or forcing anyone to save. This can happen whenever there are resources which are not being fully utilized in the economy. If the amount of underutilized resources is large, governments can print large amounts of money, or credit-creating institutions can create large amounts of credit, and large amounts of new capital goods can be built, using the slack resources.

The admission by present-day economists educated in the classical tradition that it is possible to bring about the creation of new capital goods by social action (printing money or expanding credit) without prior moneysaving by capitalists and without forced saving by consumers generally, points out a serious limitation in the usefulness of traditional theory. It constitutes an admission that society, acting through laws and other institutional factors, can direct our economy and do it well. Society can do it better in the real world, from a goods and services standpoint, that the automatic and impersonal forces of price and competition which (by the theoreticians at least) have been depended upon for 200 years. The theoreticians excuse themselves by admitting that the real world exhibits underemployment of resources, which the theoretical world ruled out. However, a few modern economists are reexamining the original idea, and ask if the building of the first fish net did not itself require underemployed resources. How did Robinson Crusoe manager to store up enough

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berries for his 3 weeks of net-making? He must have lived in a surplus-producing area—a partially underemployed economy. In a society fulfilling rigorously the assumptions of the classical theory, it is entirely possible that there never could have been any capital-goods creation. It is probable that in every society, everywhere, enough underemployed resources exist (or can be freed by adoption of new techniques) to allow great amounts of progress through social redirection of resources.[1]

E. Capital formation by social dictate

Whether or not we believe that the theory of capital-goods formation through prior-savings was faulty from its beginning, most economists today acknowledge that society quite properly engages in the process of dictating a great part of the capital-goods formation that now takes place.

Whenever our society makes the decision that certain things must imperatively be built, those things are built, whether or not anyone had previously saved enough money to build them. The wartime expansion of our Nation's capital equipment is an excellent example, of course. The doubling of capital equipment in the last 15 years has occurred mainly because of social direction. That social direction included the creation of funds, the allocation of scarce materials, Government construction of plants, guaranteed or supported prices, preferential tax treatment, and many other similar measures. An exact measurement is impossible of the extent to which America's capital goods have increased due directly and indirectly to social action. The chief economist with a large American corporation argued that I was wrong, in an article I wrote in 1953 in which I said that "more than half, and perhaps almost all" of America's doubling of capital goods has occurred because of social action. He conceded the war plants had been built with RFC and other direct Federal money, but concluded that the balance, much more than half, was expansion from private funds. But that misses the point. Those private funds, profits of American business, were as large as they were because of definite decisions made by the American people. The decision to fight the war and to build war-related industry was a social decision. Once that decision had been made, most profits became automatically guaranteed for some years to come, not only in the war industries but also in all the less- and non-essential industries. Practically all of these industries enjoyed the most tremendous prosperity they had ever known. Savings from the net profits of private corporations did of course finance a great deal of the growth, but most of these net profits resulted directly from social decisions completely outside of the realm of a society governed by the laissez-faire doctrine.

There can be no doubt that a great deal of such net profits resulted from the existence of patents, trade-marks, price fixing, and other modifications of pure competition which society has decreed or acquiesced in. There can be no doubt that rapid tax writeoffs, coupled with the fact that the Government directly influences about one-fourth of the total income flow in the Nation, now guarantee business stability at a high-profit level for much of the so-called private enterprise sector. I should like to repeat my 1953 statement to which the aforementioned business economist objected: "The doubling of capital equipment that has taken place in the past 14 years has occurred very greatly (more than half, and perhaps almost all) because of the creation of funds beyond the amounts saved by capitalists, and certainly beyond the amounts capitalists could have saved had our economy been competitive in the classical sense." In other words, the funds for capital-goods creation were funds created by society, or allowed to be created because society has not thought it wise to force business to be classically competitive. In other words, the United States has through social programs directly created or has underwritten the creation of most of our capital goods. The effect of this great increase in capital equipment has been a tremendous increase in physical productivity, in goods and services, of the American economy. The results are undoubtedly better, in the physical-productivity sense, than a purely competitive society could have achieved.

III. THE CHANGING RATIO OF CAPITAL VALUE TO LABOR IN THE 20TH CENTURY

During the course of the industrial development of modern society, the money investment in capital equipment per worker has of course increased greatly. The average cost of capital equipment associated with each worker in American industry is more than $10,000; it is almost twice this amount in railroads and utilities.

[1] A better understanding of these factors can enable us to do a more realistic job in aiding the underdeveloped areas of the world to industrialize themselves.

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Investment in capital goods per worker has increased greatly in the past half century as the size and complexity of industrial operations have increased. The worlds of finance and industry have long been organized in such a way as to provide these large amounts of capital equipment without requiring either the laborer or the entrepreneur to make prior savings of large amounts of money funds. Indeed it is almost an axiom of business that new industrial enterprises be started with little or no money. (The entrepreneurs are expected to have production ability, but even that is not necessary—engineers can be hired.) Promotional ability is perhaps the main requisite to starting industrial enterprises, and on so precarious a basis (in the technological sense) funds are raised from investors. The promoters usually receive no-value common stock for their promotional efforts; the cost of physical plant and working funds are supplied by investors in preferred stocks and bonds. Competent studies, such as were made by Berle and Means and others, have shown that complete control, i. e. ownership of all common stocks, of America's largest industries was achieved with an investment of only about 7 percent of the real construction cost of the industries—the other 93 percent was furnished by investors who received securities bearing little or no right of control over the industries.

Great physical performance of the American industrial system has characterized past years, and profitable financial performance has characterized most of them. These two factors have adequately justified the optimistic hopes of an institutional system that permits entrepreneurs and laborers with ideas and abilities, but without money, to associate themselves with thousands of dollars worth of capital equipment during the best and most productive periods of their lives. To take the different course suggested by Robinson Crusoe economics would be unthinkable—to require an industrial entrepreneur to work up the ladder from a common laborer to a skilled laborer to a small backyard shop to a larger shop to a small factory to a larger factory, buying the more expensive equipment in each case from the money savings he had made by abstaining from spending part of his income in the prior stage. He would be senile before he had saved the price of one forging hammer.

America's Horatio Alger folklore to the contrary notwithstanding, that is not the way an industrial economy makes progress.

Progress is made because society has made a complex chain of decisions, some legal, some institutional, which bring entrepreneurs and workmen together to work, during the most productive period of their lives, with capital goods which society has decreed shall be created.

Modern societies have learned, though most elementary economics texts avoid this fact, that economic growth is self-financing. As the conservative London Economist editorialized, in discussing the "lessons of the war," we have learned that "anything that is possible physically is possible financially." This is true because in modern societies, there are always rather highly flexible elements of underemployment of many resources, even in the times of greatest emergency, and further because when banks and governments create funds the prospect of economic growth so increases property values as to justify the creation of the funds.

Of course a recognition of this process does not mean that governments or banks can safely create money by whim. If the new money is not matched by real physical growth and productivity increase, inflation results. In some cases of forced-draft increases, as in war, considerable effort must be expended in areas of stress by controlling some prices, allocating some materials, and altering some of labor's mobility. However, the generalization is a safe one that our technological ability to increase our capital equipment (and therefore our productivity) makes it possible for us to finance the increases. This is the exact reverse of the teaching of traditional economics.

Acceptance of this more modern way of looking at the problem of progress and growth underlies the Employment Act of 1946. That act expresses with the highest ceremony possible in our society, formal act of Congress signed by the President, and implemented by a top-rank professional staff, that we have to a large extent adopted a new theory of economic development, that we as a sovereign Nation will do whatever is necessary to maintain an expanding, growing economy.

IV. CAPITAL GOODS FOR AMERICAN AGRICULTURE IN THE FUTURE

If this is a realistic picture of the changed and more realistic explanation of the tremendous technological progress made in the Western World, and in the United States in particular, to what extent has agriculture shared in these

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changed concepts? As compared with industry, agriculture has shared very little. This generalization is not intended to belittle the great significance of the social action programs of the last 20 years. Price supports, incentive payments, farm credit at reasonable rates, supervised credit of FSA-FHA, road building and the REA's—all of these have helped many farm producers to adopt new methods, invest in new capital equipment, and greatly increase their productivity. However, as between industry and agriculture, with regard to their ability to do an adequate job of meeting the challenge of an expanding economy for the next 2 or 3 decades, the gap is still great. In considering how to improve the physical efficiency and productivity of America's farms in the future, I should like to direct attention to some new methods of expanding the amount of capital equipment available to farmers.[2]

Agriculture is the main residual area in which the "save first before building" idea prevails. Twenty years of social and political concern with the farm problem has partially changed this idea, but in the main too many people still think that there is an agricultural ladder, and that the task of climbing it need not be materially eased by Government.

I submit that the same general type of technological and financial revolution that has brought our industrial society to the place it is today needs to take place in agriculture.

On the most successful farms the physical revolution has already taken place. The farm that can support a family in decent middle-class living now requires an investment of more than $40,000. About the maximum that a farmer can borrow for such an enterprise, without parental or other family assistance, is 50 percent. Raising $20,000, or even $10,000, is a difficult matter for most American farmers. For the young farmer it is usually impossible.

To improve agricultural productive efficiency for the America of the future will require that methods be found to enable competent farm producers to associate themselves with adequate capital equipment early in life, when their vigor and ambition are highest.

As in the case of industrial America, the association should prove successful. A farmer who can thus associate himself should ordinarily achieve physical productivity high enough to pay his initial loan off within about 20 years. In such cases, the increased productivity has amply justified the loan. If, however, the prevailing farm-finance pattern of today is continued, those 20 years of highest physical ability must often be partially wasted on inadequate and ill-equipped farm enterprises.

V. IF SOCIETY TAKES A HAND

American planners should consider whether or not we should participate in the process of making capital funds available to increase farming efficiency in an expanding economy to an extent beyond anything contemplated in present laws and institutions. To this end, capital funds up to 90 or 100 percent may need to be supplied to farmers who give evidence of being good entrepreneurs. Implicit in this proposal is, of course, the proposal that some measure of competence be devised and applied to applicants for funds.[3]

Much of the new investment funds thus made available would be from sources outside of agriculture. Whether the loans come from private financial institutions, private institutions with Government guaranties, or Government lending agencies, they will inevitably be more impersonal than is customary in present farmer-country banker relationships. Outside credit will probably require, and probably should receive, considerable guarantee of stability, as far as interest and principal payments are concerned. This stability feature in industry has been important in the wide acceptance of the principal of outsiders furnishing capital funds. If the principle is extended to agriculture, income stability of farmers becomes a very important factor. Incomes in agriculture need to be made more stable from two standpoints: (1) The quality of the entrepreneural decisions needs to be kept high to insure productive efficiency on the individual farm, and (2) farm incomes need to be stabilized to avoid great variations.

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[2] Although "equity" to farm people in access to social capital is important, productive efficiency is the matter here under consideration.

[3] Lest this be considered too radical a departure from American practice, we should remember that society through both public and private action has often furnished 100 percent of the capital funds required by promoters to set up new industries. These promoters very often would not have been able to give even a fraction of the evidence of technical ability that we have customarily required for the smallest rehabilitation loan of the Farmers Home Administration.

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If society takes a hand in the provision of capital funds for agriculture, it will undoubtedly demand a hand in the selection of the farm enterpreneurs and in periodic examination to see how they are discharging their stewardship.[4]

Furthermore, if society takes a hand in the selection and examination of farm enterpreneurs, we will need to devote considerable study and understanding to the problem of keeping social participation democratically responsive and maintaining the greatest possible decentralization of authority and freedom of action of the individuals concerned.

Finally, if society decides to take a hand in such matters, it will have to safeguard itself from possible adverse consequences of its action. For example, stability in land prices and proper land use would undoubtedly need to be achieved through legal action—otherwise easing of agricultural credit could result in wild bidding up of land prices, or land might be ill used for one short-run purpose when social considerations would require it to be used differently for long-run conservation ends.

CONCLUSION TO APPENDIX I

If agricultural productive efficiency is to keep up with the demands of our expanding economy, entirely new arrangements must be devised for providing capital funds to farm operators. The point has been made here that the prospects for growth justify the creation of capital funds by the Government and by banks, in much the same manner as the capital funds have been created for America's industrial growth. Both the amount of funds created and the interest rate charged for the rent of these funds are subjects for social decision. There is no valid reason for letting either of them fluctuate adversely as long as capital growth is needed in important industries.

APPENDIX II. PRICE STABILITY AS A GOAL?

We economists are almost all honest men; we all are sincere in our quest for roughly the same goals (adequate production, decent income, and maximum possible individual freedom); why is it then that we arrive at such widely different recommendations? One of the main reasons is that we start with completely different assumptions as to the nature of man and society, and we inevitably arrive at different answers. For example, if we start with an assumption that is implicit in the work of most American economists that prices are the proper governor for most economic decisions, the conclusion is bound to follow that a policy which promises more price freedom at any point is always better than a policy which promises less. This is a common feeling of economists, whether they are discussing farm prices or the price at which money is loaned. I think it is only fair to point out that even though the overwhelming majority of professional economists probably believe such things, they are not true.[5] In our complex society decisions are made under the influence of a number of forces other than price; most of the prices which show up as a part of America's economic transactions are themselves influenced by forces which are either modifications or violations of, or excluded by definition from, the free market as it must be defined by traditional economic theory.

American political reality has agreed with the foregoing analysis as to the factors that should influence economic production and distribution for many decades—not just since 1933. The economists have ordinarily disagreed. Who has been more nearly right, the American governmental processes, or the economists? Economists should at least keep their minds open. The prima facie case for a self-regulated society whose major activities are directed by free market prices has been wrecked both by logic and by experience.

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[4] In industry, society has in some cases demanded such a hand, and in some cases not. SEC regulations, public-utility regulations, wage-and-hour laws, and hundreds of other welfare measures are examples of society taking a direct hand in management. An indirect hand is taken in the many cases in which some businesses are assisted, others inhibited, by tariffs, patents, and various other oligopoly positions allowed or condoned by society.

[5] Most of the economists have invested many years of their lives in learning the analytical tools of the pure competitive, laissez-faire, price-regulated economic system. They are undoubtedly swayed by the fact that retooling would be so costly for themselves that it would be personally cheaper for them to try to change the rules under which the American economic system operates. Furthermore, the alternative tools of the more realistic socio-politico-economic theories are usually ill regarded by economists—they are full of inexactness, psychology, sociology, political science, and other social ideas not nearly so clean and sharp as economics, which deals precisely with prices and quantities and uses calculus and geometry. So most economists prefer to hold on to the beautifully embellished but highly unrealistic theory based on the free-market assumptions.

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Another questionable assumption most economic writers make is to assume that our national economic policy should be aimed at price stability. Again we find that economists and America have disagreed for well over a hundred years. America's political activities are influenced to a great extent by segments and groups in our population, some inflationary in their demands, some deflationary. In general, farmers, laborers, and entrepreneurs have been in the former category; in the latter have been white-collar workers, pensioners, and annuitants, both individuals and institutions whose wealth or income was measured in fixed dollar amounts.[6]

Any time a discussion of American policy begins with the assumption that a stable price level is a major goal of society, it is bound to conclude that any policy that does not work against inflation is an incorrect policy. Yet it is quite possible that America's physical production increases most dramatically in times of controlled but nevertheless continual mild inflation, with tremendous increments of created capital funds pumped into the system at specific points. Certainly the inflationist idea wins in the political arena every time it is clearly presented. The 85 percent of our people (approximately)[7] included in the segments which seem to prefer a little bit of inflation have in recent years been able (aided by the overriding urgency of depression and war) to stack the deck sometimes against the 15 percent who would have profited by stability or deflation.[8] Again, we must face the question: Who is right, the majority of the economists or the majority of the American people?

Of course, stacking the deck against the 15 percent is to be regretted. There have been various practical suggestions in their behalf. For example, school teachers and other future pensioners are now encouraged to put half their savings into common stocks and real property. Some people suggest that insurance companies should do the same. (None of these suggestions is helpful to low-income people who have no savings aside from their interest in retirement or social-security funds.)

Some economists nowadays sincerely believe that to attempt to maintain a stable price level is potentially very dangerous to our economy, and that the welfare of the 85 percent should not be tied inflexibly to a stability fetish to guarantee the purchasing power of bonds and retirement funds owned by the smaller group. The case for controlled inflation has not yet been proved, of course. A number of great problems (in addition to those of the endowed universities and pensioners) remains to be solved. But the case against controlled inflation has not been proved either.

In the stable-price economy beloved by the traditional economists, private decisions would govern where to, whether to, and how fast to expand America's industrial economy. It is ordinarily admitted by such economists that periods of stagnation and contraction might occur; but freedom from socialistic control has always assumed to be a benefit sufficient to offset a growth rate considerably below the feasible and desirable. If we intend to keep America fully employed, it is my opinion that we should maintain a slightly bullish pressure on price levels. This, interestingly enough, will probably make governmental intervention in capital growth less necessary, simply because it should minimize the occurrence of the types of crisis in which the Government is called on "to do something." There are numerous other good reasons for this expansive policy; for example, foreign trade expansion probably depends on it—imports will be received in America with far less business anguish in times of steady upward movements.

Even in an economy of controlled inflation, a large amount of decision making as to investment will nevertheless be retained in private hands. However, the total of all investment decision making will be kept expansionist, led by easy credit and such incentives as rapid tax writeoffs in specified lines, and pushed by Government contracts. In a stable-price economy, reluctant, nonexpansive corporate managers feel they cannot be badly hurt because of their reluctance, and might, if depression ensues, prove to be men of great wisdom and parsimony. In an economy of controlled inflation, such men are fools, and become less and less important as their neighbors seize the torch of industrial progress and development. The American people have recognized the truly incredible rate

[6] Here, too, we must recognize that economists have a vested interest in the traditional assumption. They customarily fall into one or more of the deflation-oriented groups because of fixed salaries and institutional jobs.

[7] This is, of course, an oversimplification, inasmuch as there are many people who have interests in both categories. Primary interest is the point here, however.

[8] In all modesty, this minority never publicly professes to want anything better than stability.

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at which our industrial economy has developed under controlled inflation. They apparently do not feel that their personal freedoms have suffered too much in the process. When truly great performance is urgently needed, even imperative as in the case of war, there is never a serious question of whether to use controlled inflation; it is only a question of where to set the controls and where to pump in the incentives.

CONCLUSION TO APPENDIX II

At least two factors will press America in peacetime to continue mild inflationism: (1) The belief that the free world must dramatically outproduce the Soviet's rising industrial might; to do this, investment decision making needs a shove toward expansionism comparable in scope with what it got in the war. (2) The acceptance, both popularly and in law (the Employment Act), of the idea that the American economy is badly managed if it does not produce in peacetime for peaceful purposes the expanding volume of goods and services of which three wars have shown us capable.

One of the main—perhaps the main—argument of the Federal Reserve System and the Treasury for raising the general structure of interest rates is that such a policy is required "to fight inflation." This appendix has suggested that these institutions were probably fighting the wrong thing.

Senator FLANDERS. Thank you, sir.

You have kept within the normal time; you have propounded a number of questions which I find it difficult to keep from pursuing myself, but since we have agreed to go through the list, we will wait until later.

The next one in alphabetical order is Mr. Edward S. Shaw, of the Brookings Institution, on leave from Stanford University. Mr. Shaw.

STATEMENT OF EDWARD S. SHAW, THE BROOKINGS INSTITUTION

Mr. SHAW. It would take more courage and wisdom than I can muster to answer question I confidently and explicitly. So I take some comfort from the fact that official answers from the Treasury and the Federal Reserve are neither complete nor quite complimentary. The Treasury view seems to be that restraint was necessary in early 1953 and that the May issue of 3¼ percent bonds was a salutary measure of restraint. I understand the Federal Reserve to say that excess liquidity was removed after April 1951 and that monetary growth balanced real growth until "unduly severe" tensions developed in May 1953. In this view the 3¼ percent issue was a tension that needed offset by a roughly equivalent open-market-buying operation. Neither of these views recurs to the theme of the Council of Economic Advisers, in its report of last January, that signs of impending deflation were evident at the turn of 1952 to 1953.

My own ill-defined impression is that monetary restraint was skillfully balanced against forces of expansion in 1951–52; that monetary and debt restraints were pressed too hard and too long in early 1953; and that subsequent easy finance was at least congenial to the specific pattern taken by the late recovery. It is still too early for the casual observer to guess whether restraint has been renewed too quickly.

The reply of the Federal Reserve to question II is generally very lucid and instructive. I have a single quibble. The reply tells us why changes in legal reserve requirements are a defective instrument of control. It does not tell why so defective an instrument is used so frequently. There must, under some circumstances, be merits to balance the defects.

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One does gain the impression that, in taking so skeptical a view of both variable reserve requirements and operations in long-term securities, our central bank is tending toward an immaculate, high-church, and 19th century view of its responsibilities.

One defect allegedly is that "* * * the results [of a change in requirements] affect simultaneously and immediately all banks in each reserve class." In many instances results so widespread would appear desirable on a money market as extensive as ours. Now that the Federal Reserve has denied itself access to the long-term market, the pervasive effects of change in reserve requirements may be especially valuable.

The large and infrequent changes in reserve ratios, which the Federal Reserve takes to be the result of defects in the instrument, may instead be responsible for those defects. Open-market operations of comparable magnitude can also be a shock to the markets.

Question III and the Federal Reserve's reply to it touch on fundamental issues in central banking theory. The Federal Reserve has made this decision: to deal only on the short end of the market; to lend no support during Treasury operations; to intervene in disorderly markets. The result, it is said, should be to develop a private middlemen's inventory of Government securities that will absorb minor market disturbances. Private enterprise will preserve orderly markets.

Then long rates may vary less in short periods, reducing market risks for all investors in long-term securities. This should mean an improved market for Treasury long debt. Changes in long-term rates should become a more reliable index of changes in the terms of trade between savers and investors and, hence, a more reliable guide for monetary policy. Other advantages to the Federal Reserve may be expected, including a reduction in the turnover of its portfolio.

The Federal Reserve has bowed off on the long market. It will no longer manipulate relative market supplies of long-term and short-term securities. That function passes to the Treasury. The Treasury proposes to push out long securities, at relatively high rates of interest, when excess liquidity is contributing to cyclical boom. It will borrow short, at low rates of interest, when more liquidity may soften a cyclical recession. Debt management is stepping into the market arena from which the Federal Reserve has withdrawn.

The Treasury, with a new look, to be sure, has apparently gained in a new accord, prestige lost in the accord of 1951.

There are disadvantages in this particular way of dividing responsibility between monetary action and debt management which are, after all, different techniques for attaining identical results.

It raises interest costs on the public debt, because long borrowing is done when long borrowing is dear. These extra costs appear to be in part a social cost of reviving the middleman function on the Government security market. The new technique may mean higher costs, too, because the Treasury, without central banking support, may need to put more favorable prices on its long-term issues. Finally, Treasury techniques for managing the rate structure are less agile than central banking techniques, so that the range of fluctuations in rates may not be reduced after all.

In recent years commercial banking has lost ground to other institutional channels for lending and investing. Money has become less

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important among the financial assets that feed inflation. It is being superseded to a degree by savings deposits, savings and loan shares, insurance policies, and other vehicles of saving. Control by direct or indirect means of the institutions that create and issue these media is increasingly vital to economic stability. There has been some reason to believe in recent years that the Federal Reserve was developing indirect controls over nonmonetary financial institutions through its operations in long-term Treasury issues. Now it appears that the Federal Reserve has abandoned the experiment and is limiting its area of responsibility to the traditional commercial banking field.

Comments by the Federal Reserve on question IV and comments in other connections by the Treasury supply a clean-cut statement of national monetary and debt policy. Within the business cycle the range of fluctuation in interest rates is to be increased, by Federal Reserve action to stabilize the money supply and by Treasury policy of refunding on the cyclical rise. Over longer periods, the money supply is to grow along the narrow line that separates inflation from unemployment while the public debt is to be dispersed largely in funded form to investment-type portfolios.

The policy of cyclically variable interest rates is correct if it does not jeopardize the recoveries that constitute economic growth. I object only to refunding when it is most expensive. It should be the central bank, not the Treasury, that sells long-term securities in cyclical recoveries. Refunding ideally should occur in recession when a successful operation, supported by the banking system, can assist in reducing long-term rates of interest.

In response to question V, the Federal Reserve indicates gratification that the money supply did not contract in the recent recession. It traces monetary stability primarily to bank purchases of Government securities and suggests that hereafter the substitution of Government issues for private securities in bank portfolios will brace the money supply against the contractive forces of recession. My own impression is that the money supply held firm in part because the recession has been so mild. Private borrowing at banks continued strong. With incomes still high, the public continued to want large money balances. We should not be surprised in a more decisive recession if the public insists on economy in its cash balances, as it did in 1948–49. Nor should we be worried about a contraction in money balances if it is voluntary on the public's part and if, hence, it coincides with falling interest rates.

Two queries come to mind in connection with the Treasury reply to question VI. First, issue of a 5-year, 10-month bond in February 1953 is said to have been a measure of restraint on inflation, yet issues of comparable maturity in late 1953 are said to have been neutral with respect to Federal Reserve monetary policy. It is not clear why lengthening of the debt is at times a restraint and at other times neutral in the monetary sphere. Second, if the explanation for this anomaly is that the intermediate securities are placed away from banks in booms but in banks during recessions, one wonders whether it is necessary to pay the banks so well for lending capacity that would otherwise be idle.

In general, question VII has elicited a most helpful response from the Treasury. The doctrine officially laid down is a quite remarkable advance over traditional dogma that the only good debt at any time

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is either long or long dead. I wish to question only the Treasury's excessive modesty in claiming that it must cope with a free money market. The bulk of official testimony in these replies has been that the money markets, short and long, are not free and cannot safely be left free. They are the segment of the economy that must be so controlled as to communicate to other segments the signals that inflation or deflation have gone too far. These markets cannot be regarded as free in any important sense when they are managed and manipulated by the instrumentalities of the central bank and the public debt.

The final question barely touches on the fringes of vital and highly disputatious issues. It has to do with a minor aspect of the relationship between banking and government. The maintenance of Treasury balances with commercial banks and the various agency services that the banks perform for the Treasury should be considered in the broader context.

Securities of the Federal Government were over 40 percent of all commercial-bank earning assets in mid-1954. Earnings and sale profits on Government securities approximated 30 percent of member-bank earnings in the first half of 1954, significantly more than enough to cover all taxes on all banking operations. The banks are deep in the business of monetizing public debt, and they are paid well for it. Private assets in their portfolios are sheltered by Government guaranties; excessive competition is restricted by Government authority; expensive services are provided by an independent agency of Government. The banks, in return, provide an efficient payments mechanism and a principal channel for allocation of the community's savings. My judgment is that such minor aspects of bank-Government relationships as are suggested in question VIII cannot be considered judiciously apart from aspects of much deeper significance.

Senator FLANDERS. Thank you, Mr. Shaw.

Our next witness is Mr. Rudolf Smutny, senior partner of Salomon Bros. & Hutzler, New York. I take it, sir, your firm deals actively in Government securities?

Mr. SMUTNY. Mr. Chairman, that is correct.

Senator FLANDERS. Thank you; you may proceed.

STATEMENT OF RUDOLF SMUTNY, SENIOR PARTNER, SALOMON BROS. & HUTZLER

Mr. SMUTNY. I would also like to say, Mr. Chairman, it is the first time in 38 years in Wall Street that I have been called an economist.

My approach to the problems here under discussion is that of the bond dealer who specializes in the institutional investment market, of which United States Treasury obligations constitute so large a part.

The unpegging of Government securities prices in March 1951, was long overdue. Pegged prices, being economically unsound, simply did not work. They destroyed the freedom of the market and made buyers and sellers largely dependent on the Federal Reserve banks. They encouraged some institutional investors to put short-term funds to work in the long-term market. They tended to lodge the initiative in the creation of reserve balances with the holders of Treasury securities, and, as a corollary, to deprive the Reserve authorities from

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exercising their proper influence on the availability and cost of credit.

In the "pegged" market dealers were many times, for all practical purposes, merely messengers. At such times all market decisions rested with the Federal Reserve authorities. "Unpegging" the market restored its freedom of action, and broadened the scope of trading activity.

It seems to me that debt management and credit control policies during the past 2 years have, on the whole, been sound. My only criticism is that, during the transition period in the early part of 1953, the Government bond market was left without even interim token support from the monetary authorities. Moreover, and more important, it was needlessly subjected to many utterances regarding future financing policy which tended to upset market stability. It seems evident, too, that the price decline in Government securities at that time was sharper than was warranted by supply-and-demand factors. For example, during the period January–May 1953 Treasury 2½ percents of 1967–72 declined by 5.8 percent while high-grade corporate bond prices decreased by about 4.875 percent. The sharp break in prices of Government obligations naturally had an unsettling effect on the entire money and capital market.

Fortunately the situation was soon rectified, and from mid-1953 to the present time, the debt management policies of the Treasury and the credit policies of the Federal Reserve have been handled with consummate skill. They have been geared to assist the money and capital markets and to help direct the flow of capital into corporate securities and mortgages so that corporate capital expenditures, and business and residential construction might be stimulated.

While the supply of Government securities is very large, the present demand for long-term Government bonds is not impressive. There is, however, a very strong demand for short-term Government obligations with maturities of not more than 1 year. This is illustrated by the fact that from the beginning of 1954 through the first week in November, 40 major life-insurance companies, the leading institutional investors, purchased United States Treasury bonds to the extent of $360 million, which figure came to only 3.5 percent of their total investments of $10.5 billion. On the other hand, they acquired bills and certificates of indebtedness to an amount of $2,132 million, or 20.3 percent of the total.

The incidence of greatest demand, therefore, is in the short-term market, and a major sector of that market, United States Treasury bills, in the chosen medium in which the Open Market Committee operates to influence the reserves of the member banks, a factor which, from time to time, greatly intensifies demand-supply ratios in this short-term area. So long as the economy is as active as it is today, and building construction continues at a high level, it is doubtful whether institutions, other than banks, will be large investors in long-term Government bonds. Rather, they will endeavor, as in the immediate past, to acquire high-grade bonds and mortgages which afford a better return than that obtainable on United States Government obligations. The fact that, early in 1953, Government bonds decreased considerably in price and that their marketability was materially reduced has also lessened their popularity to some extent.

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However, I believe we should not overlook even a minor opportunity for issuing long-term bonds and lengthening the average maturity of the Federal debt. We know that many smaller institutional investors, such as public and private pension funds, and a wide variety of local governmental and labor-union funds are always in the market for offerings of the highest yielding marketable Treasury security, regardless of maturity. Over the period of time under discussion a moderate amount of long-term bonds could have been placed with such relatively small institutional buyers. And, I think, that had public offerings of even lesser amounts of long bonds been made they would undoubtedly have served to cushion the pronounced price mark-up in the general bond market which has since occurred as a result of the actions of the monetary authorities.

Now I should like to turn to the problem of reserve balances and Open Market Committee operations. The reserve balances of the commercial banks are the basis of our credit system. The most important factors which increase or reduce reserve balances and thus expand or contract credit are: Changes in reserve requirements by the Federal Reserve Board, borrowing by the member banks from the Federal Reserve, and open-market operations by the Federal Reserve banks. Right now, I believe, open-market operations ought to be reexamined in the light of recent experience.

As previously indicated the Federal Reserve banks in conducting open-market operations now deal exclusively in Treasury bills. Now the bill market is one of the most important segments of the money market. Through it financial institutions and industrial corporations provide for their liquidity. Banks must, of necessity, keep a large volume of bills on hand in order to cope with their daily cash swings. Many corporations keep their tax accruals in bills and use them to maintain their liquid assets. As a result of this pressing financial need for short-term paper there is a large and constant demand for Treasury bills. Hence, when the Federal Reserve conducts open-market operations in the bill market it can have a pronounced effect on yields.

This reliance on bills as the sole vehicle for open-market operations is doubtless due to respect for the traditional Anglo-American central banking practice of operating exclusively in "the nearest thing to money"; also, perhaps to a fear of even seeming to sponsor anything remotely resembling the discarded "pegs." However, under present circumstances open-market operations do not appear fully to be achieving the desired objectives. The volume of bank loans has consistently lagged, and the level of bank rates has remained unchanged. Many corporations have cut down on bank loans and built up their emissions of short-term paper. Therefore, when "the nearest thing to money" is in persistent and relatively short supply, and when open-market operations in bills in pursuit of a policy of "active ease" have merely resulted in declines in bill and commercial paper yields while leaving the volume of loans unchanged, it may be surmised that something more than operating in the bill market is needed.

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An arbitrary increase in the supply of bills is not the answer. I think, rather, that it is to be sought in widening the scope of open-market operations to include securities other than Treasury bills. To this end the Federal Reserve should use its authority to buy and sell in the open market Treasury obligations with maturities, in the first instance, of up to 1 year, and should this prove ineffective, after suitable trial, then be authorized to operate up to 3 years. After all, the amount of Treasury securities due within 1 year, other than bills, is far larger than the entire Federal Reserve portfolio of Treasury securities.

I do not believe such a liberalization of open-market operations would do violence to the traditional central banking practice of operating solely in "the nearest thing to money." At the same time it would reduce undue pressure on the bill rate. I think we must all concede that, thus far, the policy of "active ease" has had a much more pronounced effect on the level of bond prices and the yields on short-term paper than it has had on the volume of commercial loans and the level of bank rates. I do not believe that the modest increase in the area of open-market operations here proposed would have any significant effect whatever on the long-term Government market. Certainly it could hardly be construed as a return to the unsound practice of pegging the prices of long-term bonds.

I would like to comment on just one more point, which, while not covered in the questionnaire, is, nevertheless, germane to this discussion. All of us—businessmen, bankers, economists, and public officials—have our jobs to do. We are all concerned, of course, with the overall well-being of the national economy. However, those of us engaged in the rugged competition of private enterprise have to think first of making a living and keeping solvent. We have to keep our eyes on the main objective, and, it must be confessed, the national economy is apt to become a rather remote concern. This is only natural. Nevertheless, I think we would all agree that concern for the well-being of the national economy is not the job of our public officials alone. Our own actions, therefore, ought, at all times, to take into account the public interest in our activities.

It is now amply evident, for example, that committing short-term funds in the long-term Government market did not, in the long run, serve the best interests of all concerned. Turning to more recent events, it now seems apparent that raising the prime rate at a time when conditions in the bond market were extremely critical was not the wisest course of action. I am proud to recall that, at that time, when Treasury 3¼ percents of 1998–78 fell to a discount while still "when issued," we at Salomon Bros. & Hutzler, and many other investment firms as well, ran advertisements in nationally circulated newspapers unequivocally recommending their purchase.

The lesson in recent financial history is clear for all to see. The job of managing the national economy is not solely that of the monetary authorities. It is our job, too. To do it well we must learn to practice the art of financial statesmanship and to conduct our private activities within the moral as well as the legal boundaries set by our public responsibilities.

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(The tables and advertisement referred to in Mr. Smutny's statement follow:)

TABLE I.—*Life-insurance company investments (based on reports from 40 major companies)*

	Year 1954 through week ended Nov. 6	Percent of total
Mortgage loans:		
Farm loans	$274,689,200	2.6
Loans on dwellings and business property	3,370,030,554	32.1
Real estate: Real estate acquired for investment	117,897,175	1.1
Railroad securities:		
Bonds	235,625,813	2.2
Stocks	11,612,312	.1
Public utilities:		
Bonds	861,345,066	8.2
Stocks	220,193,326	2.1
Industrials:		
Bonds	1,733,065,752	16.5
Stocks	86,980,818	.8
Governments:		
U. S. Treasury bonds	361,662,104	3.5
U. S. Treasury bills	2,065,136,032	19.7
U. S. Treasury certificates	67,097,253	.6
U. S. Treasury notes	62,545,477	.6
Canadian Government bonds	108,572,575	1.0
Other foreign governments	16,162,554	.2
State, county, municipal	432,825,176	4.1
Miscellaneous:		
Bonds	458,338,238	4.4
Stocks	25,571,199	.2
Total	10,509,350,424	100.0
Recapitulation:		
Mortgages	3,644,719,754	34.7
Real estate	117,897,175	1.1
Bonds	6,402,375,840	60.9
Stocks	344,357,655	3.3
Total	10,509,350,424	100.0

TABLE II.—*Market yield on Treasury bills percent per annum*

	1953	1954		1953	1954
January	1.96	1.18	July	2.04	.72
February	1.97	.97	August	2.04	.92
March	2.01	1.03	September	1.79	1.01
April	2.19	.96	October	1.38	.98
May	2.16	.76	November	1.44	.....
June	2.11	.64	December	1.60	.....

TABLE III.—*Interest-bearing marketable public debt of the U. S. Government of selected maturities (as of Dec. 15, 1954—000,000)*

	Up to 1 year inclusive of Dec. 15, 1955 (excludes Treasury bills)		Treasury bills		1 to 3 years		3 to 5 years		1 to 5 years	
		Percent		Percent		Percent		Percent		Percent
Treasury bills	.....	.....	$19,509	100.0	.....	.....	.....	.....	.....	.....
Certificates of Indebtedness	$28,382	65.7	.....	.....	.....	.....	.....	.....	.....	.....
Treasury notes	12,218	28.3	.....	.....	[1] $10,063	58.4	$5,728	26.0	[1] $15,791	40.2
Treasury bonds	[2] 2,611	6.0	.....	.....	[2] 7,176	41.6	[2] 16,271	74.0	[2] 23,447	59.8
Total	43,211	100.0	19,509	100.0	17,239	100.0	21,999	100.0	39,238	100.0

[1] Includes 4 issues of 1½ percent notes amounting to $2,911,000,000 of which the Federal Reserve System owns all but about $200,000,000 thereof.
[2] Includes all Treasury bonds with a first redemption date within this period.

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Holdings of U. S. Government securities, including guaranteed securities, of the Federal Reserve banks (as of Nov. 24, 1954—000,000)

	Amount	Percent
Up to 1 year	$15,804	64.4
1 to 5 years	6,321	25.7
5 years and over	2,428	9.9
Total	24,553	100.0

[This advertisement appeared in the New York Times, New York Herald Tribune, the Wall Street Journal, and the New York World-Telegram and Sun on April 20, 1953]

UNITED STATES TREASURY

3¼-PERCENT BONDS, DUE JUNE 15, 1983

(noncallable prior to June 15, 1978)

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We recommend that holders of Series F and G United States Savings Bonds, maturing this year, exchange them for the new United States Treasury 3¼-Percent Bonds. This exchange privilege expires April 30, 1953.

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Mr. SMUTNY. Mr. Chairman, I would like to request that my detailed answers to the eight questions be made a permanent part of the record.

Senator FLANDERS. Thank you, sir.

(The answers previously referred to follow:)

ANSWERS BY RUDOLF SMUTNY, SENIOR PARTNER, SALOMON BROS. & HUTZLER, TO THE QUESTIONS PROPOUNDED BY THE SUBCOMMITTEE ON ECONOMIC STABILIZATION OF THE JOINT COMMITTEE ON THE ECONOMIC REPORT OF THE CONGRESS OF THE UNITED STATES

1. What role did monetary policy play in the period of relative stability following the Treasury-Federal Reserve accord in 1951, in the months of boom late in 1952 and early in 1953, and in the recession of 1953–54?

Answer: The 1951 accord between the Treasury and the Federal Reserve System paved the way for the effective employment of monetary policy, first, to combat the threat of further inflation; second, to promote economic stability; and third, to head off unduly deflationary tendencies in the economy. Pegged prices for Government bonds had a number of undesirable effects. They encouraged commitment of short-term funds in the long-term market. They promoted monetization of long-term debt, thus adding to inflationary trends. They tended to lodge the initiative in the creation of reserve balances with the holders of Treasury obligations rather than with the Federal Reserve authorities. They helped to make economic policy unwarrantedly subservient to Treasury finance. They deprived the market of freedom of action.

At the time of the accord we were still in a shooting war in Korea, and our economy was under severe pressure. Not only was there a considerable demand for goods and manpower on the part of the Federal Government for building up the Nation's defenses, but there was also a strong demand for capital and labor from the private sector of the economy to meet civilian requirements as well as to construct defense plants. After the outbreak of the Korean war wholesale prices rose by 17 percent from June 1950 to March 1951.

For a few months following the accord the Federal Reserve policy continued to be one of restraint. Thereafter, however, the policy might be termed one of

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neutrality, since the authorities realized that to restrict the availability of bank credit might interfere with defense efforts. Approximately the same policy was followed by the Federal Reserve during 1952.

Toward the end of 1952, and particularly in the early part of 1953, the policies of the Reserve authorities underwent a considerable change. The policy of neutrality was again changed to one of restraint. In January 1953 the discount rate was raised from 1¾ to 2 percent, the first change in nearly 2½ years. Member-bank indebtedness increased from a general level of under $500 million in the first half of 1952 to over a billion dollars in the second half of 1952 and the first few months of 1953. These changes were accompanied by a considerable increase in money rates and a correspondingly sharp decline in prices of Government securities. The Treasury bill rate on new issues rose from 1.78 percent in October to 2.13 percent in December and 2.23 percent in June 1953. The price of the 2½-percent Victory bonds witnessed a decline of 5.8 percent from the end of 1952 to the begining of June 1953, one of the sharpest drops on record.

The credit policy followed by the Federal Reserve also led to a decline in the availability of bank credit. As the member banks became more heavily indebted to the Reserve banks, they became more hesitant to extend credit. Coupled with aggressive borrowing by the Treasury in active competition with private borrowers, this had a decided effect on the capital market. Rates of interest on mortgages increased. FHA-insured mortgages sold at substantial discounts and the flow of capital into private securities and mortgages was reduced.

While it is my opinion that the Federal Reserve authorities and the Treasury went perhaps a little too far and too fast in restraining credit expansion, their objectives were achieved. The forces of inflation were brought to a halt by the middle of 1953. This experience seems to demonstrate that if interest rates go high enough, and portfolio depreciation in financial institutions becomes sufficiently severe, inflationary booms can be halted.

When the Federal Reserve and the Treasury realized that the inflationary forces had run their course and that some deflationary pressures were becoming apparent, their policies were quickly changed. Member bank reserve requirements were lowered in July 1953 and again a year later. Open-market purchases were carried out on a large scale, with the result that holdings of Government securities of the Federal Reserve banks increased by over $2 billion from April to December 1953. Excess reserves increased by $333 million from the end of April 1953 to the end of April 1954 and by $656 million to the end of September. Prices of Government obligations, long term as well as short term, increased considerably. The Treasury restricted its borrowing and refunding operations to securities which did not compete with private borrowers, and hence stimulated the flow of funds into the building industry and capital investments by corporations.

While, of course, other factors and governmental measures also played an important role, the changed credit- and debt-management policies of the Reserve authorities and the Treasury contributed materially to the fact that the readjustment, despite the decline of $4.6 billion in national-security expenditures in fiscal 1954 and a reduction of $4 billion in business inventories in 1 year, did not go very far. The index of industrial production decreased by 10 percent from its peak in July 1953 to the lowest point reached in 1954. Unemployment did not exceed 3,725,000. Commodity prices, on the whole, remained stable and disposable personal income actually increased.

The credit policies of the Reserve authorities and the debt-management policy of the Treasury, from the middle of 1953 to the present time, have been skillfully handled. Reserve requirement changes have been used sparingly and banks have been encouraged to use their discount privileges freely. In so doing they have apparently been brought into direct touch with Federal Reserve thinking concerning general economic conditions and the banking policy appropriate to such conditions. If any criticism is to be made, it is that the change in policy in 1953 might have taken place a month or two earlier, and that some intervention by the monetary authorities in the Government bond market would have prevented such a drastic decline as took place.

2. How has the emphasis in the use of monetary instruments changed during the period since mid-1952? For example, how have the various instruments—open market operations, discount rates, and administration of discount operations, and reserve requirements—been used under varying conditions? Has there been any reliance on moral suasion during this period?

Answer. All the credit instruments at the disposal of the Reserve authorities have been used during the period since mid-1952. However, increasing use has been made of the discount mechanism, while open-market operations have been

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used less actively. Similarly, changes in Reserve requirements were used only to supplement the policy of ease in 1953 and 1954.

In the early part of 1953, when inflationary pressures were rather strong, the Federal Reserve followed a policy of restraint. It made net sales of $900 million of Government securities in the first 3 months and raised the discount rate to 2 percent. During this period, considerable reliance was placed on moral suasion. Various utterances were made by high officials of the Federal Reserve System and the Treasury, all of which tended to depress the Government bond market and to curb the willingness of the banks to extend credit.

In my opinion, the moral suasion, if anything, went too far, and at times did more harm than good. If any lesson is to be learned from the experience of the early part of 1953, it is that the Federal Reserve and the Treasury should rely more on action and less on pronouncements. The actions can be studied and their consequences ascertained. The utterances are at times enigmatic in character and may be—and often are—misinterpreted.

The moment the inflationary pressures began to disappear and signs of an economic decline set in, the credit and debt management policies of the authorities underwent a considerable change. Reserve requirements were lowered in July 1953 and also in June-August 1954. The Reserve banks began to buy large amounts of Treasury bills in the open market, thereby enabling the member banks not only to repay their indebtedness to the Reserve banks but also to increase their excess reserves materially.

Since the middle of 1953 the policies of the Reserve authorities and of the Treasury have been handled with skill, and both have contributed materially to the stability of the economy.

3. What is the practical significance of shifting policy emphasis from the view of maintaining orderly conditions to the view of correcting disorderly situations in the security market? What were the considerations leading the Open Market Committee to confine its operations to the short end of the market (not including correction of disorderly markets)? What has been the experience with operations under this decision?

Answer: So long as the policy of the Reserve authorities was to maintain orderly conditions in the Government bond market, dealers and investors more or less knew what actions to anticipate on the part of the Federal Reserve. So far, nobody in authority has described what the term "correcting disorderly situations" means. The fact of the matter is that the Reserve banks have not intervened in the market for quite some time. Even in the first half of 1953, when prices of Government bonds declined sharply and their marketability was materially reduced, the authorities did not find it advisable to intervene. Apparently, they did not consider the Government bond market disorderly at that time. It would be helpful if some explanation were to be forthcoming from the monetary authorities as to what comprises a disorderly situation in the bond market.

Although the Federal Reserve Board in its annual reports makes public the deliberations of the Open Market Committee, it is extremely difficult for an outsider to analyze the considerations which led the Committee to confine its operations to the short end of the market. This answer can best be given by those responsible for the decision.

The experience with operations under this decision, in my opinion, has not been entirely satisfactory. As I stated in my opening statement to the committee, the policy of the Federal Open Market Committee of operating only in Treasury bills has caused bills to fluctuate widely at times, and has induced corporations to turn more to the commercial paper market than formerly, which has not helped to increase the volume of loans. Because the bill rate has fluctuated so extensively, bills have become a less desirable investment instrument for corporations, institutional investors and banks. This has also tended to reduce the earnings of the commercial banks. While it is evident that Federal Reserve policy should not concern itself with earnings of member banks, it must be borne in mind that the cost of doing business for banks has increased considerably and that a sound banking system is essential to the Nation's economy. The large commercial banks, in particular, play an important role in the money and capital markets.

The operations in bills imply that consideration about total bank reserves is sufficient; it does not recognize that such open-market operations have a magnified impact initially on a limited number of the (larger) banks, particularly those in New York City. Geographical differences are ignored, as well as differences between bank and nonbank buyers and sellers.

Since, in my opinion, the experience with Federal Reserve open-market operations confined exclusively to Treasury bills has not been satisfactory, I believe that the Federal Open Market Committee should be given the power to operate in all

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Treasury obligations with, in the first instance, a maturity up to 1 year and then, if need be, up to 3 years. This would have a stabilizing effect not only on Treasury bills but also on the entire financial market. It would enable the Reserve banks to assist the Treasury more effectively, if necessary, in its refunding and borrowing operations.

4. What is the policy with respect to the volume of money?

Answer: As far as I can judge, from the point of view of an investment house actively engaged in the money and capital markets, the supply of money is ample. Since the middle of 1953, the Reserve authorities have followed a consistent policy of providing the member banks with adequate reserves to enable them to meet all the legitimate requirements of industry and trade and the Government. Money rates, on the whole, are easy. With the exception of fluctuations brought about by the flow of funds and the movement of gold and currency, money rates have been relatively low and have stimulated the flotation of a large volume of tax-exempt securities, as well as the sale of mortgages.

5. Has monetary machinery (*a*) worked flexibly, and (*b*) has the market demonstrated flexibility in its responses to changes in policy? For example, how has the policy of active ease been reflected in the level and structure of interest rates, the volume of credit, and the roles of various types of lenders?

Answer: The policies of the Reserve authorities and the Treasury have been highly flexible. During the first few months after the accord, and again in the latter part of 1952 and the first half of 1953, measures were taken to tighten the money market and to reduce the availability of bank credit. These measures were reflected fairly promptly in the movement of interest rates, as may be seen from the following figures.

Movement of money rates and bond yields, January 1951–June 1953

[Percent]

	Treasury bills (new issues)	Prime commercial paper (4–6 months)	Long-term Government's (2½'s)
1951—January	1.39	1.86	2.39
April	1.52	2.13	2.56
July	1.59	2.31	2.63
October	1.61	2.21	2.61
1952—January	1.69	2.38	2.74
April	1.62	2.35	2.64
July	1.82	2.31	2.61
October	1.78	2.31	2.74
1953—January	2.04	2.31	2.80
April	2.18	2.44	2.97
May	2.20	2.68	3.09
June	2.23	2.75	3.09

During the middle of 1953, the policies underwent a change and were directed toward easing the money market. The lowering of reserve requirements and Federal Reserve open-market purchases increased materially the volume of excess reserves. Money rates went down, as may be seen from the following figures:

Movement of money rates and bond yields, June 1953–October 1954

[Percent]

	Treasury bills (new issues)	Prime commercial paper (4–6 months)	Long-term Government's (2½'s)
1953—June	2.23	2.75	3.09
August	2.09	2.75	3.00
October	1.40	2.55	2.83
December	1.63	2.25	2.79
1954—January	1.21	2.13	2.68
March	1.05	2.00	2.51
May	.78	1.59	2.52
July	.71	1.43	2.47
September	1.01	1.31	2.51
October	1.03	1.31	2.52

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Lower interest rates and increased availability of bank credit, as well as the changed debt-management policy of the Treasury, have had a favorable effect on the capital market. The volume of securities offered, particularly tax-exempts, has increased considerably, the mortgage market has improved, and lower interest rates on mortgages have helped to stimulate building activity.

6. Has the debt-management policy of the Treasury—both as to objectives and techniques—been consistent with the monetary policy of the Federal Reserve throughout the period since mid-1952?

Answer: The debt-management policy of the Treasury has been closely coordinated with the policies of the Reserve authorities. For example, when the policy was one of restraint, the Treasury cooperated by floating longer term issues (to mid-1953). Later, when active ease was desired, the Treasury shortened its new issues and made them more attractive to banks, thus aiding an increase in the money supply. The use of tax-anticipation series reduced the impact of seasonal changes in tax receipts on the money market.

Up to the middle of 1953 both were endeavoring, to the best of their ability, to tighten money. Since the middle of 1953 the policies of both have been geared to make money easy and to stimulate the flow of capital into corporate securities and mortgages. The cooperation between the Treasury and the Reserve authorities seems to have been carefully thought out and well handled. However, I do think greater boldness in the issuance of long-term bonds, such as the Treasury 3¼s, might well have been consistently undertaken. As a general thing, whenever a change in any matter of policy is contemplated, there is always a temptation to avoid action on the plea that "the time is not ripe." Since the end of the war there have been several periods during which truly long-term Treasury bonds could have been issued. Even during the period of time since mid-1953 the Treasury could, at each financing period, have offered a basket of issues which included, in each instance, a long-term bond whose dollar amount could have been left to the discretion of the market place.

Doubtless there would have been very little interest in such a long bond on the part of commercial banks, savings banks, and insurance companies. But pension funds, both public and private, and a wide variety of local governmental and labor-union funds are always in the market for offerings of the highest yielding marketable Treasury security, regardless of maturity, and it is conceivable that, over a period of time, a moderately large amount of long-term bonds could thus have been marketed. In addition, if such offerings had been made, a psychological check on the pronounced markup in the general level of bond prices which has since occurred would have been set. Violent swings in the bond market are not beneficial to overall economic stability and impose, besides, undesirable burdens on the long-term institutional investor.

7. What considerations should dictate the maturity distribution schedule of the Federal debt—first, as to the long-run ideal to be pursued; and, second, as a practical operating matter—giving weight to timing and contemporary conditions?

Answer: The long-run ideal in maturity distribution of the Federal debt would be, briefly, as follows: To have an adequate amount of bills and certificates outstanding to meet the liquidity requirements of the economy; to have an adequate amount of Government obligations with a maturity of 1 to 10 years to meet the needs of investors who desire to space their maturities; and, finally, to have a considerable amount of long-term securities primarily in the hands of ultimate investors, such as individuals, corporations, pension funds, and insurance companies. Because the Federal debt was increased so rapidly during the war, the existing maturity distribution leaves a great deal to be desired. Debt management is a very complicated affair, however, and has to be handled with extreme care. The problem should not be approached with preconceived notions or the desire to establish ideal conditions within a short time.

Debt management has an important effect on the flow of capital into corporate securities as well as into mortgages. The supply of capital is limited to the savings of the people, unless, of course, it is desired to monetize the debt, which is unsound and leads to inflation. Since the Federal debt is very large and the amount of marketable securities coming due within 1 year totals about $60 billion, it is evident that if the Treasury were willing to pay a high enough rate of interest it could preempt all the savings of the Nation. Obviously, such a policy would be undesirable and unsound.

The debt-management policy must be tailored to prevailing economic conditions. In periods when industry is not operating at capacity and there is more than normal unemployment, the Treasury in its refunding operations should not

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compete with other borrowers for long-term funds. It should leave the capital market to private borrowers and political subdivisions. When private borrowers, such as industrial corporations, home builders, and the construction industry in general, borrow money, they use it for purposes which stimulate the economy. The same is true of borrowing by States and local governments for public works. When the Treasury, on the other hand, refunds matured or called obligations into long-term bonds, it merely mops up that amount of capital without favorably influencing the economy.

The short-term money market is usually the cheapest and most easily accessible source of funds. In principle, as far as the public debt is concerned, it would be desirable to keep it free for emergency needs, and for the execution of depression fighting financial strategy, as, for example, when the Federal budget is deliberately unbalanced in an effort to maintain or to stimulate economic activity.

Under existing conditions it would seem advisable for the Treasury to offer some long-term bonds as previously indicated. That is, a moderate amount to meet the requirements of State pension funds, labor-union funds, and smaller institutional investors, whose investments consist largely of Government securities. At present, private investors, and especially institutional investors, are more interested in obtaining a higher yield than prevails on Government securities, or, in buying tax-exempt obligations. The debt-management policy of the Treasury, particularly as regards efforts to lengthen maturities and to reduce the volume of the floating debt, must therefore be handled with great care and must be based on existing conditions and not on preconceived theories.

8. Are the benefits and costs to commercial banks of handling Government transactions clear enough, or can they be made clearer, to determine whether or not the banking system is being excessively compensated or undercompensated? What about the Treasury cash balance—its size and management? Should the Government receive interest on its deposits with commercial banks?

Answer: It is difficult for a noncommercial banker to make an authoritative statement as to whether the banking system is being excessively compensated or undercompensated. It seems clear, however, that the banks are rendering many services to the Treasury for which they are not being compensated. I might mention, for example, the handling of E, F, G, and H bonds, which involves a great deal of labor and which the banks are cheerfully doing as a patriotic duty. Also, the banks have been in the forefront in most bond drives and have otherwise rendered valuable services to the Treasury.

In view of the magnitude of the Federal budget, the Treasury should have a working balance of about $5 billion in order to be in a comfortable position. A large cash balance can be used to assist monetary policy. For example, it can ease the strain of heavy tax payments. Or, its manipulation can reenforce a contraction, for example, by shifting idle balances from commercial banks to the Federal Reserve. If there is a temporary monetary stringency, a large cash balance would enable the Treasury to postpone new financing until conditions improved.

It would not be advisable for the commercial banks to pay interest to the Government on its deposits. By the Banking Act of 1933 the commercial banks were prohibited from paying interest on demand deposits. This was done in order to avoid keen competition for deposits among the banks through the payment of higher and higher interest rates, which past experience indicated had had an adverse effect on banking policies and bank lending and investing activities. It would be unfortunate, indeed, if legislation were to be passed to enable the Treasury to obtain interest on demand deposits. This might lead to a renewal of the unsound practices which existed prior to 1933. In view of the large number of services rendered by the commercial banks to the Treasury, the insistence that the banks pay interest on Government deposits would undoubtedly have an adverse effect on their relationship.

There are other arguments opposing interest on deposits: One is that of favoritism, that the Government would be given better treatment than other demand depositors. Second, a cost-minded Treasury might be tempted to keep a maximum of funds with the bank to earn the interest, drawing them out just after payment days, instead of gradually as required. This would make for wide swings in bank reserves, especially at interest-payment days. And, at the same time, the banks' costs will have risen, since its interest payments to depositors (the Government) will be higher.

In my opinion, therefore, it would be unsound for the Treasury to require that it be paid interest on its deposits with the commercial banks.

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Senator FLANDERS. Our next witness—I may say that all of you have cooperated in making your brief presentations.

Our next witness is Mr. Wilde, Frazar B. Wilde, president of the Connecticut General Life Insurance Co.

I am interested to note, Mr. Wilde, that you are in a present office or position which I once held myself, as Chairman of the Research and Policy Committee of the Committee for Economic Development.

STATEMENT OF FRAZAR B. WILDE, PRESIDENT, CONNECTICUT GENERAL LIFE INSURANCE CO., AND CHAIRMAN, RESEARCH AND POLICY COMMITTEE, COMMITTEE FOR ECONOMIC DEVELOPMENT

Mr. WILDE. Mr. Chairman, I feel honored to try to be in your position, because I am not an economist, and I do not think that the work of our complicated civilization which we are now trying to run, is such that any one of us has enough knowledge to carry out on our own, so with the committee's permission I wish to make a brief statement with respect to this paper.

I have tried to make the following points: First, that a flexible monetary policy is useful and constructive and is within the general interest if it is operated by a central bank, and that bank is free to use its individual judgment.

I have said that I believe that a flexible monetary policy helps, and it has always helped in fighting inflation, and it can function in restraining unhealthy moves.

It has an equally valuable positive function in that it enables an increase of the money supply in proportion to legitimate growth demands of industry, trade, and commerce.

It is my opinion that the Nation could use a flexible monetary policy as an important instrument in contributing to our objectives of growth and high levels of employment without inflation, but this does not mean that we should place our sole reliance on monetary policy.

A given situation will require several measures, but a flexible monetary policy is important for at least three reasons. First, its timing is more flexible. This would contrast particularly with budget policy. Now, I feel that budget policy is an important part of any program for the prevention of inflation as a deterrent to sound growth. But there are political and economic obstacles to excessive reliance on budget surpluses as a means of controlling inflation. Monetary policy is the most sensitive and flexible instrument, and I do not believe that an adequate anti-inflation program is possible without it.

Second, as compared with direct controls or with selective measures, monetary policy has the merit of being a general, overall, impersonal instrument and, as a matter of fact, direct controls are not likely to be available except and save in time of war, and I think are an inferior instrument, even if they were available, and I do not understand the confidence that some of our panel members have if our country would permit select measures or direct controls, if they were to have this good instrument.

Thirdly, I believe that our recent experience with a flexible, two-sided monetary policy has been most encouraging and justifies its continuation; and I think we have demonstrated that monetary policy

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can be of assistance in the development of a healthy boom, and without developing serious consequences.

In my opinion, the most important consequences of a flexible monetary policy are its effects upon the stability and growth of the economy. Monetary policy should not only attempt to counter the short-term inflationary and deflationary movements, but should gear the money supply to our long-run growth potential; and, I believe, therefore, that the policy should be judged in terms of these important effects and not in terms of who gets or who pays higher or lower interest rates.

As a matter of fact, it is exceedingly hard to trace the income distribution effects of a rise of interest rates and to make any judgment as to the desirability of these effects. There are a number of reasons for it.

First, the initial payers or receivers of interest are, for the most part, not the ultimate payers or receivers. The large financial institutions which receive interest as payments represent millions of depositors and policyholders; in other words, we are dealing with literally millions of people who are both debtors and creditors at the same time, which is a relatively new economic development in this country.

On the other hand, corporations and governments which pay interest represent millions of customers and taxpayers. You cannot trace and be dogmatic about who receives and who pays.

Now, secondly, the alternative to higher interest rates is not simply lower interest rates, but lower interest rates on a larger volume of credit. Interest rates are kept from rising when demand is active by an expansion of the volume of credit. It is not clear that financial institutions would earn more from higher rates than from lower rates on a larger volume. I make that point because there is an apparent belief on the part of some students that institutions are always narrowly and selfishly concerned with high rates as being more profitable. That is not necessarily true.

Third, along with higher interest rates usually go losses on capital accounts, that is, the market prices of investments decline. The net effect of this would vary for different investors.

In general, the net distributional effects of higher or lower interest rates are so diffuse and uncertain that they could not be a major factor in deciding upon monetary policy.

In my paper I have belabored inflation, urged that we should concentrate at all times on stability and upward growth instead of taking undue risks with inflation.

Now, that may be a personal bias, but I am always alarmed at the relaxation of my friends, many of whom, perhaps, may be skillful enough to take temporary advantage of inflationary conditions, but I read the history of the world, and I look at countries like France, which have capable people, who have great national resources, and the continual inflation of a country like that is one of the major deterrents to its growth. It cannot get capital for capital expansion which they need, when people have no confidence in the future value of the money.

I may be biased because of the fact that my business sells money for future delivery, and to me it is a pretty wicked thing to consider the possibility that people will make present sacrifices for future protection, and then get dollars of much lower value.

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I am not talking about this country going into an extreme inflation, but I am talking about the continuous erosion, deterioration that can happen if we adopt what to me might be reckless monetary and fiscal policies.

I think it is quite unfair for large groups of the population, because it does lead to booms and busts of employment, with human suffering and money losses, which unemployment causes, and I am quite unable to be relaxed and optimistic about expansion with mild inflation as being a sound and safe thing to do.

I have developed the theme that the difficulty with providing flexible monetary policy is because there is quite a lack of public understanding of how it is and how it can best function. The history of the last few years to me is evidence of the great use of monetary policy and accompanying extensive criticisms.

It requires a combination of at least three major elements: Favorable, friendly, optimistic environment; sound, constructive fiscal policy; flexible, healthy monetary credit and debt management policy. These are the ultimates which in combination can lead to a steady growth which the country desires, and which we believe it can have.

I do say that this growth should be upward progressively; it cannot be in a straight line without any fluctuation. It will go above a straight line of growth and progress, and we will dip below it if we are going to have a free society, and I do not want to have a society that is entirely regulated and planned, because I do not think it is either good judgment or in the American spirit.

That is the end of my remarks.

(The prepared statement of Frazar B. Wilde is as follows:)

FLEXIBLE MONETARY POLICY AND INFLATION—STATEMENT SUBMITTED BY FRAZAR B. WILDE, PRESIDENT, CONNECTICUT GENERAL LIFE INSURANCE CO., HARTFORD, CONN., AND CHAIRMAN, RESEARCH AND POLICY COMMITTEE, COMMITTEE FOR ECONOMIC DEVELOPMENT

My name is Frazar B. Wilde. I am president of Connecticut General Life Insurance Co., Hartford, Conn.

The views expressed in this testimony are my own, and are based on some 20 years of experience in the management of an insurance company portfolio as well as a bank trustee. In addition to my business experience I have been for some years active in the work of the Committee for Economic Development, a nonprofit organization of businessmen conducting research on economic problems. Currently I am chairman of the research and policy committee of the CED. I have distributed to the members of your subcommittee copies of two policy statements that our committee has issued on the subjects of the present hearing. I do want to make it clear, however, that I am appearing today, in response to your invitation, as an individual and not attempting to register the considered current position of CED, which can only be done through its formal papers.

A central bank which recognizes its responsibility to contribute to economic stability and growth, and carries out its duty by following a flexible monetary policy, is bound to be unpopular. Many of the reasons for this are unrelated to the merits of a flexible policy as such. This is the climate in which any inquiry into central banking operations is inevitably conducted. If any useful results are to come out of such an inquiry, we must at the outset take this climate into consideration.

The principal reasons for this unpopularity are obvious, and yet are constantly forgotten by the critics. The most important of these arise out of the occasional need for restraining action on the part of a central bank.

Even those who accept a flexible monetary policy in principle frequently object in practice, when restraint is the order of the day. Since people do not like to be restrained, and since they seldom agree on the correct timing and on the extent

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of credit restriction, even though they accept the idea in theory, we find our monetary authorities generally in hot water. The sound direction of a flexible monetary policy is always handicapped and troubled by basic human emotional characteristics.

The second reason arising out of the occasional need for restraint is that some do not believe in the use of a restraining monetary policy at any time. They question the effectiveness and the appropriateness of combating inflationary pressures by the use of general monetary and credit restraints and prefer other instruments. They feel that relatively low interest rates are appropriate under all conditions.

A third reason for the underlying unpopularity of a central bank is that a large part of the public finds monetary matters difficult to understand and is either indifferent to or confused about them. At any rate, it is easily swayed by the propagandist, whether he is the businessman or the politician.

A fourth reason is a historical tendency on the part of many groups in this country to distrust and to criticize banks and banking. By tradition, bankers are a convenient scapegoat.

For all of these reasons it is difficult to make a rational evaluation of central banking operations. We should remember too that it is even more difficult, in such an atmosphere, for a central bank to carry out successfully a flexible monetary policy. Unfair and excessive criticism is never conducive to good administration.

As a result, the central bank's imposition of restraint is in practice almost universally criticized and its expansion of the money supply, while more generally accepted, is often condemned as too little and too late. The unfortunate thing is that a good deal of such criticism comes from persons who believe implicitly in the theoretical virtues of a flexible monetary policy. Too often the practical result of these conflicts is an excessive reliance on easy money.

I. THE UNPOPULARITY OF RESTRAINT: 1950–51

A striking illustration of this principle—in terms of debt management as well as of central banking practices—appeared in the fall of 1950 and the early spring of 1951. By that time there was increasing criticism of the Treasury and Federal Reserve, who were collaborating at the insistence of the administration in maintaining pegged prices for Government bonds. While there was good reason to believe that the Federal Reserve, recognizing inflationary dangers, had wished to discontinue the practice at an earlier date, no important action had been taken up to the end of 1950. The majority of those who understood the crippling effect upon the Federal Reserve of maintaining a pegged Government securities market were in agreement that this practice should be discontinued. The Federal Reserve has a major role in contributing to the maintenance of a sound and growing economy, and fixed prices for Government bonds, which might have been justified during wartime, were wholly unwarranted 5 years after the war.

Those who believed that fixed prices should be maintained included several groups. There were those partisans who felt that to change this policy was a direct criticism of the administration. There were others who felt that low interest rates per se were desirable regardless of the actual and potential danger of inflation they created. Few, if any, who understood the true function of central banking and the need for freedom in operations, and certainly none who had respect for sound money, wanted the support program continued.

At long last, in March of 1951, an accord was reached permitting flexibility in Government bond prices. This involved some retreat in prices. Immediately there was a hue and cry, and it didn't all come from politicians.

The purchaser of a marketable bond, whether an individual or an institution, must be willing to accept the fact that in a free, capitalistic economy, security prices are certain to fluctuate. When there has been a heavy demand for investment funds or bank loans relative to supply, interest rates are bound to increase and bond prices must reflect this situation, other things being equal, by going lower.

Many buyers of Government securities had forgotten that this fluctuation is normal. They had been spoiled by the abnormal wartime condition of pegged prices which had existed for a long time. They grew to think that par and, in many cases, a premium over par was the natural price for their securities. This attitude is difficult to understand—in fact, quite incomprehensible—as to institutions whose buyers certainly know, or should know, the history of the market place. It is easier to understand in the case of individuals with little experience

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in bond buying; but these, for the most part, were not the persons involved. The unsophisticated investor usually held E-bonds or some other nonmarketable security which did not fluctuate in price.

Many seasoned investors were most vociferous, particularly after the end of the war, in contending that in a free economy fixed prices and price supports should be abandoned everywhere. Then when the fixed price for bonds was withdrawn, some of these same people expressed dismay and unhappiness that it should happen to them and their institutions.

The fact is that many people who should have supported a flexible monetary policy, even if it affected their own institutions, failed to do so. This episode is an excellent example of the way in which human nature tends to resist, even against the arguments of reason, any restraining pressure on the economy.

II. THE CASE FOR A FLEXIBLE MONETARY POLICY

In my opinion the Nation should view a flexible monetary policy as a principal instrument for contributing to our objectives of economic growth and high levels of employment without inflation.

This does not mean that we should place sole reliance upon monetary policy. Any given situation will require a complex of measures. But a flexible monetary policy is an important and especially valuable instrument in our kit of tools for at least three reasons.

First, its timing is more flexible. This is especially true as compared with budget policy. I would certainly agree that budget policy should be an important part of any program for the prevention of inflation. But there are political and economic obstacles to excessive reliance upon budget surpluses as a means of restraining inflation. Monetary policy is the most sensitive and flexible instrument and I do not believe that an adequate anti-inflation program is possible without it.

Second, as compared with direct controls, or with selective measures, monetary policy has the merit of being a general, overall, impersonal instrument. As a matter of fact, direct controls are not likely to be available except in wartime, and would be an inferior instrument even if available.

Third, I believe that our recent experience with a flexible, two-sided monetary policy has been promising and warrants continuation.

In my opinion the most important consequences of a flexible monetary policy are its effects upon the stability and growth of the economy. Monetary policy should not only attempt to counter the short-term inflationary and deflationary movements, but should gear the money supply to our long-run growth potential. I believe therefore that the policy should be judged in terms of these important effects and not in terms of who gets or who pays higher or lower interest rates. As a matter of fact, it is exceedingly hard to trace the income distribution effects of a rise of interest rates and to make any judgment as to the desirability of the effects. There are several reasons for this.

First, the initial payers or receivers of interest are for the most part not the ultimate payers or receivers. The large financial institutions which receive interest represent millions of depositors and policyholders. On the other hand, the corporations and governments which pay interest represent millions of customers and taxpayers. We do not know who ultimately receives or who pays.

Second, the alternative to higher interest rates is not simply lower interest rates, but lower interest rates on a larger volume of credit. Interest rates are kept from rising when demand is active by an expansion of the volume of credit. It is not clear that financial institutions would earn more from higher rates than from lower rates on a larger volume.

Third, along with higher interest rates usually go losses on capital accounts, that is, the market prices of investments decline. The net effect of this would vary for different investors.

In general, the net distributional effects of higher or lower interest rates are so diffuse and uncertain that they could not be a major factor in deciding upon monetary policy.

III. A FLEXIBLE MONETARY POLICY IN PRACTICE

How has a flexible monetary policy worked? The first 6 months of 1953 provide a spectacular illustration combining both the techniques of debt management and the operations of our central banking system.

As many read the signs, the economy was giving definite evidence of boom in the closing months of 1952 and early spring of 1953. The demand for funds for permanent capital and for inventory accumulation was sharply accelerated.

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Demand for residential and commercial mortgage funds, for municipal funds, and for consumer credit was pyramiding. The situation required the central banking authorities to refrain from adding to the credit supply. Their duty was clear. If boom and bust was to be avoided or mitigated through banking procedures, this was a time to let the borrowers compete for whatever credit was in existence, rather than to expand credit, no matter how vociferous the demand. Some would have said that sharp restrictions of credit were in order. The authorities lived up to their responsibilities. They restrained expansion of the credit base and, because the demand was far greater than current resources, money and credit became scarce, and interest rates increased as a matter of course.

During this period, in furtherance of sound debt management policy—namely to lengthen the debt—the Treasury offered a long-term obligation. In order to assure the success of this issue, it was necessary because of market conditions to place a 3¼ percent coupon on the bond.

In April and May, and running into June, the demands for capital and credit increased. Potential borrowers tended to stampede the capital market and interest rates increased sharply. Many borrowers who really didn't need funds at the moment sought money or credit lines immediately, probably in expectation of higher interest rates to come. A psychological situation developed which was perhaps the more acute because the issue of a long-term bond coupled with a restraining monetary policy had not been encountered in the market place for many years. The Federal Reserve quietly made bank reserves more readily available in May, and the clear-cut realization by the market in June that monetary policy was not a one-way street—that it indeed was flexible—brought the stampede to a halt.

The impact of this episode on production, trade, and commerce was slight. There was enough money available for current use in trade and commerce and for the payment of construction bills. Some demands for future funds, it is true, were not met at the time. It was not imperative that they should be, and no serious damage resulted to the country as a whole. The postponement of new building because a commitment could not be obtained was not serious. A new housing development or a new factory was merely postponed. This was entirely proper in view of the high rate of building and the full utilization of men and materials at the time, and probably contributed to the mildness of the subsequent recession.

The same observation could be made in respect to other sectors. Further inventory accumulation would have been detrimental to the economy and would only have aggravated the later decline.

Some strain developed in the mortgage market in the spring of 1953. The situation was a complicated one. When overall credit is restricted and money becomes scarce, those sectors of the investment area which are weakest will register the greatest difficulty. The mortgage area was weak for several reasons. A large volume of mortgages had been issued for several years. Institutions tend to operate portfolios under the theory of diversification. Many banks and insurance companies had as many mortgages in their portfolios as they wanted. They were anxious to balance by buying more securities. The mortgages in many cases, because of small size and scattered locations with apparent greater credit risk and handling expense, were relatively unattractive as compared to bonds. The result was a shrinkage of prices for mortgages offered for sale and a reduction in the commitments made for new mortgages.

No great harm if any, resulted to the economy from deferring commitments. Any sound project, whether it was a new housing development or a new commercial enterprise, was simply deferred and this was highly desirable in view of the full employment conditions in the building trade. In the case of housing already constructed, where the builder wished to sell and found it difficult to arrange mortgage financing, there was a possible loss. Either he didn't make the sale immediately or he accepted a lower price. This was not as serious a situation as it sounds. It did not in most cases mean an actual loss, but merely a reduction in profit. So we're back again to a basic situation; namely, that in a profit and loss economy there will be times of loss or reduced profits which we must accept if they are a result of a sound overall national policy, namely, credit restriction to prevent an unhealthy boom.

Viewed broadly, the operation of banking restraint in the early spring of 1953 is a good illustration of sound policy in the money and credit field and not, as the critics claim, a misuse of it.

During such a period, when restraint had to be and was exercised, it is to be expected that some administrative mistakes would be made. With the bene-

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fit of hindsight some things would be done differently. Certain isolated instances might be discovered where there was actual economic damage, but the total of these individual cases of damage would bulk very small in the whole economy. Even overall, nonselective restraints are not perfectly uniform in their impact; it cannot be otherwise. But, overall restraints are much better than any attempt to use selective credit restrictions in time of peace. Under the latter practice very great mistakes are almost inevitable and large elements of inequity develop . . .

This experience teaches something which has been known for some time, namely, the need of constant efforts to improve the market for Government bonds. The Government debt is very large and will continue to be of great magnitude. The capacity of the market mechanism to handle a large volume of longer term issues needs improvement so that more orderly markets may prevail in periods of strain. But this must not be done at the expense of eliminating price fluctuations which are vital to the success of any flexible monetary policy.

People have said that the Federal Reserve should have publicized its intention to reverse a tight money policy if conditions indicated thte wisdom of reversal. It is a fact that in May and June such a reversal was under way, but no categorical public statement to this effect was made. I think it is important that the basic objectives and instruments of Federal Reserve policy be generally understood. But, publicity for day-to-day changes of direction seems to me a rather debatable proposition. At any given time actions speak louder than words. For the Federal Reserve to discuss fully its actions and the reasons for them at the time they are taking place is certainly debatable, and it may be undesirable.

This much is certain—the Federal Reserve is entitled to great commendation for what it did. It identified changes in the situation in May and had the moral courage to act in accordance with the changed evidence.

IV. INFLATION AND FLEXIBLE MONETARY POLICY

Belief in the desirability of a flexible monetary policy is, to my mind, necessarily allied to the belief that inflation is one of the great menaces to any modern society. The wickedness of inflation is in its gross inequity. The great majority of people, and those least able to protect themselves, are the great sufferers in periods of inflation—people who have saved, people on salaries, working people in the majority of instances—despite the fact that certain union groups seem strong enough at times to keep their wages in line with the depreciated buying power of the dollar.

The impact of inflation in the period running from the end of the war until 1953 was not felt as acutely as the depreciation in the value of the dollar would indicate. This was due to a high rate of employment and to multiple breadwinners in the family and other factors such as overtime; but, even with these advantages, there was great distress among millions of workers and people who were retired and on pensions.

We expect in this country an increasing group of older citizens enjoying their retirement through income arising partly out of Government social insurance, partly out of private insurance, and partly out of their own thrift. Their standard of living will be jeopardized if we accept either the idea that inflation is not a bad thing or that we cannot control it.

The fact that monetary policy standing alone would be unable to cope with inflation is no reason for abandoning it. Courageous use of monetary measures is one of the most effective policies in the fight against inflation. Of course, fiscal policy, debt management, and growth of production are all factors which must be included in our attempts to conduct a successful, free society.

Congress, reflecting the ambition of our country for constant progress, has expressed its viewpoint in the Employment Act of 1946. The Federal Reserve, along with other agencies of the Government, is expected to make its contribution to the objectives of this act. No central bank, no matter how long its experience nor how wisely executed its responsibilities, could carry out this directive in the sense in which some interpret it. The idea that at all times—every week, every month, and every year—we could have full employment of all the citizens in this country who might under any conditions wish to be employed is a concept of Utopia. No free society could ever hope to attain it and the Congress itself, as the debate shows and as the act's statement of policy shows, did not expect it. This country can have, within the framework of a free, competitive, capitalistic society, a dynamic and evergrowing standard of living together with high employment—and certainly without serious unemployment. Most of us believe that we can do this and at the same time respect the individual and his freedom

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so that we can say that while we make material progress we are still a free society.

Progress will not always be in a straight line. There must be periods when the growth will be above the line, and some when it will drop below. If we reduce the severity of these fluctuations and still march on the upward path, our country will make a major contribution to modern civilization.

The program necessary to accomplish this goal will require continuous collaboration and the maximum of cooperation between all groups in our country. No one law or resolution passed by the Congress can hope to do it. Sound fiscal, monetary and debt management policies, as well as a stimulating environment, must be included.

Senator FLANDERS. Thank you, sir.

Now we have a little better than a half hour. In order to give time for the other members of the subcommittee, I am at this time planning to raise only some general questions to some of which the members of the panel may, if they wish, engage in their discussion with other members of the panel this afternoon.

One is this: I get the impression that some members of this panel feel that high levels of production, employment, consumption, can only be reached through means of inflation. If I have correctly understood some of the documents which have been presented, I would hope that that question would be discussed among you this afternoon.

Another observation which I would like to make is that I get the impression at times in this discussion that there is some ultimate value assigned to stability or to inflation or to other elements of debt management and credit control, aside from its effects on men—aside from its human results. I would like to make the observation that personally I cannot assign any important objectives that are not human objectives. I am not going to catechize them at this time—I hope the rest of you will.

In connection with the presentation of Professor Mitchell, I was a little bit puzzled by his, what seemed to me to be, indication of a need for great investment or at least considerable investment in agriculture, without taking into account what seems to be to the onlooker a situation of agricultural surplus and overproduction at current prices.

That is all I wish to say at the present time, in general. As the man said, I am "instigating" you gentlemen to question each other this afternoon.

Now, Mr. Patman, have you any questions you would like to ask at this time?

Representative PATMAN. Possibly I should raise certain questions, Mr. Chairman, so that the panel will be in position to discuss them this afternoon.

I think you have had some good statements filed today, Mr. Chairman. I have enjoyed every one of them, and I have certainly profited from the information that has been furnished. I would like to raise this question for discussion this afternoon: Are the members of the panel satisfied with the present Federal Reserve System as now constituted or should changes be made?

The Open Market Committee is the most powerful Committee in the United States; it is more powerful even than the Congress in many fields. The Constitution gives the power to coin money and regulate its value to the Congress. The Congress has, in turn, delegated that power and authority to the 12 members of the Open Market Committee. Sometimes I think it is more important that the Open Market Committee meet in Washington and do something to help the country than

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it is for the Congress, because Congress has delegated to that Committee so much of its power and authority.

Since that committee has so much power to determine whether or not we have sufficient money or lack of money, or whether or not we are going to have high interest rates or low interest rates, in fact whether or not we have a depression or prosperity, the question I would like to raise is whether we should have anyone on that board or committee except people who are charged directly and solely with protecting the public interest.

That committee, as now constituted, has 7 members of the Board of Governors when membership of the Board is complete. Because of the vacancy on the Board there are only 6 on the Open Market Committee now. There are also five presidents from the Federal Reserve banks.

The Federal Reserve bank presidents are elected by the bankers in their districts, either directly or indirectly. The question in my mind is whether or not a person who is in any way obligated to a business that is to be regulated or controlled by it should have anything to do with the great power and policymaking provision that the Congress has delegated to the Open Market Committee.

I remember when the Federal Reserve Act was passed, President Wilson referred to the fact that bankers should not run it any more than railroad owners should run the Interstate Commerce Commission.

Of course, if railroad owners were to run the Interstate Commerce Commission they would not only fix the rates of railroads but they would fix the rates of the buses and the trucks and the airlines and express companies. I just wonder if we have not gone quite far in terms of the role the bankers play in the Federal Reserve System. If so, is that in the public interest or should it be changed?

May I say further that Mr. Eccles, Marriner Eccles, was on the Board of Governors, I guess, longer than any other one person, and I recall one time he made this statement:

> When a Reserve bank president sits as a member of the Federal Open Market Committee, he participates in vital policy decisions which affect all banking. So far as I know, there is no other major governmental power entrusted to a Federal agency composed in part of representatives of the organizations which are the subject of regulations by that agency.

Another question that has been raised here by the panel members is about the ownership of Government bonds by the banks. I have no objection to the banks owning Government bonds when it is necessary to give them ample earnings. I believe in a privately owned commercial banking system. I believe in a profitable banking system, because if they are not allowed to make profits they cannot function satisfactorily for the people, so we want a profitable banking system.

I do not object to their owning bonds, but should we allow them to fill their portfolios with bonds to the extent that they have no desire or not a sufficient desire to make local loans and serve the local communities they are obligated to serve when, in fact, that is the reason they were given charters.

The question in my mind is, with banks filled with Government bonds like they are, and getting so much from their Government security holdings, and they are pretty well satisfied with their earnings as to whether or not they are performing their local functions in a satisfactory way. What raises my suspicions in that respect is that

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small-loan companies are springing up all over the Nation, taking over functions that the banks, I think, should normally perform. Is that due to the fact that the banks in certain localities are not taking care of their local needs? I would like the panel to discuss that question.

I would like a discussion, in particular, about the present setup of the Open Market Committee and the Federal Reserve System, and next as to whether or not the banks are doing their duty and whether or not they are persuaded or disuaded from supplying local needs because they get so much of their income from riskless securities of the Federal Government.

Senator FLANDERS. Thank you, Mr. Patman.

Much of this discussion which we have listened to so far seems to occur in a peculiar sort of vacuum. For instance, there is no reference made to the situations external to the monetary system, although connected with the debt system, which have tremendously influenced our whole economy.

No mention, as I remember, was made of the inflation which followed on the beginning of the war in Korea.

Again, no mention was made of the great drop in Government expenditures in the fiscal year 1954, and a presumably still greater drop in 1955, which resulted in a decrease of defense production.

Those things are things pertinent to the whole problem, and it seems to me that monetary and fiscal policy should be considered with reference to that war inflation and with reference to that decrease in defense expenditures.

Senator Goldwater.

Senator GOLDWATER. I have two questions that have come to me that I think we should discuss briefly this afternoon. Throughout the presentation of most of these papers I have been impressed with the seeming thought of the authors that low interest will solve most of our problems—our economic problems.

I would like the panel to give this consideration during the lunch hour. If that is true, why did not low interest rates help or why did they not add more between 1933 and 1939 than they did? The thesis that you now hold that we should keep interest rates low, that it is an obligation of the Government, does not quite seem to hold water in view of the fact that the market between 1933 and 1939 was a constantly downward one, and business—the business indexes—never recovered from the low of 1932, actually, until the start of the war.

I have another question that comes to my mind, too, that I think is of importance: The desire to get money into our economy is the most important attitude that I think we should consider—investment capital, if you want to call it that.

In view of that, we should explore the fields from which that investment capital will come.

I would like to know the attitude of the panel on tax reductions based on a sound fiscal policy as a means of getting more and more money into the economy to stimulate its growth.

I am prompted to ask that question for discussion in view of the rather healthy condition of the economy at the present time, particularly in the construction business, that I personally feel was brought about in a large measure by the relief in the recently enacted tax bill in the investor levels or investor areas.

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That is all I have, Mr. Chairman. I will pursue those further this afternoon.

Senator FLANDERS. Senator Douglas?

Senator DOUGLAS. I am afraid we are raising more questions than the panel will have time to deal with this afternoon, but I would like to raise one general question, if I may.

It would seem to me we should have a dual set of goals. We should have, on the one hand, substantial growth and substantially full employment, and, on the other hand, substantial stability in the price level. Both of them are needed.

Now, I had always hoped that those two aims might be consistent. I know that some say that they are inconsistent; that we have to have at least a moderate degree of inflation in order to get substantially full employment and growth. I hope that may not be true, but, at any rate, let us consider the question as to whether or not it is. Others are so afraid of imaginary dangers of inflation that they sometimes seek a fall in the price level at the expense of growth and full employment. I would like to raise the theoretical question as to whether it is not possible to attain both of those goals, and, if so, how; and, secondly, I would like to point out that period from March 1951, the date of the so-called accord, to December of 1952 was one, on the whole, of substantially full employment and also of substantial stability in the price level.

I have taken a monthly record of prices and I find that on the wholesale index, the index fell from 116.5 in March of 1951 to 109.6 in December of 1952, or a fall of 7 points; that in the field of consumer prices there was a rise from 110.4 to 114.1; and if you take an average of the two, there was substantial stability or perhaps a 1-percent decline.

Therefore, I would like to suggest that in those 21 months we had a successful economic policy in which those goals were combined. Was that accidental? Was it just happenstance or were there factors behind it?

I would like to have some discussion both on that practical feature and on the theoretical issue this afternoon, if that meets with the approval of the group.

Senator FLANDERS. Thank you, Senator Douglas.

Mr. Talle, have you any thoughts for the consideration of this panel?

Representative TALLE. Mr. Chairman, I have a couple of questions in my mind, but I would prefer to withhold them so that we may proceed immediately to sit at the feet of this impressive faculty of teachers.

Senator FLANDERS. We have 20 minutes or so left of the time that I announced; we ought to do something with it.

Representative PATMAN. May I ask Dr. Clark a question, Mr. Chairman?

Senator FLANDERS. You may do so.

Representative PATMAN. If I properly interpret your statements, Dr. Clark, you suggest that the Federal Reserve should use reserve requirements instead of the open market operations.

Mr. CLARK. Yes, sir.

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Representative PATMAN. Would you go so far as to fix a standard or a guide to govern them to the extent that open market operations would be unnecessary?

Mr. CLARK. Open-market operations to support important Treasury financing should always be undertaken by the Federal Reserve. In order to stabilize its own holding of Government bonds, it will then be necessary after the financing has been concluded, for the Federal Reserve to ease out its open-market purchases, doing it slowly; whereas their first move would have been an aggressive, rapid one. That, I think, is the extent of open-market operations that would benefit the present situation. It would have too small an effect upon the total economy at this time to engage in open-market operations for the purpose of adding to the reserves of banks.

On the Federal Reserve action with respect to reserves, the point I would make, first of all, is that there is not at this time any circumstance that justifies the imposition of reserve requirements higher than the limits fixed by the Federal law, and under those——

Senator DOUGLAS. When you say "normal" or "legal" limits, do you mean the minimum limits, Dr. Clark? I notice you used the phrase "normal," and I was not certain what you meant by that, whether it was the minimum that you meant.

Mr. CLARK. Yes; they are the minimum.

Representative PATMAN. None of them are normal now.

Mr. CLARK. They are prescribed by the Congress, and they ought to be respected excepting when there are circumstances that make it necessary for the Federal Reserve to use its extraordinary discretionary power to increase those limits to twofold. Now, I do not know what would be the effect of this. It would be a massive movement, and we apparently need some massive movement right now to start the economy under way, because we have had nearly a full year of nonexpanding economic activity. We have seen one thing which develops in a period in which the economy lags, and that is a slow lowering in the rate of private capital investment, a prime factor in maintaining the economy and in bringing it upward to the level established by the Employment Act.

Representative PATMAN. I will have to admit, Dr. Clark, that I have not looked with favor on the use of reserve requirements, because of what I consider to be an unfortunate experience we had in 1936.

You will recall on June 15, 1936, the veterans of World War I were delivered about a billion and a half dollars in money in payment of what was called the bonus of the First World War.

In order to offset that and acting on predictions that had been made, unwarranted predictions and unjustified predictions by the monetary authorities, who said it would be highly inflationary, the Federal Reserve Board, for the first time since it had the power—it was given the power by Congress shortly before—doubled the reserve requirements of banks and contributed to the downturn in the early part of 1937. Since then I have not looked with favor on the use of the power to alter reserve requirements, but, at the same time, I recognize that it depends upon how it is used and the people who have the authority to use it.

It looks like a very effective weapon to me, a very effective weapon. I know it worked in 1936 because I witnessed the disastrous effect it had upon the economy.

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Mr. CLARK. Mr. Patman, may I repeat what I said, that from the standpoint of the monetary authorities themselves, it should be highly desirable to gain leeway for action if they hereafter need to use reserve requirements boosts in order to meet some inflationary situations.

As it is now, they have very little leeway. The reserve requirements have been reduced so slightly in the past year——

Representative PATMAN. That is only in certain banks, Dr. Clark.

Do you think that the authorities should reduce them for certain banks, or certain categories or should they be reduced in proportion as Congress provided in the formula used for the reserve requirements of banks? In other words, where it is 26 and 20 and 14, if there is going to be any reduction, should it be uniform across the board, or should they be allowed to reduce the 26 if they want to one-half, and not touch the others at all?

You know the last year or 2 or 3 years, rather, reductions have been made in the first 2 categories, I think, but not much in the lower ones; is that right?

Mr. CLARK. Well, there was not very much leeway in the lowest category on time deposits.

Representative PATMAN. On demand deposits.

Mr. CLARK. They were only 3 percent above the normal limit.

Representative PATMAN. I am talking about demand deposits.

Mr. CLARK. On demand deposits, they did reduce the central reserve bank limits a little more than the others, but I was sympathetic to that because I agree with the idea that there are no longer any conditions in our banking system that make it necessary to have a higher reserve requirement for Chicago and New York than they have for the other so-called reserve cities.

Representative PATMAN. Well, that brings up a different theory entirely from the congressional act.

Mr. CLARK. But the larger reduction for those two cities, I think, was just——

Senator FLANDERS. I wonder if any other members of the panel would like to comment on this question of using to a greater extent than, perhaps, as the primary tool, the reserve requirements rather than other tools at the disposal of the Treasury or the Federal Reserve?

Mr. SMUTNY. Mr. Chairman, may I say a word in reference to that?

In the first place, I do not believe the reserve requirement is a flexible enough instrument. In other words, you cannot bounce the reserve requirements around. In other words, you are trying to use that as a substitute for the Open Market Committee.

Now, if you have excess reserves, and the Federal Reserve wishes to let some bills mature rather than doing it, would you go ahead and change the reserve requirements that week, would you follow it the following week by a change in reserve requirements? You would have to confuse the banks with that situation It is not as mobile and flexible an instrument as the purchase and sale in the open market would be.

Point No. 2 is that the change in the central bank, the reserve requirements of the central bank is, of course, the recognition of the difference that exists now, which did not exist in prior years, that the deposit relationship with the interior has, has become much more im-

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portant, the correspondent bank does not have to depend as much on the large New York and Chicago banks, so why should they be discriminated against, you might say, in having a higher reserve requirement as far as the central banks are concerned. I think that is something that has to be taken into consideration today.

Representative PATMAN. Dr. Clark suggested that both be used.

Mr. SMUTNY. Well, at times it can be, but it is not an instrument that should be used as actively, let us say, in my opinion.

Senator FLANDERS. Do any others of the panel wish to comment on the question?

Mr. HARRIS. May I make just one comment, and that is that there is some advantage in using the reserve requirements in that it more or less affects the prices of all assets; whereas open-market operations tend to disturb the Government bond market exclusively, at least at the beginning, and from that viewpoint, there sometimes may be some advantage in using changes in reserve requirements as against indulging in very large open-market operations.

Mr. CHANDLER. May I make a couple of comments about that?

Senator FLANDERS. Yes, sir.

Mr. CHANDLER. The first is that I see no reason to presume that it is better to have reserve requirements down toward the lower part of the range than it is to have them up toward the top part of the range. The purpose of reserve requirements is not to assure liquidity to the individual bank; it is a device for limiting the money supply. I think that one of the reasons why changes in reserve requirements are so unfavorably looked upon instrument of policy is that so many people still persist in looking on them as a means of assuring liquidity, and that is not the primary purpose.

The other thing that should be pointed out is that the Federal Reserve will probably be reluctant to use this instrument repeatedly and frequently so long as the great bulk of American banks are free to leave the Federal Reserve System if they wish to do so. Every time the reserve requirements are raised, it creates new irritation on the part of the member banks who feel they are unfavorably discriminated against.

Senator FLANDERS. Any other comments?

Mr. LAND. I would like to comment on the geographical nature of the present reserve requirements, in that they are based on the geographical location of the banks as related to demand deposits. It would be well if somewhere along the line they could be recast so that they are based on the nature of the deposits and not on the location of the deposits.

Mr. WILDE. I would like to make this observation about the tools of the Federal Reserve. It seems to me, as a practical matter, in a country that moves as fast as ours does, the open market is the most flexible and the most useful and, then, secondly, the rediscount rate and, third, the change in the reserve requirements.

Representative PATMAN. Excuse me, the rediscount rate is not being used; is it?

Mr. WILDE. It is occasionally used.

Representative PATMAN. Seldom used.

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Senator FLANDERS. You are so classifying them with relation to the ease and quickness of application or with regard to the desirability of the results?

Mr. WILDE. I think they are practically the same, the ease and readiness and flexibility contribute to their being the most practical instruments, in that order.

Senator FLANDERS. Why is not the rediscount rate on the whole, to the extent that it is used, more rapid and direct in its application than the reserve requirements?

Mr. WILDE. Well, I do not believe, Senator, that I could answer that with conviction. As a bank director, sitting on this side, it seems to me that it would not make too much difference. But I guess just watching what the Federal Reserve was doing in the open market, as to the open-market policy, was an indication of how we should conduct ourselves more practically than with changes in the rediscount rate.

Senator FLANDERS. Perhaps an interesting subject, although we can spend more time than we have this afternoon, would be, there is some indication of the reasons for the disuse of the rediscount-rate device, which was originally the primary device of the Federal Reserve System, and I have seen some indications that it is being revived to some extent, at least, now. I do not know whether that is right or not. If it is, the reasons for that would be of interest.

Representative PATMAN. Mr. Chairman, may I suggest, of course, the banks would have to get in debt and expect to get into debt before that device would be worthwhile. If you will recall, at one time the rate was raised in the early part of 1953, and the interpretation placed on this action, and I think properly, was that it was purely a psychological move, that they were letting the bankers of the country know that money is not going to be as easy, it is going to be a little tighter. It was what you might term an unconversational understanding among the monetary authorities that they were going to make money just a little bit tighter, and if they were to lower it, it would imply that they were going to make money a little bit easier. In practice I do not think it has been worth anything except psychologically.

Mr. SMUTNY. Mr. Chairman, may I add to what Mr. Patman said?

Senator FLANDERS. Yes.

Mr. SMUTNY. Actually, as Mr. Patman mentioned, after all, reserve requirements only come into use when some bank is borrowing and at the Federal Reserve. The rediscount rates affect all the banks.

Now, therefore, would it not be a good idea to study the relationship between our reserve requirements in the United States versus those that pertain to banks in Canada and England?

If you look at those rates they are very substantially below ours; of course, they have fewer banks, that is true, but, as you know, there are a very minor number of banks in comparison to the 11,000 banks we have, but nevertheless in Canada, if I recall their reserve requirement rates correctly, I think they are using something around 8 or 9 percent, and in England 6 percent.

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Now, after all, we are tying up substantial funds of the assets of a bank in the use of reserve requirements in this country in the rates we have.

Senator FLANDERS. We have arrived at the announced time for adjournment.

Mr. Ensley?

Mr. ENSLEY. Mr. Chairman, we have received a statement from Aubrey G. Lanston & Co. relative to the questions that the Treasury and the Federal Reserve answered and, with your permission, we would like to insert the statement in the record at this point.

Senator FLANDERS. Without objection, that will be done.

(The statement of the Aubrey G. Lanston & Co., is as follows:)

STATEMENT BY AUBREY G. LANSTON, AUBREY G. LANSTON & CO., INC., NEW YORK, N. Y.

The contribution to monetary policy made by earlier committee hearings

The earlier hearings on monetary policy under the chairmanships of Senator Douglas and Representative Patman produced many expert points of view, a record of events, and helpful data that otherwise would not have become available. These served to enlighten students and to broaden public knowledge. The complex nature of the things that must be considered in evolving monetary policy was fully demonstrated. The need for flexibility consistent with changing economic conditions was driven home to a mass of people, some of whom had rarely given this matter any thought.

The conclusions reached by these earlier subcommittees lacked complete agreement on some important points, but the areas of agreement were sufficiently broad that this served as a mold by which future developments in monetary policy could be, and have been, shaped.

The ensuing years have been marked by more than ordinary progress. They have been years of change; of change in the direction of more widely accepted monetary policy objectives. The methods and techniques employed, and the workings of monetary policy have undergone change, also.

The results have been multifold. People throughout the world have become more sure of the toughness, the resiliency, and the lasting qualities of American economic life. The public has demonstrated a renewed confidence in the stability of the currency. Generally, people have acquired more confidence in the longer run economic future. People have begun to believe, once more, that the horizons of our economic future are the widening, limitless ones of a society wherein individuals are permitted, and encouraged, to initiate new ideas and methods; to be free to apply these with their full energy and to be rewarded more commensurately—free of the hampering restrictions of a self-perpetuating bureaucracy. At the top of these rewards is the better safeguard privilege of freedom—freedom to run the details of one's own life.

Both the Douglas and the Patman subcommittees have contributed substantially to these ends because they helped to release monetary policy so that it could do the job of which it is capable, to free it so that it might better serve our kind of economy—the most dynamic the world has known.

I believe that these hearings, under the chairmanship of Senator Flanders, will help to preserve the healthy changes that have been made, and to promote further progress.

Monetary policy is a three-wheeled vehicle

As you know, monetary policy is not a one- or a two-wheeled vehicle. It is three wheeled. Treasury debt management can't do the job by itself, neither can Federal Reserve credit policy. The two of them alone can't do it, either, at least very well. This is because the big wheel of the vehicle is the Treasury cash budget and the changes that occur in this; that is, whether a cash surplus or a cash deficit comes at an appropriate time as we roll along through different kinds of business conditions.

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It therefore would be futile to attempt to analyze, or to weigh the objectives and the workings of debt management as though these could operate in a vacuum. The same is true of Reserve credit policy. The actual and prospective results in the Treasury cash budget cannot be ignored.

A monetary policy, or the absence of one?

In fact, the results in this budget—and I refer to both the actual and the prospective results in the cash budget—have a lot to do with the facility with which the debt can be managed. The way the debt is managed has a lot to do with the workings of credit policy. If the Treasury budget results are particularly bad, such as an actual or prospectively large cash deficit during a business boom, the impact on the Treasury's management of the debt is bound to produce a compounding, adverse impact on Reserve credit policy. The grinding and crashing repercussions that may be produced will be heard, felt, and seen throughout the Nation. But these are not the workings of a monetary policy—they are the consequences of not having one.

Such a situation might better be described as one wherein Treasury and Reserve officials are forced to struggle to prevent the big wheel of the Treasury's deficit from running amuck in a way that might produce anything from mild economic instability to inflation or worse.

Responsibility and improvisation

Congress cannot be careless with respect to the results in the Treasury cash budget and still discharge its responsibility for the creation and proper functioning of monetary policy.

If the Congress ignores whether the Treasury has a cash surplus or deficit, and whether these results are consistent with changes in the conditions of business, and the accompanying economic climate, the Nation is headed for trouble.

In the absence of an appropriate cash budget result, any review of the objectives and workings of Treasury debt management and Reserve credit policy confines justifiable conclusions with regard to monetary policy pretty much to whether, in the resultant adverse monetary background, Treasury and Reserve officials have worked well together, and have done as much as might be expected of well-intentioned, well-informed human beings. It is not a question of how well, or how badly, monetary policy may have functioned; the omission of the required budget result means that monetary improvisation had to make up for an absence of policy.

My review of the objectives and workings of monetary policy aims to illustrate the part that is played by the Treasury's cas budget results

It seems to me that I might best review the objectives and workings of Treasury debt management and credit policy over the last few years by pointing out (1) how, during the boom period of 1952–53, a Treasury cash surplus might have enabled monetary policy to contribute more to economic stability and (2) how the Treasury's cash deficits multiplied the problems the Treasury and the Federal Reserve had to resolve.

It will be seen from this, I am sure, that the Treasury and the Reserve have done a good job.

The relationship between the Treasury security market and monetary policy

The committee asked several questions about the Treasury security market and its use in connection with the development of credit policy. These questions, and the answers, also develop the relationship between the Treasury market and monetary policy. In the Reserve's response to question 3 it describes the workings of the Treasury market; it tells how the normal functioning of the market was obstructed by past Reserve open-market operations; of how a return to these would cause the market to become less rather than more self-reliant. The Reserve's explanation is the most complete I have seen.

But, because I live with the Treasury security market throughout most hours of the day, and sometimes the night, and because I have a sincere conviction about the importance of an adequate Treasury market to the future welfare of our economy, I want to add some comments of my own. I want to tell you why I believe the Treasury security market must be free—as it is now—to reflect in market prices and yields, the public's desire to buy and sell Treasury securities and their transactions. No other kind of market will adequately reflect the response of the public to business and credit conditions and to monetary policy.

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I want to say something about the kinds of alternatives that might be devised to replace the present publicly made market for Treasury securities. As I see it, the alternatives are an inflexible monetary policy and consequential inflation or an increasing number of selective controls, of diverse sort; ones that would serve, once more, to undermine our competitive form of enterprise and to infringe upon individual freedoms.

Should the newborn free play in the Treasury security market be considered an experiment or a permanent characteristic?

In the Reserve's reply to question 3 it describes three decisions that have been made with respect to the conduct of its open-market operations. It says the purpose of these was to foster a stronger, more self-reliant market for Treasury securities in order to contribute as far as possible, to the development of a responsiveness, by that market, to monetary policy. It adds that the results, on the whole, have fulfilled its expectations. Then it goes on to say that this approach, to open-market operations, is still experimental, that insufficient time has elapsed to draw firm conclusions.

As you know, a minority of Reserve officials hold that these decisions went too far in imposing limits on the open-market operations. This minority urges a partial return to the very kinds of open-market practices that, as the Reserve's replies carefully point out, abort the normal functioning of the Treasury market. I hold the firm belief that any action taken by the Reserve which permits the Treasury security market to more fully reflect the response of the public to credit policy is not an experiment—unless flexible monetary policy, competitive enterprise, and individual freedoms also are to be viewed as an experiment. Contrariwise, if the clock were to be turned back toward more open-market intervention in and manipulation of Treasury security prices and yields by the Reserve banks that would be an experiment to see if the Reserve could go back part way. The last such experiment turned out badly. I want to discuss what might happen if we tried to embark on another.

We have a good market for Treasury securities; it still has some problems—these can be resolved

The functioning of the Treasury market has constantly improved; it is considerably improved compared with that of 1½ years ago. In fact, we have a pretty good market. I am concerned only that our aim continue to be to promote and to improve the functioning of this market. The Reserve has helped mightily to bring about improvement. The Treasury also has helped. Yes, we still have some major problems to resolve.

The further help of the Reserve, of the Treasury, and of those who have either a responsibility for or an interest in monetary policy is needed. I do not believe I overstress the importance of an adequate public Treasury security market when I say that failure to maintain it, and improve it, might make it more difficult to combine flexible monetary policy, competitive enterprise, individual freedoms, and a large national debt compatibly.

Suppose the Treasury had had a cash surplus during 1952–53

When business activity is at a high level, as it was from mid-1952 to mid-1953, it is not surprising to see a strong demand for capital and credit accompany the boom. Had the fiscal policy of the Government produced a cash surplus throughout this period this surplus could have been used to reduce the Treasury debt held by the general public. Had this been effected through the retirement of Treasury securities held by nonbank investors, more money would have become available with which to meet the private demand for capital and credit. Surplus tax receipts would have been channeled back into productive investment, interest rates would have been under less upward pressure, a lesser demand for bank credit would have been generated. The Treasury would have been placed in a better position to lengthen its debt.

Had the Treasury cash surplus been used to retire Treasury securities held by the commercial banks, the availability of private bank credit would have been increased without the necessity for quite as much restraint in credit policy, and without a too large increase in the money supply.

The impact on monetary policy, from mid-1952 to mid-1953, of the Treasury cash deficits

But fiscal policy did not produce Treasury cash surpluses. For fiscal 1952 the Treasury managed to just about break even on a cash basis. For the second half of calendar 1952 the Treasury had to finance a substantial seasonal cash deficit,

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This was only partly offset by a cash surplus during the first half of calendar 1953. Moreover, the cash deficit for the second half of that calendar year, 1953, promised, early in the spring, to be quite large. When the market awakened to its true size (in May) the results were explosive. These Treasury cash deficit needs were important in the factors that precipitated the mild crisis in the money and bond markets in May and June (1953).[1]

The reasons for this were quite plain. After all, the Treasury had to raise the money from either nonbanks or banks. Individuals could not be expected to supply much, if any, of the Treasury's cash needs. Nonfinancial corporations were seeking additional funds. Nonbank financial institutions were being asked to supply more private credit and capital than they could raise, even by selling Treasury securities on balance. And, so—the only remaining source of funds was the commercial banks.

The supply of bank credit available to private borrowers had proven to be an exhaustible amount, borrowers had begun to anticipate further increases in borrowing costs, they began to hoard bank credit by taking more than they needed—if they could get it.

With this sort of a background, in this sort of climate, how willingly and how readily would the Reserve make available the bank reserves necessary to support Treasury cash deficit financing through the banks? How high would interest rates go? Was this to be the death knell of a flexible monetary policy, or the return to a 4-percent rate for Treasury bonds?

Belief in the stalwart resolution of Treasury and Reserve officials to prosecute a policy of monetary restraint, to the extent necessary to cope with this new inflationary threat, was mixed with a belief that the increasing tightness of credit conditions would soon bring about its own correction. The latter proved to be the case and when Reserve officials acted to shift their aim with an insight and intuition that has been rare in central bank history, the quick turnaround in the availability of reserve credit produced stabilizing forces—instead of an expectancy that might have arisen, namely, of a new rapidly spiraling inflation.

The actual and prospective results of fiscal policy in the period of mid-1952 through mid-1953 are outstanding examples of how an inappropriate fiscal result dominates Treasury debt management and creates, for the Federal Reserve, a series of difficult and hazardous decisions.

The buildup in the amount of the near-dated debt and in Treasury debt-management problems

The Treasury, as far back as December 1949, had recognized, apparently, the desirability of extending the near-dated debt. During the 12 months, to November 1950, the Treasury came to market 3 times with securities of from 4¼- to 5-year term. Thereafter throughout a period of about 15 months—Treasury-Reserve differences, the resulting accord, and the unexpected release of the Treasury market (from years of manipulation by the Reserve banks) made longer-than-1-year financing impractical.

By February 1952 the Treasury found it possible to return to longer-term financing with modest success. In May, it offered 6-year bonds, but this was to meet a part of its cash deficit requirements; it did not serve to reduce the near-dated debt.

By the time the present Treasury administration took over, in January 1953, the amount of the near-dated debt[2] (in the form of marketable issues) had approached or exceeded the peak levels of January 1, 1946 (see charts 1A, 1B, 2A, and 2B).

Adverse market conditions existed during the first half of 1953. These came about partly because of the heavy demands for capital and credit. They also were an inevitable consequence of the only appropriate credit policy in such circumstances—namely one of restraint. This overall situation plus the Treasury's second half-year cash deficit requirements again prevented the Treasury

[1] There is some element of surprise in the picture. Treasury announcements, in connection with the offering of the 3¼-percent bonds did not adequately reflect the size of the Treasury's forthcoming cash needs. Re the much-debated 3¼-percent offering: A straight cash offering of these bonds might have been successful. This is clearly indicated by the initial reaction of bond firms throughout the country and of many professional investors. Actually, however, the 3¼'s were offered for cash and for exchange. The terms of the exchange encouraged many to convert into 3¼'s for the purpose of reselling these. This sort of secondary market supply figured importantly in the setting up of fresh forces for a decline in bond prices.

[2] Measured either by the total due in 1 year or the total due within 2 years.

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from making any net reduction in its near-dated maturities in spite of the change in credit policy to an easy-money objective. As a matter of fact, by January 1, 1954, the near-dated debt had increased by a substantial amount.

Once again—the Treasury had to rely largely on the banks

The Treasury cash deficit and refunding needs of May 1953, and thereafter, must have urged upon Reserve officials some greater degree of active ease than might have been necessary otherwise. Obviously, the Treasury had to seize upon the more favorable market conditions to reconstruct its maturity schedules.

Among what classes of investors could this be accomplished? Not much help could be expected from individual investors, except through a more aggressive campaign to sell series E and H bonds. If nonfinancial corporations were to be persuaded to hold more Treasury securities substantial progress in this direction meant, conversely, that a like amount of the profits and cash resources of businesses would not be turned back into investment, production, and payrolls.

Nonbank financial institutions continued to be sellers of Treasury securities on two counts: one, to take up forward commitments entered into earlier and, two, to meet the enlarged capital market demand emanating from toll road, other new money financing, mortgages and, later, to refund bank loans.

Thus, once again the Treasury was forced to rely largely on the banks.

Treasury success, and a backwash

During 1954, the Treasury has come to market seven times. On five of these occasions it has sold notes or bonds designed to lengthen the debt. On four such occasions the Treasury's financing has resulted in substantially reducing the amount of its 1-year debt. All such operations took place in a climate provided by a subnormal demand for bank credit and a credit objective of active ease. In these circumstances the existence or promise of a further cash deficit did not constitute an adverse market force.

Early in 1954, the declining trend in bank loans, the easy money policy of the Reserve and Treasury debt-lengthening operations served to multiply the forces which were pushing the yields of short-term Treasury securities to lower and lower levels. There was first the normal, sharp decline that had come from the shift in credit policy in June 1953 plus the turn-of-the-year ease. The decline in loans, the loan outlook, and Treasury refunding began to operate with force as we moved through the first quarter of 1954. As a consequence of the latter, a sharp reduction in the amount of short-term issues outstanding occurred.

Indeed, by June 1954, the erosion in the yields on short-term Treasury securities became so pronounced that the Reserve was forced, more or less, to employ methods which, while they would continue to effectuate "active ease," also would act to prevent the yields on short-term Treasury securities from disappearing altogether.

Then, there was the other side of the coin, namely, a corresponding increase in the amounts of Treasury securities outstanding in other maturity areas, notably in issues of from about 4- to 9-year term. During the latter part of 1954, the increase in the supply of these issues had become large enough to cause their yields, and those on most issues of longer Treasury securities, to retrace most of the decrease that had taken place during the earlier portion of the year.

The relative movements of such yields on Treasury securities is shown on chart 7.

It may be noted that the differences between the yields offered on short-term Treasury securities (of up to 2-year term) and those of longer term (5 years or more) became, and remain, quite wide. In fact, these yield spreads are about the widest on record. This was a natural result of the Treasury's having to take the bull by its horns if it, finally, was to be able to effect any substantial reduction in its near-dated debt.

The income-consciousness of banks, during 1954, plus the success of the Treasury's debt-lengthening programs makes for a sharply triggered bond market—one that could lead to a rather sharp decline in bond prices

The primary reason that the Treasury was able to effect a substantial reduction in this portion of its debt was that bank investors, on whom the Treasury had to rely, became increasingly income minded; that is, the desire to maintain future income, or to purchase insurance against too large a drop in earnings, caused them to be willing to decrease the amount of their short-term holdings below a level they might have wished had loans been increasing.

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Consequently, the liquidity of banks has been sharply reduced. In terms of deposit liabilities, the ratios for member banks (expressed in terms of Treasury securities with a term of 2 years or less) are about as low as they were at the beginning of 1951 and 1952—the low points for the postwar era. In terms of risk assets the situation is about the same. (See chart 6C.)

At the present time business activity is increasing. It is expected that this will continue—at least for some months. If it does, then the risk assets of banks, particularly loans, may turn upward sooner than many now hope. Bank deposits will follow suit.

The Treasury cash budget result necessary to underpin an acceptable monetary policy in such circumstances, and the minimum result that might be necessary to maintain general confidence would be nothing short of a balance between the Treasury's cash receipts and disbursements. An appropriate monetary policy would call for a cash surplus.

A balance (in the cash budget) would mean no increase in the Treasury debt held by the public, although an increase in the total debt would occur. A cash surplus should permit a reduction in publicly held debt. This would be expected to take place through the retirement of publicly held, maturing obligations. The commercial banks are the largest holders—would such retirement be made from bank portfolios? If so, what would be the attitude of the commercial banks toward their longer Treasury security holdings?

In a period when both bank deposits and risk assets are rising, bankers may become more conscious of their liquidity needs. Will individual banks then seek to prevent another lowering of their liquidity ratios by attempting to sell Treasury bonds of longer term? Who will the buyers be? Attempts by individual banks to sell means that banks as a group—the mainstay of the present level of Treasury security prices—will have reversed their position. In such event, Treasury bonds could fall in price rather sharply, before private bank credit expands very much.

Therefore, the Treasury bond market has become very sharply triggered: its response to any relaxation in the present credit objective of active ease would be quick—possibly anticipatory.

The short-term sector also is becoming more sharply triggered and any further upturn in short-term rates could touch off a slide in the prices of longer dated issues

As I mentioned earlier, several forces have operated to reduce the yields on short-term Treasury securities—declines in loans, a credit policy of active ease and a large, steady drop in the amount of publicly held short-term Treasury securities. The problem of getting the near-dated debt under better control has been pretty much accomplished. The fact that the amount of short-term issues outstanding may not undergo further reduction, removes one factor that helped to bring about the present relatively low yields on these securities. A revival of the loan demand, or the prospect of a less than seasonal decline in loans during the early part of 1955 would remove a second such force.

Consequently, and in spite of the reduction in the short-term debt outstanding, yields on these and on money market securities in general may prove to be surprisingly sensitive to any change away from the present degree of "active ease."

But, an appropriate credit policy has to concern itself with other matters besides the condition of the market for Treasury securities; for example, the money supply and the rate of change in it, the overall economic climate and expectancies, and the like. So, even though an upturn in the yields on short-term Treasury and other money-market issues might touch off a slide in bond prices, the Reserve might nonetheless consider that economic conditions require a less heavy accent on active ease within the near future.

Wide yield spreads between short-term and longer term issues are an invitation to many investors to lengthen maturity but it's a danger signal, too, in the present situation

There is a rather general belief among investors that extensions of maturity should be made largely when these can be effected at reasonably good increases in yields. In other words, the recent and prevailing wide yield spreads between short and longer term Treasury issues have been a factor in making possible the Treasury's sales of many longer dated securities, as well as being a consequence of these sales. At the same time, investors have been able to take the

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view that the higher income to be obtained on these longer issues compensated them for the increased risk to principal that had to be assumed.

Conversely, however, when interest rates are low (bond prices high) increases in the yields of successively longer maturities are wider than is the case when bond prices are low. Reference to chart 7 will illustrate this—note the difference between the yields prevailing on Treasury securities of varying terms during 1951–52 and during the second quarter of 1953.

Consequently, when longer term bonds are purchased (at relatively high prices during periods of easy money) the possible loss through some subsequent downturn in prices is substantially larger dollarwise, than are the potential gains (through further price increases). The compensating factor of the increase in income that was obtained when the bonds were purchased becomes, at this time, a thing of the past. The prospective gain versus loss equation begins to dominate the attitude of the investor. This is particularly apt to be the case if a large number of investors (in this case bankers) believe their portfolios have become out of balance (too few short-term and too many longer-term holdings) for the current and prospective outlook.

Such a set of circumstances would make it more necessary than heretofore that a further advance in the levels of business activity be paralleled by the expectancy of a Treasury cash surplus. This might be used to retire short-term issues and thereby (1) cause banks and others to become more reluctant to sell longer Treasury securities while (2) it also would provide banks with the reserves needed to extend private credit.

A lot of charts

In my remarks I have referred to certain of the charts that accompany this statement. A brief explanation of all the charts is appended to them.

One particular chart that shows the Treasury security holdings of the Federal Reserve banks, 1D, deserves comment before I leave this general area.

Did the Reserve banks prefer certificates to bills?

Throughout most of the 1940's, the Reserve's holding of Treasury bills was quite large proportionately. Today, and for the past several years, they have been quite small although the Reserve's open-market practice has been to confine its purchases and sales largely to such securities. The reasons for this are excellently set forth in the Federal Reserve's replies to the committee's questions.

In the refunding of 2 weeks ago the Treasury made 2 short-term offerings, a new 1¼-percent certificate and an additional amount of the 1⅛'s of August 1955. The latter was said to be largely to permit the Reserve banks to achieve a more even distribution of their holdings. This Treasury move invites questions: Did the Reserve prefer to diversify its certificate holdings or to diversify by a reduction in certificates and an increase in bills? Why did the Treasury offer the Reserve additional certificates, instead of offering additional amounts of the weekly series of Treasury bills?

A nutshell picture of the progress made by the Treasury in debt reconstruction and some delayed-action problems that have been created

The Treasury has been able to reduce its near-dated debt so substantially that the major portion of this task should be completed for now. Moreover, by withdrawing savings notes from sale, and by permitting series F and G bonds to mature without receiving any specific new refunding offerings, a net decrease may develop in the outstanding amount of the nonmarketable debt. This may give the Treasury more leeway with which to meet the steadily mounting requirements of the Government accounts. Also, while the short-term holdings of the commercial banks have been reduced at a rather rapid rate during 1954, the speedup in the tax payments of corporations may provide some offsetting supply of short-term securities over the next few years.

Altogether the Treasury has gained considerable elbow room for future debt management. The pressure of a too-large near-dated debt has been eliminated.

Some delayed-action problems may have been created. These originated in the large cash deficits that had to be financed from mid-1952 to date. The best way of resolving these potential problems would be for Congress to make sure the Treasury has a substantial cash surplus should business activity continue upward. Such a fiscal policy goal could promote that sort of business trend if it is gone about in a manner that is not hostile to business.

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If we get off to a bad start in the matter of the Treasury cash budget we are bound to head for problems. Congress needs to find a way to make fiscal policy more consistent with appropriate, flexible monetary policy objectives

What I have been trying to say, and to illustrate by the events of the past few years, amounts to this: Monetary policy has to begin with fiscal policy, that is, with the Treasury budget result. As in everything else, if we get off to a bad start we are headed for problems from there out. The results in the Treasury budget over the past few years have compounded the difficulties of managing the debt. They were a major factor in building a near-dated debt that was out of all reasonable proportion. This has not been the fault of the Treasury—regardless of which administration—it was the consequence of Treasury cash deficits.

The objectives that have guided debt management and credit policy during the past several years have been excellent.

In working out monetary policy, a great many human judgments obviously were required of Treasury and Reserve officials. Human judgments are frail. But we should recognize that human judgments are not necessary only in connection with a flexible monetary policy. They are just as necessary, and more of them are required of a monetary policy that is inflexible—designed for inflation. They are even more necessary to and far more numerous in the conduct of most alternative forms of selective controls.

We, therefore, should not confuse concepts and objectives with judgments. We can expect from judgments, not perfection, only good performance. We have met with extremely good performance by Treasury and Reserve officials during recent years.

The presently most pressing problems of monetary policy are therefore the results that flow from fiscal policy, the Treasury cash budgets. Surely the Congress can find some way to provide for changes in the rates of taxation and to control Treasury expenditures so that the Treasury cash budget can be more consistent in the future with the appropriate objectives of a flexible monetary policy, one that must deal with changing economic conditions.

Now I would like to turn to the matter of the Treasury security market and the manner in which this market ties into monetary policy.

Is the public market for Treasury securities a free one?

Of course, the public market for Treasury securities is not "a free market," in the sense of the term. But the public market must be an adequate one. It, therefore, must enjoy freedom to reflect fully, into market prices and yields, the transactions of the general public. Such transactions can take place only in a market free of direct intervention from the Reserve,[3] because the public's transactions must reflect the competition of the market place and take place in the environment of the actual and prospective condition of the Treasury's budget, the objectives and the decisions of debt management and of credit policy and of business conditions. Only in such a market can the fluctuations in interest rates reflect accurately the supply and demand of Treasury securities that constitute the country's response to changes in business activity and in monetary policy. The resulting fluctuations in interest rates are the product of what has happened, what is happening, and of future expectancies. Monetary policy of any kind would become befogged if it were not guided by interest-rate fluctuations of this kind. Some refer to the fluctuations in interest rates as the best thermometer we have by which to judge the health of the economy.

Of course, there are alternatives to the kind of a public Treasury security market we now have

Other alternatives to an adequate public Treasury security market can be devised. For example, the Treasury could engage in market transactions for its accounts, and/or for the sinking fund, and/or in the name of the stabilization fund, for the purpose of providing a market for its securities. This could take the place of the public market that is maintained through the private firms that are the intermediaries. No one can say whether the Treasury officials charged with handling the individual transactions in a market made by the Treasury could or would do so in a way that these fully reflected into prices and yields the transactions of the public. But I don't believe we could take a chance because

[3] Or the Treasury.

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some Treasury administration in the future might try. Even Barnum couldn't fool the public forever, and the monetary pressures that could build up would assert themselves in other ways—in price increases, in inflation of the usual kinds, and in an increase in the overall costs of all of us and in the costs of government. The latter, alone, would be many, many times the reduction in Treasury borrowing costs that might come from the Treasury's manipulation of interest rates.

Or, the Federal Reserve banks, with their gigantic portfolio, could engage in market purchases and sales of Treasury securities partly to provide a market, or for the purpose of facilitating the attainment of credit-policy objectives that some claim could be done in this fashion, or to further the success of Treasury financing. Each of these types of open-market operations would take on, in time, the characteristics of the past price-fixing operations—the experiment that was such a costly failure. The Reserve then would act as some kind of a benevolent dictatorship; so that interest rates would reflect only the assessment made by Reserve officials as to the prices and yields on specific issues and on maturity sectors that were "proper."

Are we interested in thermometer readings or the health of the patient?

If fluctuations in interest rates are the best thermometer we have with which to judge the response of the public to the administrations of credit policy, then any of these alternatives would be strange ones to adopt. Even the more moderate alternatives, such as advocated by those who would broaden the scope of the Reserve's open-market operations, would be dangerous, in my judgment. It would be like applying heat and cold alternately to the bulb of the thermometer so that we could obtain the temperature readings we wanted to see. Surely, we would learn little from this about the health of the patient.

How can the Reserve intervene to directly affect the prices and yields of Treasury securities only a little and not too much?

Some who nevertheless would have the Reserve discard its present narrow concept of open-market operations for an expanded one claim that it is not enough to produce and to absorb reserves; that the prices and yields on Treasury securities in the different maturity sectors are important, and may not correspond to their judgments of a proper response from the market; that credit policy cannot rely on what they claim to be the imperfect arbitrage within and between markets and, therefore, the Reserve should engage in open-market operations anywhere in the entire maturity range of the market.

I cannot understand, and I have been unable to obtain a plausible explanation, in practical terms, of how the Reserve could intervene just a little and be sure such intervention would be within limits that would be consistent with credit-policy objectives; that is, any credit-policy objective except active ease.

I have sought and I have been unable to obtain a plausible explanation, in practical terms, of how the Reserve might further the success of Treasury financing by the purchase of exchangeable and newly offered securities without running afoul of credit-policy objectives, except ones of wanton ease. Nor has anyone been able to tell me how decisions would be made that this or that Treasury financing would justify Reserve support, whereas this or that one would not.

I have asked what would happen (1) if the Reserve were to start to buy securities in the Treasury bond market because it felt prices were below some preconceived idea of an appropriate level, and (2) the amount of such purchases began to exceed that which could be made consistent with the prevailing credit-policy objective. Should the Reserve banks in such a circumstance stop their buying? If they did, the subsequent price decline might reach a level substantially below that which Reserve officials disapproved initially.

If the Reserve started off such a buying program and purchases definitely exceeded those that could be made consistent with the prevailing credit-policy objective, should the Reserve continue to buy on the grounds it might be impractical to stop such purchases? If so, which will have taken precedence—the management of the Government security market or the objectives of credit policy?

Sometimes it is said that, in any such events, the Reserve could sell other securities. If that is true then, as always happens, intervention in the normal functioning of a market at one point, requires supporting intervention at a second,

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and at a third point until, finally, intervention turns into the necessity of managing the entire market. That is what happened before.

I could give you illustration upon illustration of how Reserve intervention that aimed at directly affecting the prices and yields of Treasury securities has interfered with the normal functioning of the market; of how it first drives the intermediaries to cover and then the investor and of how, in the end, the Reserve becomes—it is inevitable—a not-so-benovolent dictator. But instead let me remind you of what happened when the Reserve attempted to further a Treasury financing of which Reserve officials fully approved. In November 1950 the Treasury offered a 5-year 1¾-percent note—precisely the terms the Reserve thought the Treasury should offer. The Reserve undertook to further the success of the financing. Before the Reserve got through, it had acquired $2.7 billion, or 40 percent of the new issue.

To this I would add that when the Reserve starts to intervene during Treasury financing periods, investors and the intermediaries, the Government security dealers, have no basis whatsoever for judging the market or the real reception that might have been accorded the new issue. Many thereupon follow the prudent course and sell. When the Reserve does not intervene, a new issue may touch par or break it and thereby actually uncover more buying power than the Reserve would have any desire to supply. This happened shortly after the offering of the 1⅝-percent notes of 1957 this fall; it happened the other day in the new 2½-percent bonds of 1963.

As the Reserve moves in to intervene in the prices and yields of Treasury securities the public market begins to move out

The basis upon which the public decides to buy or sell Treasury securities in a market that is conducted through dealers, who serve as intermediaries, is a composite of the needs and desires of individual investors plus their evaluation of current and future supply and demand, business conditions, and monetary policy. When the market is subject only to these forces and is free of attempts by the Reserve to directly affect prices and yields, we get a full response to monetary policy, and the Treasury has the benefit of this response when it has to engage in financing.

When, however, the Reserve moves to directly affect prices and yields, for whatever purpose, the public and the dealer intermediaries have to reconsider their ability to weight supply-demand and the usual factors of response to monetary policy. They begin, instead, to spend an increasing proportion of their time worrying about the character, scope, and timing of the Reserve's intervention. In fact, they begin to ignore the significant purposes of credit objectives. The entire public market slows down. Its normal functioning becomes increasingly impaired. The so-called imperfect arbitrage becomes more imperfect. The market's responses to the objectives of credit policy become more slow, or too quick, and sometimes these have boomeranged in such degree as to emasculate the Reserve's objectives.

Further, I believe it is correct to say that on about every occasion since the creation of our tremendously large public debt, Reserve open market operations that aimed to affect directly the prices and yields of Treasury securities attained a size multifold that which was expected of these, and considerably more than could be made consistent with the credit or monetary policy objectives of the time.

If the Reserve were to expand its open market operations and thereby move in, so to speak, then the public Treasury market has no other option but to begin to move out.

Judgments as to what the reactions of others will be and one actual reaction

I have heard it said that these are matters of individual judgments, that it is a matter of individual judgment as to whether the public and dealer intermediaries would react along the lines I have outlined and as stated in the Reserve's replies. This is another one of the things I cannot understand. The study made by an ad hoc committee of the Reserve Open Market Committee is replete, I am sure, with innumerable instances of how dealer intermediaries (and the public) have reacted to such intervention in the past. Why should they react differently in the future?

Yet, even within recent weeks, I have heard it said that dealer firms, such as ours, would not discontinue their endeavors to enterprise in the Treasury market,

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or to develop it, and that we would not curtail the size of the commitments we normally accept. To such a judgment, I can offer a reply which has the greater merit of being, at least, the conviction of one dealer as to what he would have to do to conform with prudent standards of conduct.

Were the Reserve to intervene again to directly affect the prices and yields of Treasury securities my firm would immediately seek to employ its capital in other fields; we could not afford to risk our capital in the same way and to the same extent that we do under the present, more normal functioning of the market. We would have to examine the desirability and the profitability of conducting a lower volume of transactions as an agent or broker.

Two troublesome problems which remain unresolved

The techniques adopted by the Reserve to foster a stronger, more self-reliant Treasury security market have contributed mightily to that objective. It is gratifying to know that the Reserve finds its expectations to have been fulfilled, on the whole. I think we do have a pretty good market in Treasury securities today. But, as I said earlier, we must continue to aim to develop this market and to enlarge its scope.

The biggest sector of the market, from the point of view of the size of transactions, and the manner in which it may be used to effectuate credit policy is the short-term end, and more particularly, the bill market. All these short-term Treasurys compete with other money-market securities. Because, short-term Treasurys are the premier money-market investment, they usually sell to yield less than other such instruments, including Federal funds. To maintain a market of desirable breadth and resiliency throughout all market conditions dealers need to carry a rather substantial inventory. But, dealers cannot afford to do this, as a regular thing, unless the interest rates they pay to carry their inventory are equal to or less than the rate of return on the securities in inventory. This is not usually the case where short-term issues are involved.

When the Reserve, beginning with the end of World War I, decided to foster and promote a broad, active market for bankers' acceptances, it ran into exactly this problem with the same results; when the cost of money needed to carry inventory was higher than the rate of return received from the inventory, dealers proceeded to reduce their holdings. Then, as now, the result is that the market loses some of its breadth and activity, and the securities involved are not as suitable as they might be to many investors.

The second problem stems from a change that had taken place in the methods employed by member banks to make day-to-day adjustments in their money positions. Before securities became the principal medium for such adjustments, the ability of one member bank to increase its reserves or to invest surplus funds brought about corresponding changes in the reserve position of the banking system. Today, Treasury securities are the principal medium for making such adjustments, and the results differ. Sales and purchases of Treasury bills, and other short-term Treasury securities, undertaken by individual banks, do not result in producing or absorbing reserves for the banking system as a whole; at least, not in ordinary circumstances. Fluctuations occur in the yields of Treasury bills and short-term Treasury securities, some redistribution of excess reserves or of borrowings at the Reserve banks takes place, but no increase or decrease occurs in the reserve position of the banking system as a whole. This means that money market conditions undergo relatively minor change, if any.

The Treasury, too, has helped to promote a better functioning Treasury security market—it can help more

In October 1953, Secretary Humphrey called for more enterprise in the money and bond markets with a view to developing a broad and vigorous market in Treasury securities. He pointed out that this was vitally important because the behavior of this market is watched and magnified throughout the country and the world. The Treasury has helped to promote such a market. It has done so by gradually concentrating its short-dated maturities, other than Treasury bills, into four maturities a year instead of the larger number that used to be outstanding. This served, as the Treasury reply points out, to leave the market more free to function normally and to reflect the public's response to credit policy.

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Perhaps the Treasury could help more along the same lines. For example, it could increase the amount of its weekly bill offerings with a view to reducing the number of its other maturities to two a year.

But there also are other ways in which the Treasury can help. Since these are technical I will not go into them except to say that their purpose would be to attract more bond firms, and more young people, into the business of regular daily dealings in Treasury securities. Although the size of the Treasury debt has been multiplied many times in the past 15 years there has not been much of an increase in the number of specialists, the intermediaries, who regularly deal in the Treasury security market. Most of us who head these firms have been in the business for 25 years or more. The number of young people coming up to take our places, throughout the industry, is too few.

The hard core of the public Treasury market is made by the specialists and their dealings with each other. Through these, the supply and demand flowing into one specialist may be matched off with that flowing into another. In such clearances, a constant testing process is also achieved wherein the specialists themselves derive what is called "the feel of the market." If there were more specialists, more intermediaries, this hard core would be, not only enlarged, but made harder, definitely more resilient and the market would become, automatically, more self-reliant. At the same time, an enlargement in the number of firms would mean a wider opportunity for young men. The Treasury security market needs them.

Progress has been made, more progress can be made, in the same way, with the help of the same people and with the help of others

To sum up this portion of my remarks: The public market for Treasury securities is not "free" in the way some have misused the term. The public market is more free than it used to be, and it must remain so because the available alternatives would make it difficult to keep competitive enterprise, monetary policy, individual freedoms and the large national debt a compatible combination.

Attempts on the part of the Reserve to intervene directly, to affect the prices and yields of Treasury securities, would be an experiment that would amount to seeing whether the Reserve could go only part way back to the past price-fixing operations which proved to be a costly experiment. When the Reserve moves in to intervene in the market for Treasury securities, the public market has no option but to begin to move out. The normal functioning of the market becomes impaired, and the need for further intervention on the part of the Reserve is soon called for. It is not necessary to rely solely on human judgments for guidance in these matters. The working papers of the Reserve System are replete with innumerable instances of how the public and the dealer intermediaries have reacted. Furthermore, I have told you how my firm, one such intermediary, would react.

There are some troublesome problems which still remain unresolved. The decisions made by the Reserve with respect to its open market operations, and the techniques with which these have been given substance, have contributed mightily to the resolution of some problems of the Treasury security market. The Treasury has contributed in other ways. Both the Reserve and the Treasury can contribute in additional ways, as can all who have a responsibility for and an interest in monetary policy.

Appendix

THE CHARTS

Charts 1A and 1B show the maturity distribution of the marketable Treasury securities on two slightly different bases (1) essentially representative of the Treasury's potential liability to meet its maturities and (2) with certain taxable bonds shown to their first call date.

Charts 1C and 1D show the holdings of the Government accounts and the Federal Reserve Banks. When considering the problems of the reconstruction of the Treasury's maturities (which have to do largely with marketable issues) these holdings should be subtracted. Over the years the amounts involved (in each case) are apt to enlarge. This means that unless the total Treasury debt

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increases, the amount of marketable debt that is publicly held (charts 2A and 2B) must decrease. Such decreases normally would be expected to come about by retirement of maturing obligations (a shrinking of near-dated debt).

But, in any event, the size of the problems and of the progress made should not be measured in terms of either the total debt or the total marketable debt. It is better viewed as two separate problems, (1) the nonmarketable debt, and (2) the marketable debt that is publicly held (charts 2A and 2B).

On the matter of savings bonds and notes, for the past 4 years the amount outstanding has decreased. This is partly because savings notes are no longer issued. Maturities of the F and G bonds have not received, recently, any specific refunding offerings. Holders have had the choice of reinvesting in the series J and K bonds, or the series E and H bonds subject to the various limits on each.

At the present time the prospects, under present Treasury policy, are that savings notes will decrease fairly steadily, as may the aggregate outstanding amounts of series F, G, J, and K bonds. Series E and H bonds should increas, but not sufficiently to offset the decreases in other savings bonds and in savings notes. This means that decreases in the total amount of such nonmarketable obligations may make it possible for the necessary increases to occur in the holdings of Treasury accounts, without having to effect withdrawals of marketable debt held by the public.

At the same time, the decrease in this nonmarketable debt may be larger than can be placed with the Treasury accounts, and this would require an increase in publicly held debt. If a Treasury cash surplus exists, it could be used to meet any such net redemptions.

Chart 4 shows the lack of any visible relationships between the net current assets of nonfinancial corporations and their Treasury security holdings. It shows, however, a very marked correlation between such holdings and Federal income-tax liabilities. Since the current amount of the latter should decrease under the speedup plan for corporate tax payments, the Treasury security holdings of businesses may decline. This would provide some increasing amounts of short-term securities for commercial banks that might be needed in view of the prospective further reduction in their liquidity ratios.

Charts 5A and 5B show the same two kinds of maturity distribution that appear earlier, in this instance, for the holdings of nonbank financial institutions. Chart 5C indicates that such investors have evidenced no concern about the decline that has taken place in their holdings of Treasury securities while their assets have been undergoing a substantial increase. We would expect these trends to continue as long as an adequate supply of non-Treasury investments is available.

Charts 6A and 6B show the maturity distribution of the holdings of commercial banks. Charts 6C shows the principal assets and liabilities of all member banks and illustrative changes in their liquidity ratios.

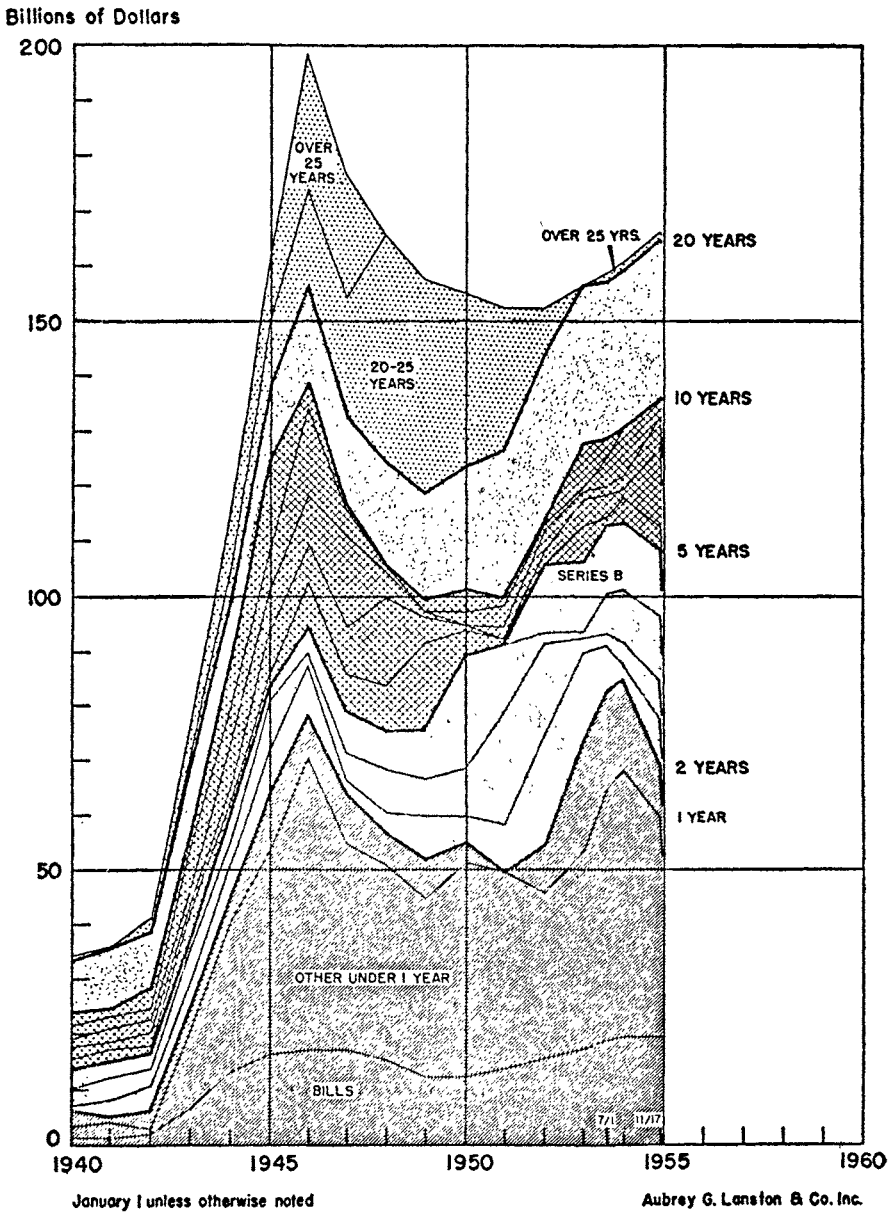
Chart 7 is largely self-explanatory—it shows the relative fluctuations in the yields on Treasury securities of various term.

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CHART IA

OUTSTANDING MARKETABLE TREASURY SECURITIES

INCLUDING INVESTMENT SERIES B BONDS IN 4-5 YEARS
EXCLUDING TAX ANTICIPATION SECURITIES AND POSTAL SAVINGS BONDS
PARTIALLY TAX-EXEMPT BONDS TO FIRST CALL DATE
TAXABLE BONDS TO MATURITY EXCEPT WHEN ACTUALLY CALLED

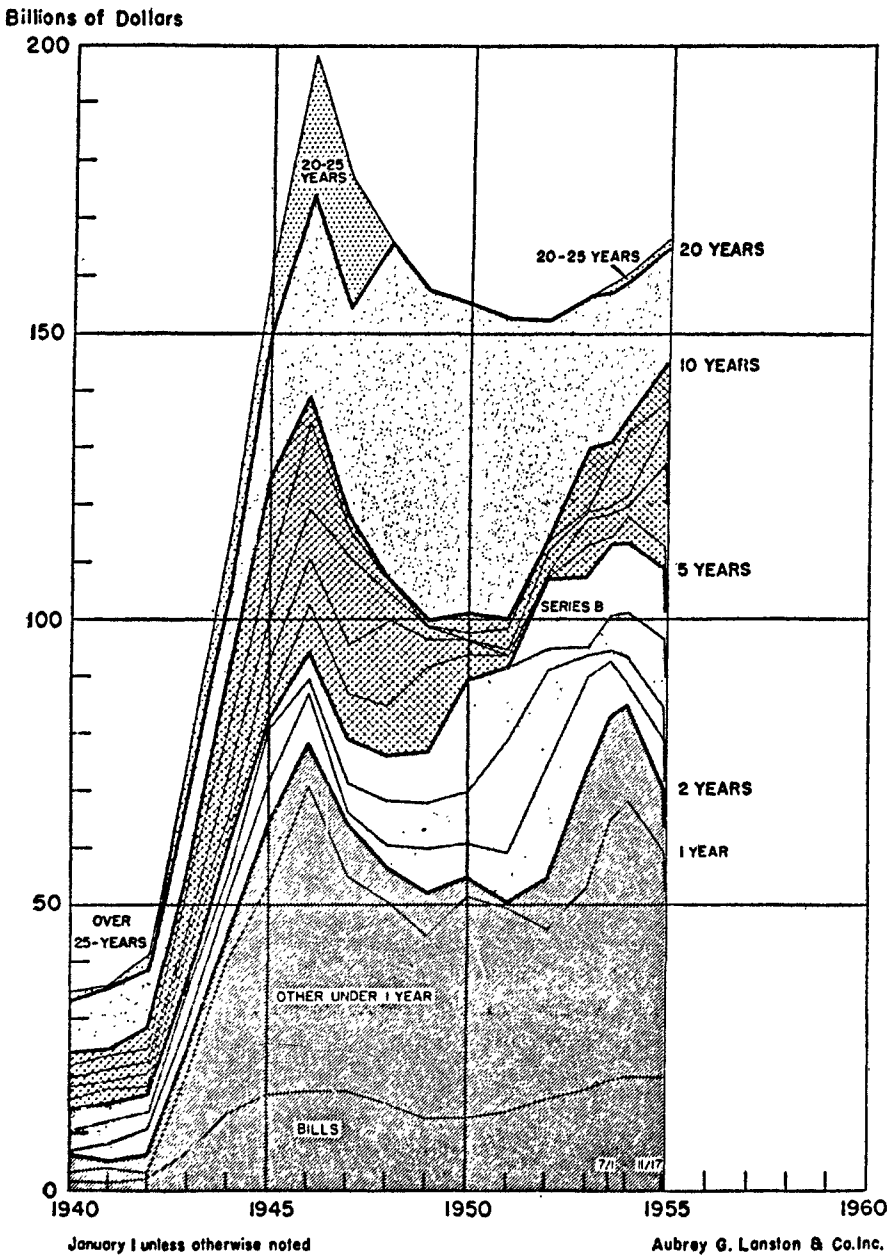


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CHART 1B

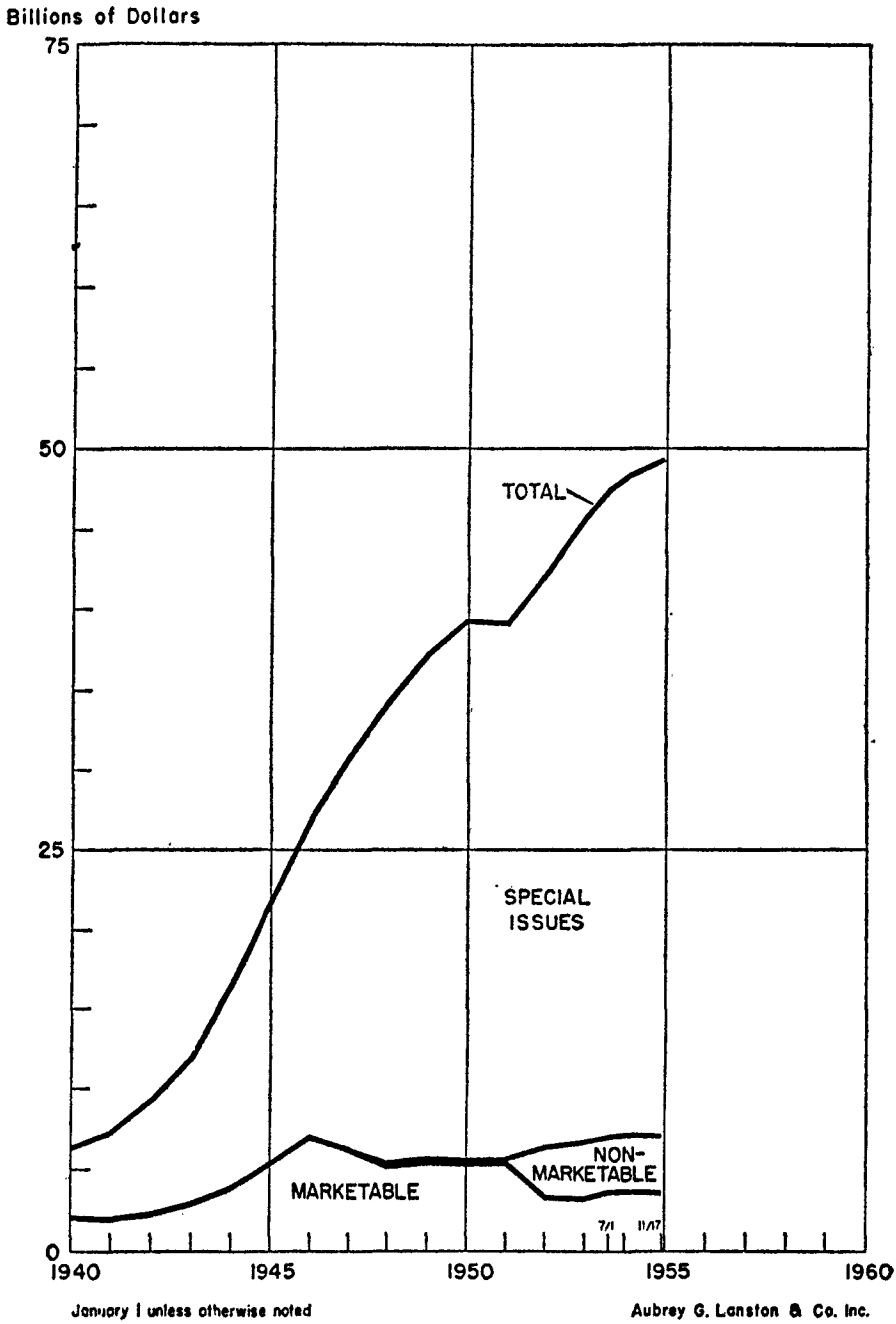
OUTSTANDING MARKETABLE TREASURY SECURITIES

MATURITY DISTRIBUTION SAME AS CHART 1A EXCEPT TAXABLE BONDS WITH COUPON RATES OF 2 ½ % AND HIGHER TO FIRST CALL DATE



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CHART IC
HOLDINGS BY U.S. GOVERNMENT ACCOUNTS

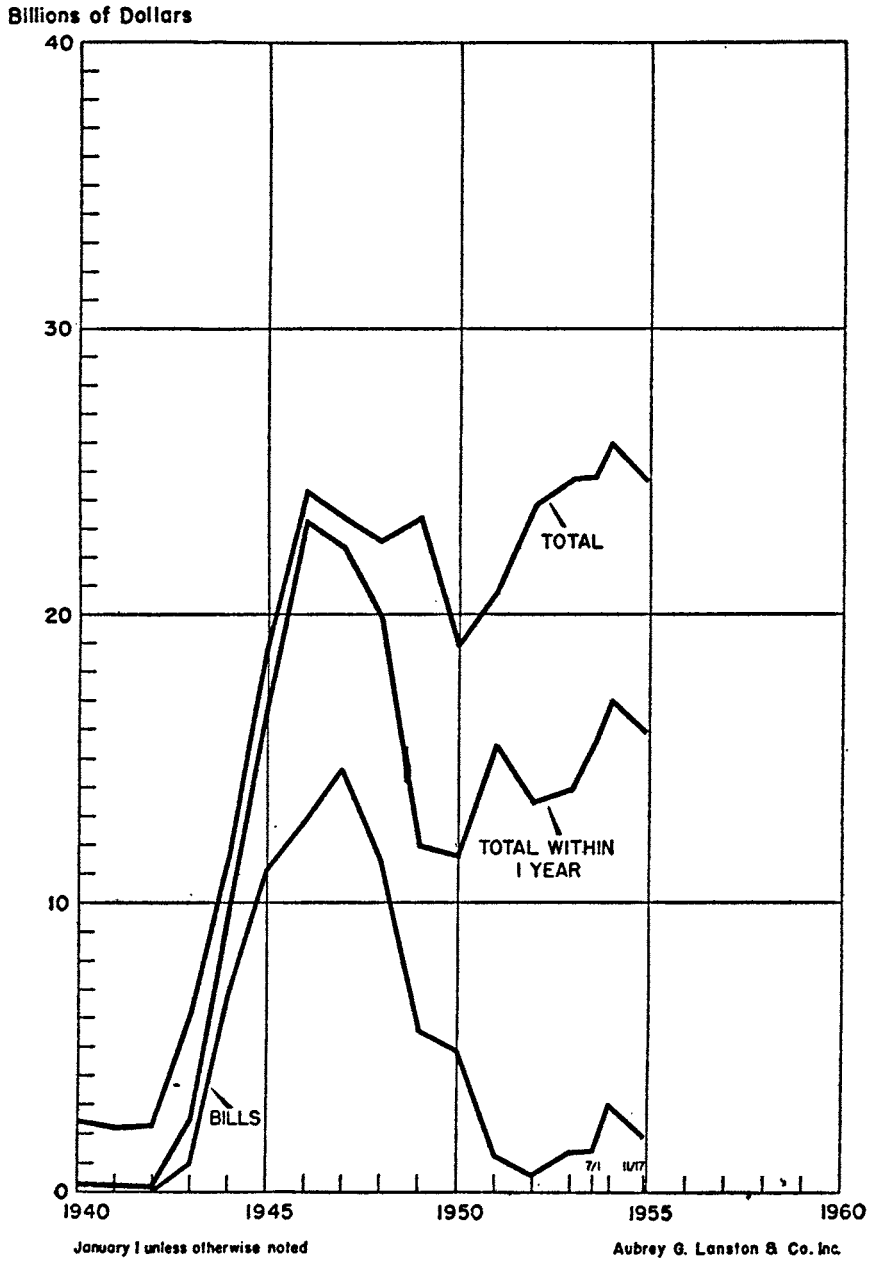


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CHART ID

HOLDINGS BY FEDERAL RESERVE BANKS

PARTIALLY TAX-EXEMPT BONDS TO FIRST CALL DATE
TAXABLE BONDS TO MATURITY EXCEPT WHEN ACTUALLY CALLED

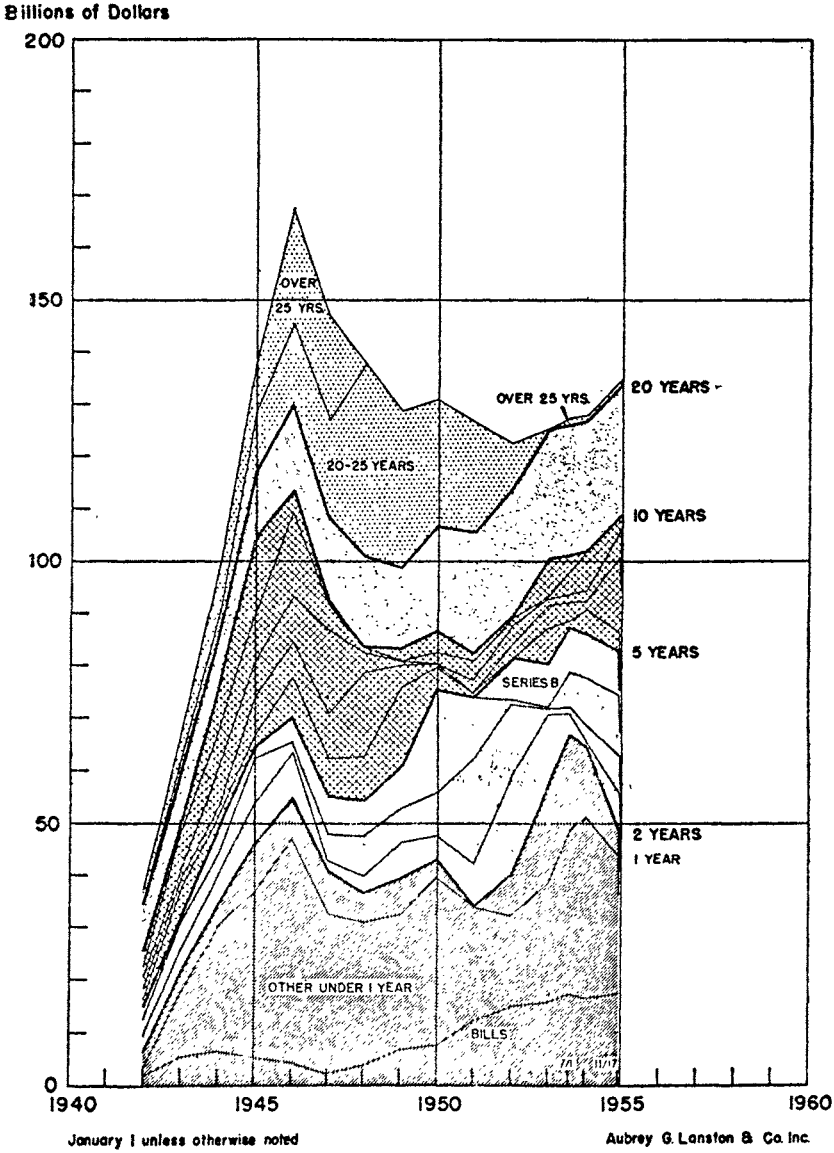


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CHART 2A

OUTSTANDING MARKETABLE TREASURY SECURITIES HELD BY THE GENERAL PUBLIC (EXCLUDING U.S. GOVT. ACCOUNTS AND F.R. BANKS)

INCLUDING INVESTMENT SERIES B BONDS IN 4-5 YEARS
EXCLUDING TAX ANTICIPATION SECURITIES AND POSTAL SAVINGS BONDS
PARTIALLY TAX-EXEMPT BONDS TO FIRST CALL DATE
TAXABLE BONDS TO MATURITY EXCEPT WHEN ACTUALLY CALLED



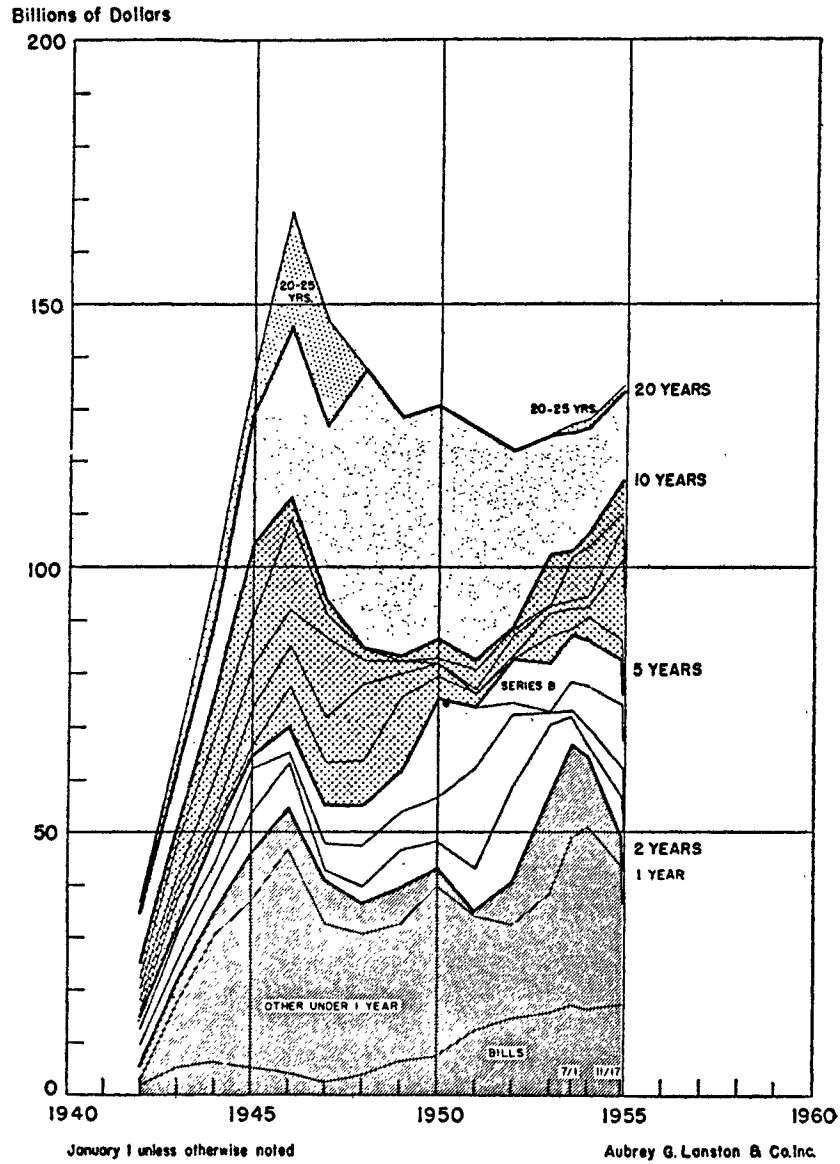
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CHART 2 B
OUTSTANDING MARKETABLE TREASURY SECURITIES HELD BY THE GENERAL PUBLIC (EXCLUDING U.S. GOVT. ACCOUNTS AND F.R. BANKS)

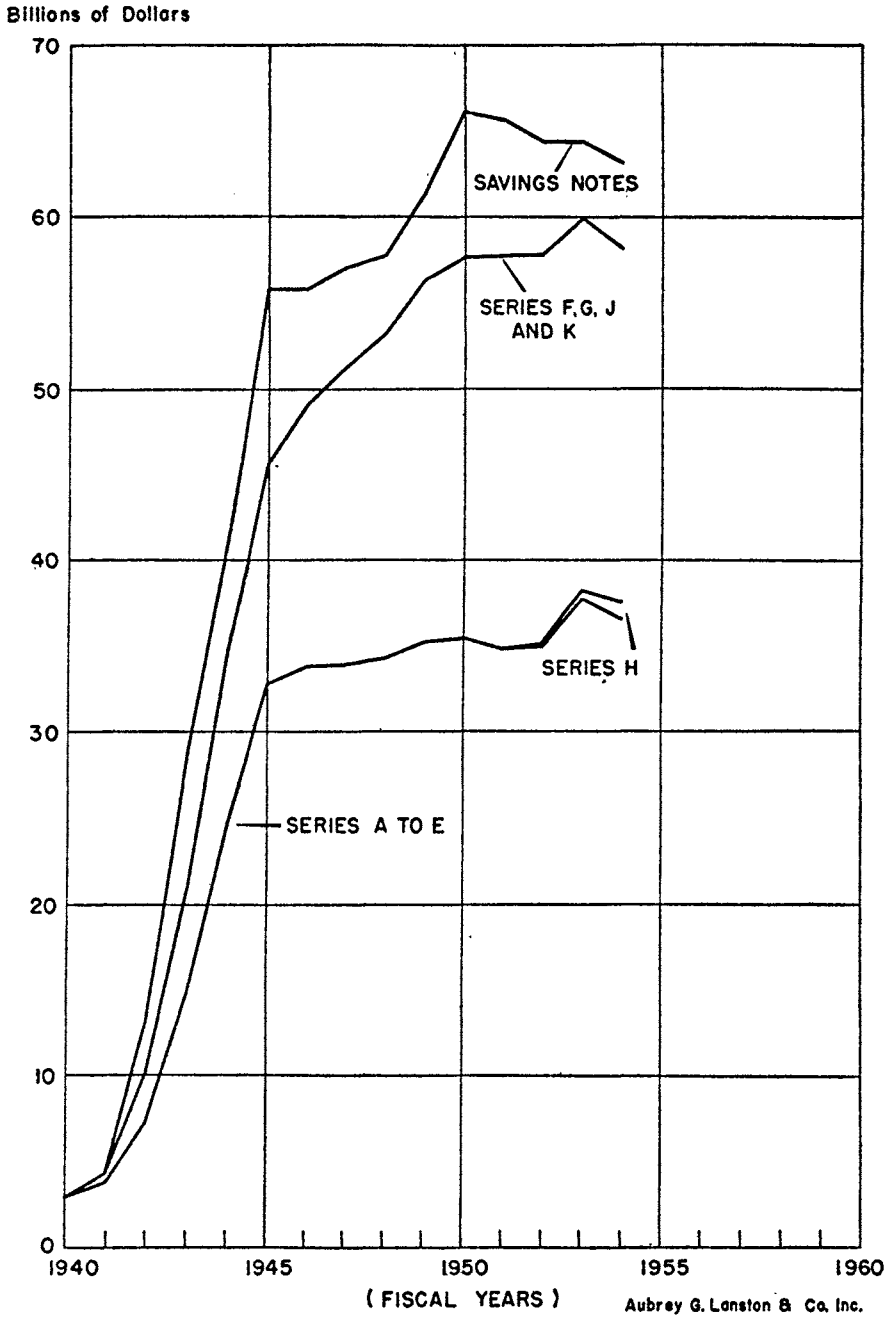
MATURITY DISTRIBUTION SAME AS CHART IA EXCEPT TAXABLE BONDS WITH COUPON RATES OF 2 ½ % AND HIGHER TO FIRST CALL DATE.



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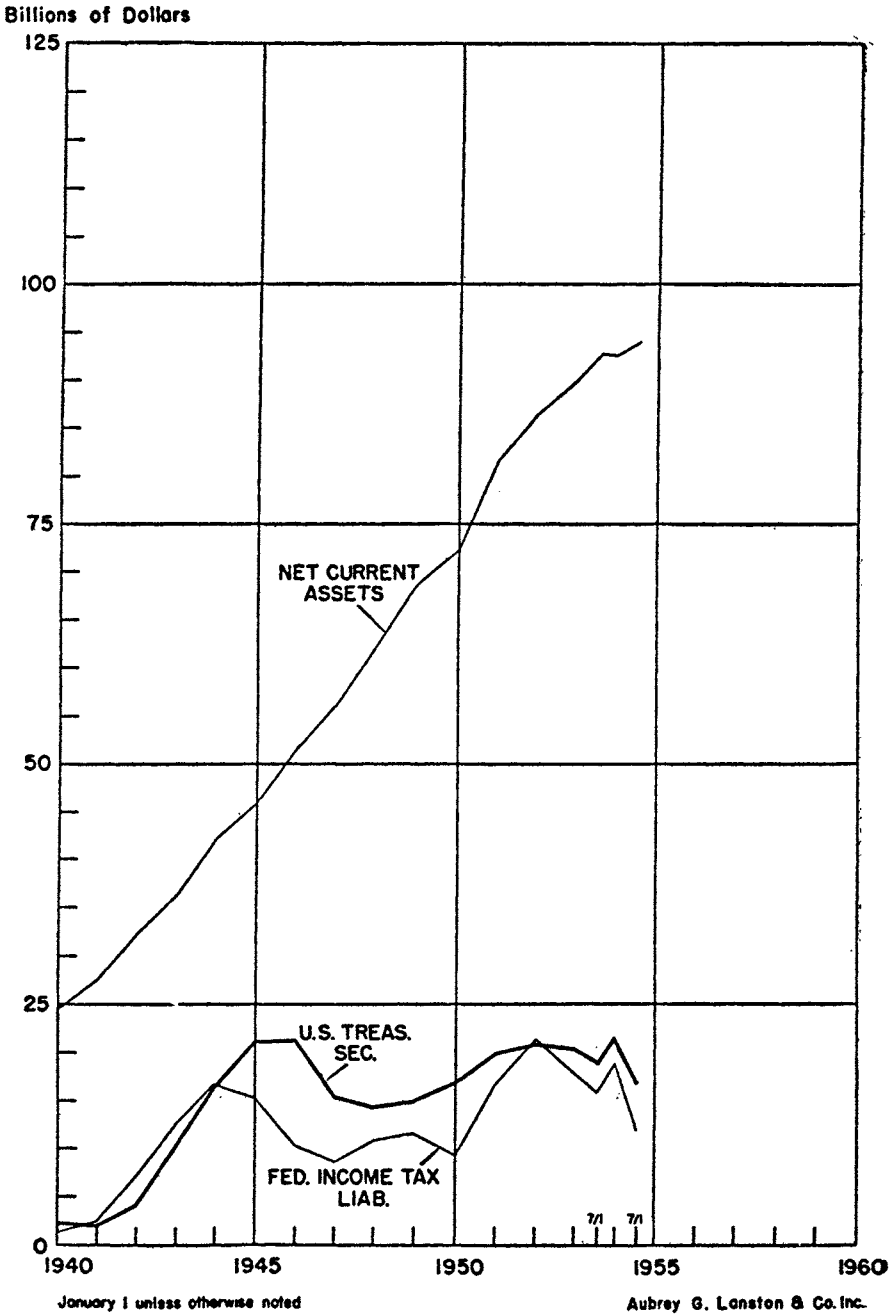
CHART 3

SAVINGS NOTES AND SAVINGS BONDS OUTSTANDING



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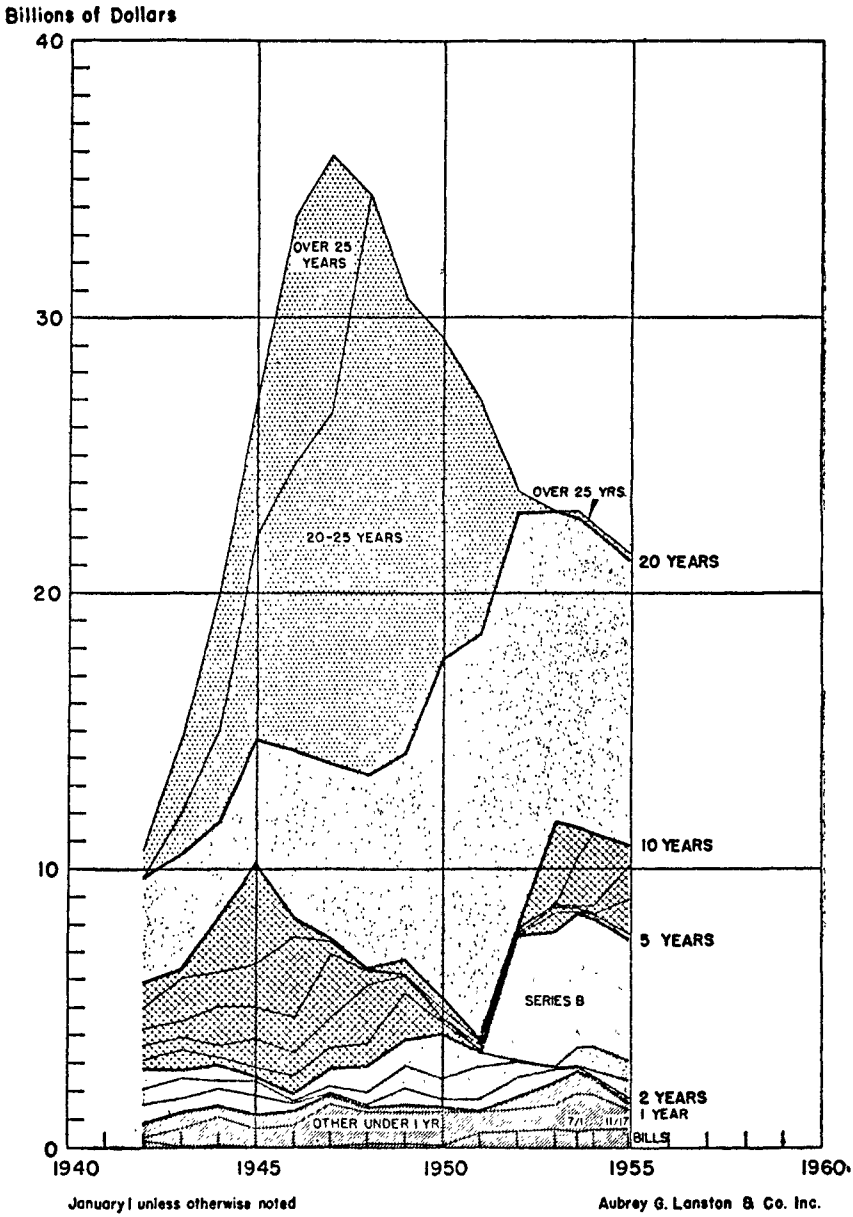
CHART 4
NON-FINANCIAL CORPORATIONS



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CHART 5A
HOLDINGS BY NON-BANK FINANCIAL INSTITUTIONS

INCLUDING INVESTMENT SERIES B BONDS IN 4-5 YEARS
EXCLUDING TAX ANTICIPATION SECURITIES AND POSTAL SAVINGS BONDS
PARTIALLY TAX-EXEMPT BONDS TO FIRST CALL DATE
TAXABLE BONDS TO MATURITY EXCEPT WHEN ACTUALLY CALLED



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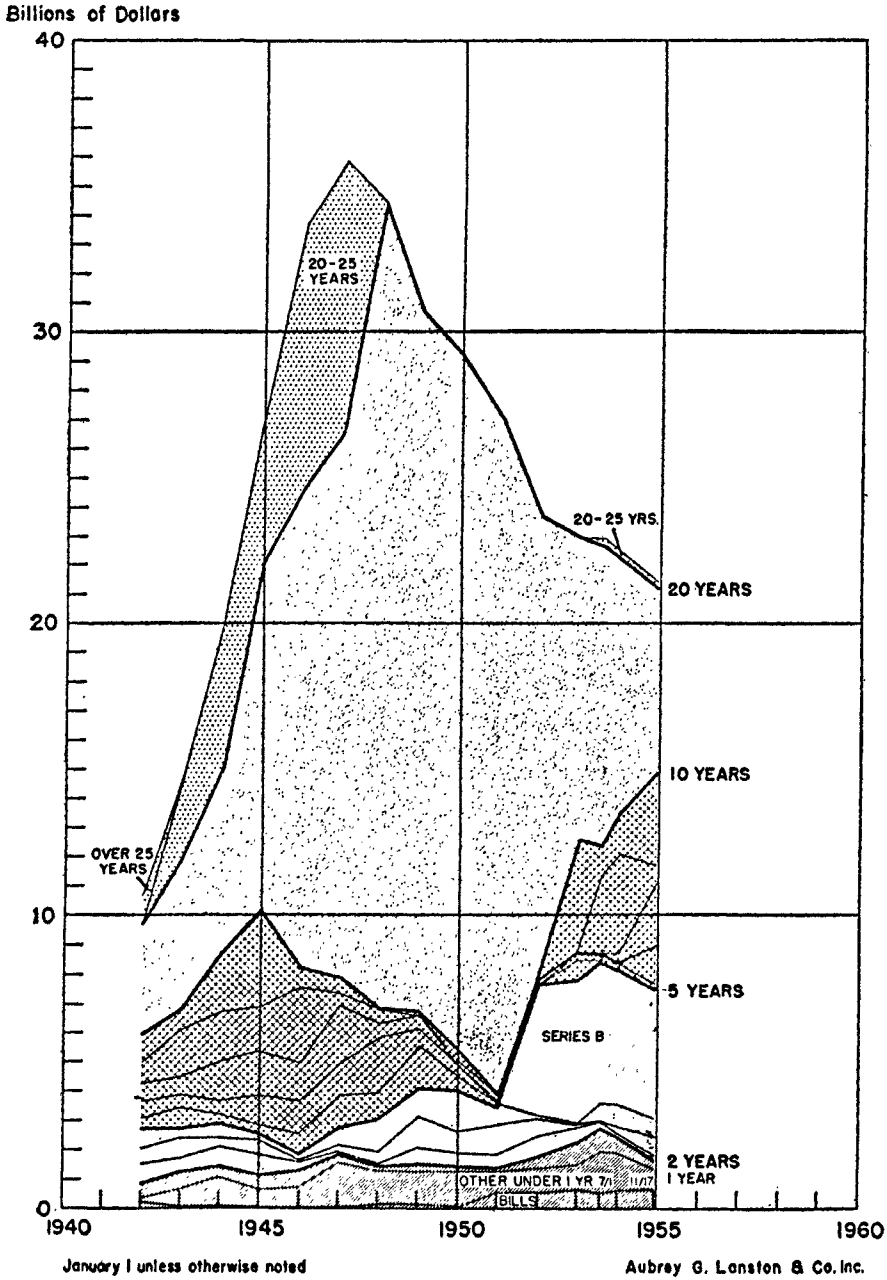
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CHART 5B

HOLDINGS BY NON-BANK FINANCIAL INSTITUTIONS

MATURITY DISTRIBUTION SAME AS CHART IA EXCEPT TAXABLE BONDS WITH COUPON RATES OF 2 1/2% AND HIGHER TO FIRST CALL DATE

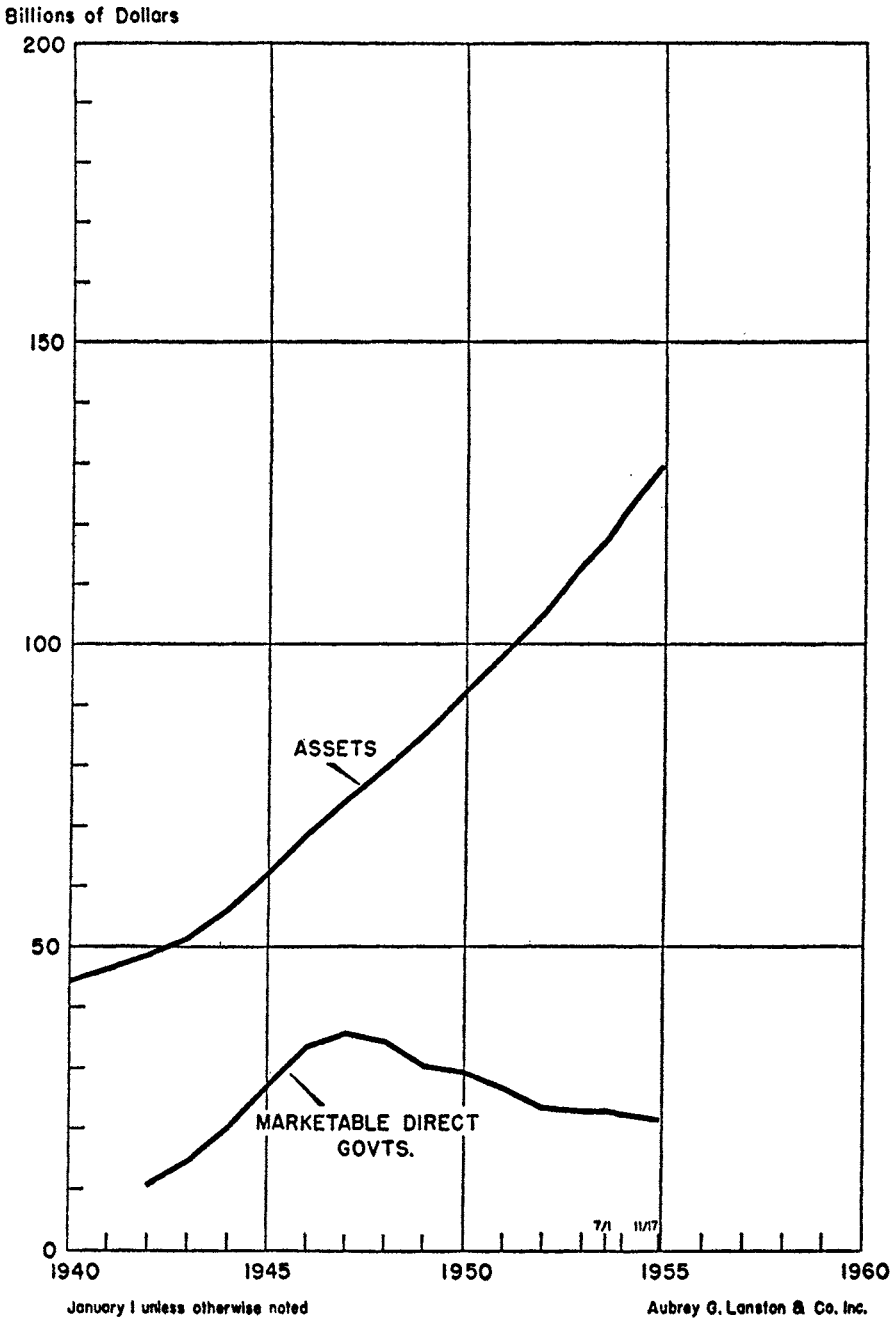


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CHART 5C
NON-BANK FINANCIAL INSTITUTIONS

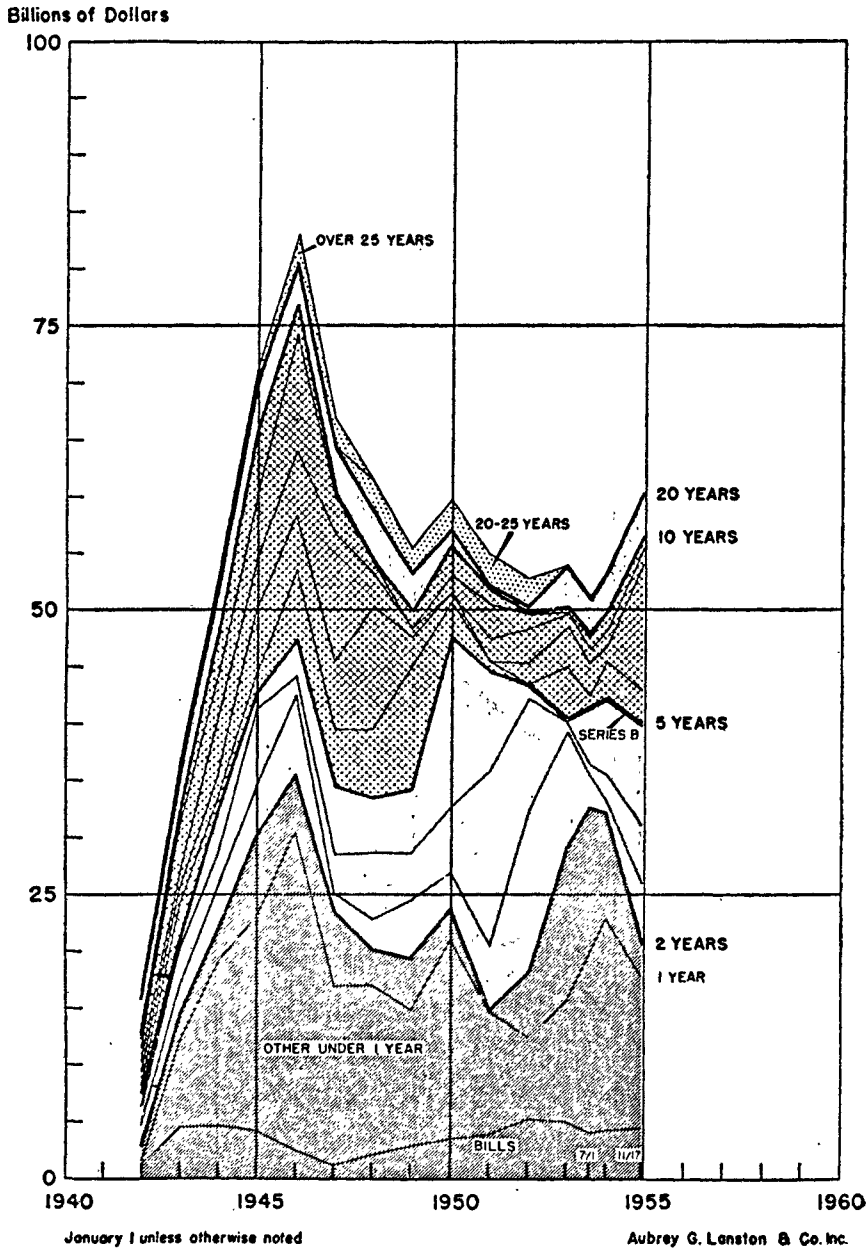


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CHART 6A

HOLDINGS BY COMMERCIAL BANKS

INCLUDING INVESTMENT SERIES B BONDS IN 4-5 YEARS, EXCLUDING TAX ANTICIPATION SECURITIES AND POSTAL SAVINGS BONDS, PARTIALLY TAX-EXEMPT BONDS TO FIRST CALL DATE, TAXABLE BONDS TO MATURITY EXCEPT WHEN ACTUALLY CALLED

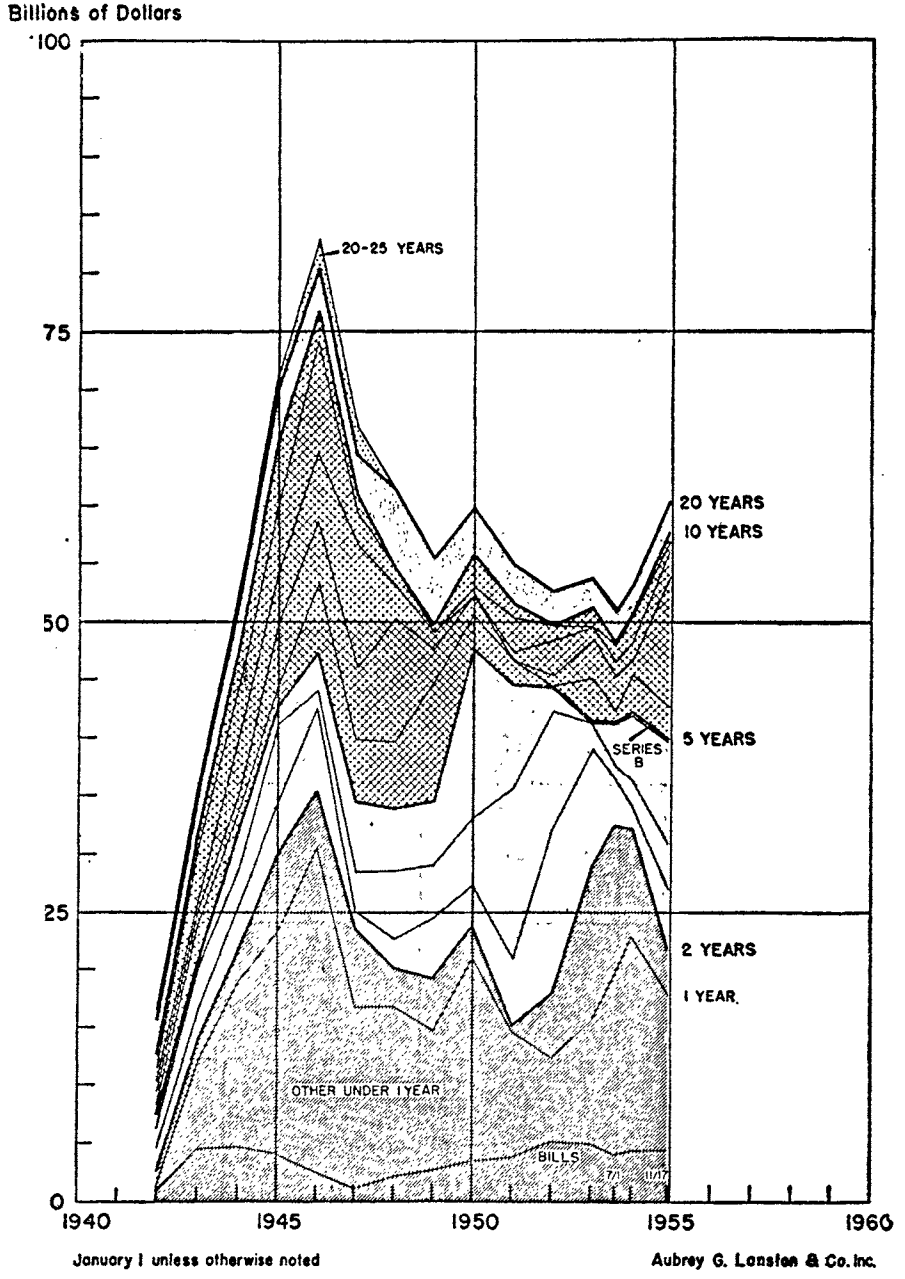


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CHART 6B

HOLDINGS BY COMMERCIAL BANKS

MATURITY DISTRIBUTION SAME AS CHART 1A EXCEPT TAXABLE BONDS WITH COUPON RATES OF 2 1/2 % AND HIGHER TO FIRST CALL DATE



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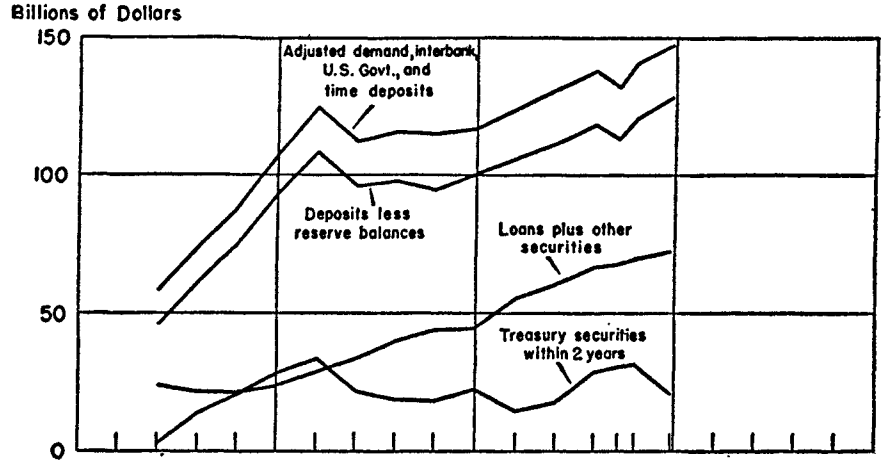
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CHART 6C

CHANGES IN THE LIQUIDITY OF ALL MEMBER BANKS MEASURED IN TERMS OF HOLDINGS OF U.S. TREASURY SECURITIES

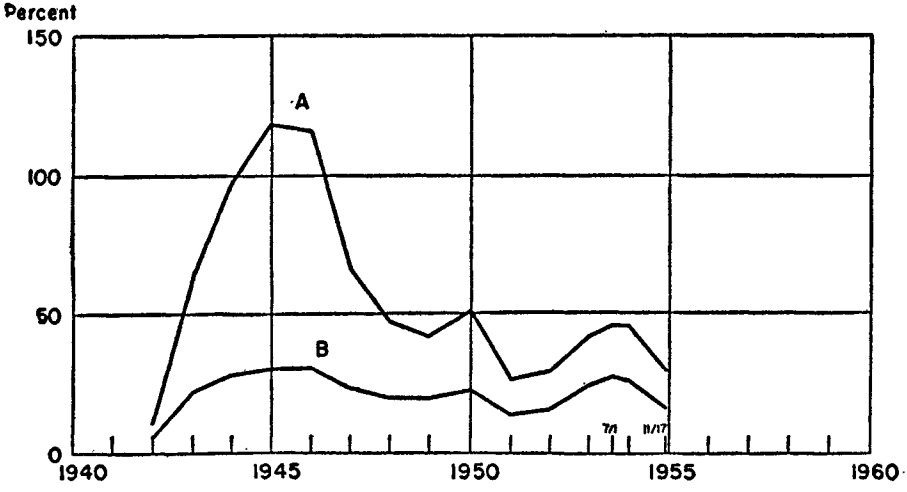
TREASURY SECURITIES WITHIN 2 YEARS: MATURITY DISTRIBUTION SAME AS CHART IA EXCEPT TAXABLE BONDS WITH COUPON RATES OF 2 1/2% AND HIGHER TO FIRST CALL DATE

PRINCIPAL LIABILITIES AND ASSETS



ILLUSTRATIVE CHANGES IN MEMBER BANK LIQUIDITY

PERCENTAGES OF TREASURY SECURITIES WITHIN 2 YEARS TO
(A) LOANS PLUS OTHER SECURITIES
(B) DEPOSITS LESS RESERVE BALANCES



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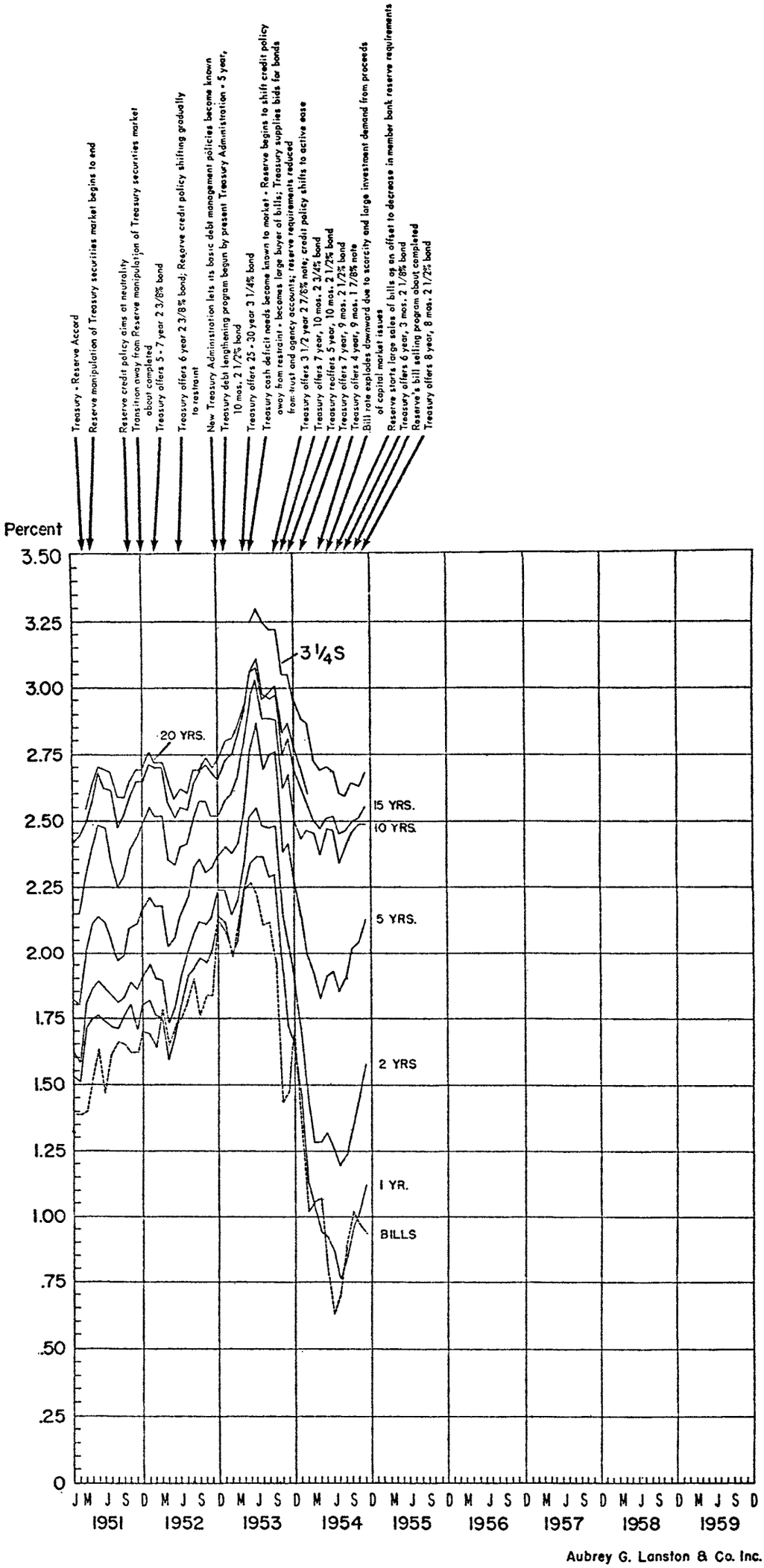
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CHART 7

FLUCTUATIONS IN MARKET YIELDS OF TREASURY SECURITIES OF VARIOUS MATURITIES AND IN THE AWARDS OF TREASURY BILLS 1951 THROUGH 1954 TO DATE

TREASURY BILL AWARDS AS OF THE NEAREST ISSUE DATE TO THE 15TH OF EACH MONTH. OTHER YIELDS FROM YIELD CURVES DRAWN AS OF THE 15TH OF EACH MONTH.



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55314—54 (Face p. 128)

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Senator FLANDERS. We will return at 2 o'clock.

(Whereupon, at 12:30 p. m., a recess was taken until 2 p. m., the same day.)

AFTERNOON SESSION

(Senator Flanders presiding)

(Present: Senators Flanders, Douglas, Sparkman, Goldwater, and Representative Patman.)

(Also present: George W. Ensley, staff director, and John W. Lehman, clerk.)

Senator FLANDERS. The hearing will please come to order.

There is the problem of initiating a chain reaction, and the thought that I have had in mind was this.

Since we worked out in the morning session alphabetically beginning at the beginning of the alphabet as represented here with Mr. Chandler, I think we will start the afternoon, the more free discussion of the afternoon, commencing at the other end of the alphabet. Mr. Wilde, I will ask you to make any observations which may seem pertinent to you about the discussion we had this morning, and initially we will proceed up the line in reverse order, but with a little more informality, a little more questioning back and forth, and it would not be completely undesirable if the discussion became so lively eventually that it had occasionally to be brought to order.

The members of the subcommittee and the main committee are invited to contribute to the discussion as they see constructive opportunity while the panelists are talking with each other.

So, Mr. Wilde, will you commence the discussion.

Mr. WILDE. Senator it is very nice to be waiting in a food line to be first, but in an intellectual feast it is better to be last and then you can make a much more cogent and forceful statement than if you are first.

Without any particular speech to make, I would like to say that the impact of the discussion this morning on me makes me feel that we give too much emphasis to the probability that through very expansive monetary policy we can drive the economy forward and have full employment.

I am not one who has that overall feeling. I believe that other elements must join to accomplish that result, and I have been trying in a small way in my formal paper to mention it.

I am talking about such things as fiscal policy, with particular reference to the kind of a tax structure the country has, and I am talking about the intangibles which are covered in a term that I used, "environment."

Those, to me, are awfully important if we are going to have the kind of a country that we all want, and I use the three of monetary, fiscal, and environment as the necessary trio that will produce a successful result, and I get, as I say, the impression that many members of the panel are more persuaded to the overriding importance of maximum use of monetary policy on the expansion side as the device that will accomplish more than I believe it will.

Senator FLANDERS. Thank you, sir.

Mr. Smutny, what struck you in the discussion this morning?

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Mr. SMUTNY. Well, I felt this. I would like rather to follow a little bit on some of the questions that you would ask, if that is in order, some of the things that have occurred to you.

You said development of a high level of our economy could only be reached through inflation. I think, whether we like it or not, as far as our setup is concerned, free endeavor, free enterprise, we are bound to have a natural tendency toward inflation. It naturally feeds upon itself, the desirability of business to expand, new operations. Naturally, to get new jobs and the expansion of our general economy along the lines that we hadn't conceived of years ago——

Senator FLANDERS. Are you now thinking of inflation in the sense of a rising price level or in some other sense?

Mr. SMUTNY. No, I am not thinking of a rise. I am thinking of the expansion of the economy itself, not a rise in the price level.

I feel that it is the natural tendency in our country, after all, to expand the entire business sphere and sometimes in that expansion new industry, and so on and so forth, that we have industries we hadn't dreamed of would develop 4 or 5 years ago, there is a misnomer of the use of inflation, inflationary tendency in prices.

I think we have stability, stability has been created as far as the price level is concerned through the operations, the monetary fiscal operations as we have seen them. I think we approve very heartily of what has been done.

I think that the purchasing power of the dollar has been kept stable and the price level was kept stable in an expanding economy, but the natural tendency, however, is toward inflation basically. It has to be as long as you are expanding.

Senator FLANDERS. Is it toward inflation as represented in the price level; is that our natural tendency?

Mr. SMUTNY. I think it is a question of demand that has built up, and demand begets production, and the answer to inflation is just a single word: production. Once you have production, you don't have inflation.

Senator FLANDERS. So now you are using inflation in the price-level sense.

Mr. SMUTNY. In the price-level sense. I don't think inflation in the price-level sense is necessary as long as our economy is free to expand, and I differ greatly with Mr. Mitchell, who felt that our economy had to be regulated.

We have been through an era of regulation, that regulation breaks down no matter how good our intentions might be, through the administration thereof. Who can administer certain price levels? How do you know one price level is correct?

You can't substitute anything for the general give and take of purchasing and selling of the market place, and the minute that you get regulation, you have abnormalities created in the market place, you have black markets, and so on and so forth, things that we are familiar with.

I would like to answer Mr. Patman with reference to the Federal Reserve System, the Open Market Committee's power, more power than the Congress. I think that, speaking as an individual, a tremendous confidence has been created throughout our country in the operation of the Federal Reserve System——

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Senator FLANDERS. I don't want to bring up anything extraneous, but since the comparison is between the Federal Reserve System and Congress, would you care to—well, I will end right there.

Mr. SMUTNY. I would like to stick to Representative Patman's statement, the way he put it.

He said are we satisfied with the Federal Reserve System, and I would say that the Federal Reserve System, the way it has conducted itself certainly over the years has begotten itself a tremendous amount of confidence outside of the general banking system.

You referred to the fact that the composition of the Open Market Committee are primarily bankers. If you look back at the history of Chairman William McChesney Martin of the Federal Reserve Board as the president of the New York Stock Exchange, his experience with the market, and so on and so forth——

Representative PATMAN. May I interrupt you there. I wasn't talking about the Board of Governors. I was talking about private banks being represented on a committee that is supposed to perform public functions like the Open Market Committee, the five private bankers, are the ones I was referring to.

Mr. SMUTNY. In compliance with the Federal Reserve Act, on the Federal Reserve Board you have people other than bankers that we are familiar with, businessmen and so on and so forth, and their composite opinion is valuable. I don't think you could say John Jones, just because he is a banker, favors the banking industry. If anything, he has a high regard for what is good for the Nation as a whole.

There is one other question you brought up about the ownership of Government bonds and that banks should stick to loans locally, in the local places where they were situated in favor of purchasing Government bonds.

Actually I think you put the cart before the horse. They have purchased Government bonds due to the fact that the demand for loans has receded, and the purchase of Government bonds has a portfolio relationship of necessity as far as the bank policy is concerned. You have a certain percentage in governments, a certain percentage in cash, bills, and so forth, and you wouldn't want the banks to use their entire assets in loans. The fact that loans in banks have receded is the reason that their bond portfolios have risen over the past years.

Also I think you brought out something in reference to the fact that finance companies have asserted the privileges of the banks to extend loans to individuals.

I have had a great deal of experience in reference to that, probably having placed the largest amount of finance paper privately of any of the investment bankers. All my experience has been this.

The banks have avoided going into the personal-loan business due to their experience in 1933, and so on and so forth. They chucked that out the window in 1936 and 1937, which you will find was primarily due to the fact they did not have the managerial experience to go into the finance market, not that there was something principally wrong with financing an individual in their time-payment plans.

It is only recently, of recent vintage, you might say, that some of our large banks have gone into that market, and the finance companies have been built up, it is true, due to their ability and experience in that type of credit, and the banks have avoided it.

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It seems to me that confidence in the finance companies has been justifiably established. You don't look down the nose at somebody who is going ahead and buying a car on time-payment plan. Nowadays it is the general experience that this is the way to finance automobile and other purchasers, and that actually what we are doing today is mass financing of mass production.

If you haven't got mass financing you can't have mass production, and that is the basis of it, and we are coming into an atomic age when the whole volume of financing will be expanded terrifically, when we consider the amount of money that will be expended on atomic plants, hundreds of millions of dollars, we will say, in one plant, then we have some comprehension of additional mass financing and larger markets necessary to maintain it.

I think Senator Goldwater said low interest rates didn't solve the problem in 1933–39. As a personal reflection on that era, it seems to me that business wasn't encouraged.

The difference between our present status and that status was the approach to the individual. You said, "Here, John Jones, you will rake the leaves from right to left and we will pay you so much, and rake them tomorrow from left to right and we will pay you twice as much." Well, that didn't support the economy because it didn't produce anything.

Actually today we are trying to maintain general gross national product. We are encouraging business to expand along certain lines.

The fact that money is cheap creates more employment because business can borrow that much more cheaply, and you can go ahead and expand your business generally, which creates employment from that angle.

In my opinion this seems to be the proper approach, along with the general tax reduction.

Senator DOUGLAS. Mr. Chairman, may I ask a question? I think it was not merely during the period from 1933 to 1939 that low interest rates failed to provide the volume of private production, but from the outset the great depression in October 1929 to 1933 in which you had the familiar lowering of interest rates unaccompanied by expansion in private activity, and, on the contrary, accompanied by precipitous decline, so while I don't wish to score any party advantage over this point, since you picked out the period 1933–39 as a whipping point, I would like to point out that this previous period was one in which low interest rates did not effect recovery, and, as a matter of fact, was at least accompanied by the sharpest decline in economic activity in the known record of the world.

Mr. SMUTNY. May I answer that, Mr. Chairman. Isn't that what this panel is here for and what we are trying to avoid today, that as a result of tremendous expansion in business you got what was commonly used in the terminology of the Federal Reserve, "that a bubble existed on top of an inflationary move," and that is what you are trying to avoid, or at least trying not to create the same situation as we once went through in 1929?

The sum of what was said this morning, at least from my reaction to the panel, and particularly was very emphatic in wanting to go on record against any encouragement of regulation in our markets. Our markets must be kept free.

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Any regulatory agencies that are built up suffer through the fact of lack of administration, and I feel that the greatest benefit to the country at large is to keep our markets free from regulatory bodies.

Senator FLANDERS. You will be willing to defend that thesis if it is challenged later, I take it?

Mr. SMUTNY. Yes, sir.

Senator FLANDERS. Mr. Shaw.

Mr. SHAW. There are so many issues, Mr. Chairman, that it is hard to know just which ones to pick on first.

Senator FLANDERS. Well, take the worst ones.

Mr. SHAW. I have listed 2 or 3 specific ones and then 2 general ones that strike me as being of peculiar importance. First a technical matter brought up by Mr. Clark.

He has urged that legal requirements be reduced to their legal minima of 13, 10, 7, 3, percent. There is no peculiar virtue in these percentages. They are a historical accident.

The effect of lowering them would be immediately to create an enormous volume of surplus reserves in the hands of the commercial banks, and, in the present stage of events, I have little doubt that the immediate reaction of the banks would be heavy buying of Government securities, whereupon the Federal Reserve, despite present pronouncements, perhaps would sell Government securities of various maturities so that the effect would be simply transfer assets from the Federal Reserve to the commercial banks, conceivably so reducing the portfolio at the Federal Reserve banks that for any repressive purposes under subsequent inflationary developments the open-market operation would be immobilized and the rising reserve requirements would have to be used.

This is difficult, as was pointed out this morning, because not all commercial banks are members of the Federal Reserve.

It seems to me that this is a step toward displacing one control instrument, open-market operations, with another control instrument, a rising legal reserve requirement for the purpose only of adding to the earnings of the commercial banks on their Government security portfolios.

Senator FLANDERS. Is what you are saying in effect that the reserves should be set at such a point that you can easily move either way?

Mr. SHAW. It should be desirable to move them in both directions. The present legal limitation is still significantly above present effective reserve requirements.

Senator FLANDERS. Have you any notion just how far above it should be at this particular time?

Mr. SHAW. I should think it would be quite adequate under present circumstances, but I admit being very sympathetic a number of years ago when the Federal Reserve requested the authority from the Congress to set higher maxima on legal reserve requirements than are now in effect.

A second minor and technical point, Mr. Patman's relatively minor point, not absolutely so, Mr. Patman. The question was raised as to whether under some circumstances, at least, Government bonds would be so attractive that banks would not lend locally. They would choose to hold Government securities.

Well, this is precisely what is desired under some circumstances.

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Under some circumstances where local loans have been pressed so hard with the local resources already in heavy use that the effect does not give more employment, but it simply brings prices up, under such circumstances it is desirable that the central bank should raise prices of Government securities so that commercial banks will not lend more for employment purposes or for output purposes on local markets, and that in other circumstances when the generality of local areas is having unemployment difficulties, that the central bank should make buying and holding of bonds unattractive to banks so that they would be under pressure to lend locally.

This is the technique of credit control, and it worries me just a little bit that the Federal Reserve, in foregoing the use of dealings in long securities, is giving up some of its grip on this particular pressure, causing local banks to be more interested at the right time in local loans and less interested at the right time in local loans.

Another relatively minor matter, the composition of the Open Market Committee. I think it is known in the historical context originally the Federal Reserve was not known at all as we regard it now. In fact, a comparison of the present hearings with the hearings of 1912–14 would indicate very great advances in our understanding of how central banks operate.

At that time the central bank was supposed to be essentially a passive instrument in the money market, giving accommodation to legitimate business, commerce, and agriculture when it should need it. It was not supposed to be, it was not intended to be, an aggressive agent increasing or decreasing the supply of money for some such goal as stabilizing price levels.

Since it was felt the central bank was set up to insure there would be adequate credit accommodation for major economic interests in the country, those interests were represented, and since it was a mechanism for bringing the commercial banks together into a tightly knit organization no longer suicidally inclined, it was felt the commercial banks should be represented, all this quite validly, I think, under that original conception of central banking.

This is no longer the conception of central banking that it should feed credit to certain specific interests, so I think the Congress might well consider some of the stipulations in the Federal Reserve Act regarding the representation of certain specific groups from which are omitted, let's say, labor unions and college professors.

We should review those regulations to see whether something more relevant to the general interest might not be substituted.

And one final minor matter: We have been debating a good deal the role of monetary policy in 1952–53. I don't think anyone of us is in a position yet to say how great the effect of the change in interest rates running from 1946, for that matter, will be when easy money was terminated. I don't see how anyone of us can say how powerful the punch was that this progressively tightening monetary policy brought or how powerful the punch has been in terminating the recession.

As one looks at the superficial data, he is inclined to say that monetary policy probably was not very important. The decline in gross national product apparently was concentrated in two major fields: (1) The spending of the Federal Government in relation to its receipts, and (2) in the accumulation of business inventory.

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The demand for residential housing slumped very little. The demand for consumer durables slumped very little. It doesn't appear because of the specific place where recession occurred that monetary policy could have been primary phenomenon.

To the professional economist this looks like an inventory cycle—a very minor inventory cycle of the type that we expect in a free-enterprise society.

Now, as to two general issues, there has not been in this country for a very long time an intelligible debate on the ultimate goal in monetary policy.

Some people have an absolute goal in mind—lengthening the public debt; other people have another goal in mind—stabilizing interest rates; other people have in mind stabilizing price supports; other people have a different goal—stabilizing employment. These are not mutually compatible goals. If one stabilizes employment, he cannot stabilize prices.

Senator DOUGLAS. Do you feel that firmly?

Mr. SHAW. I feel that quite firmly, that if one is going to stabilize employment in a technologically developing society where unit costs are falling, then he perhaps is going to have falling prices.

On the other hand, money wage rates and farm prices are being pushed ahead of rising productivity in a growing economy, then full employment is going to need a rising cost level.

It seems to me that full employment and price stability except under the very special circumstances where there is no net change in technological productivity and no net change in price——

Senator DOUGLAS. May I take up your first proposal, increasing efficiency. Isn't it possible to absorb the increased output per man-hour through increased money wages and money distribution, which in turn would be financed through an expansion of bank credit commensurate with the increase in production so that the price level would be kept relatively constant.

Mr. SHAW. If factor prices rise.

Senator DOUGLAS. In money terms as well as in real terms.

Mr. SHAW. Yes, this isn't offset. I should put my answer in net terms.

Senator DOUGLAS. Isn't that really the point. During a period in which output is expanded both in terms of total and hours, output per hour as well as total output, you should have commensurate expansion in total monetary purchasing power to help stabilize the price level.

Mr. SHAW. I think this is probably the rather fortuitously successful result of policy. I don't think it can be counted upon that factor prices will rise perfectly in step with technological advance.

Senator DOUGLAS. Of course, this cannot be done in perfect step, but if there is validity, and there seems to be long-run validity in the approximately 3 or 4 percent increase in output per year, doesn't that point to approximately a 3 or 4 percent increase in the supply of money, assuming the velocity to be constant? Isn't that a fairly good rule, granted that the adjustment isn't perfect?

Mr. SHAW. Well, my answer would still be, I think, Senator Douglas, that if our goal is full employment, then—and let me put it this way. Maintenance of stable prices is going to require that there be a closely comparable rate of increase in productivity technically to go

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right along with the increase in factor prices which is determined really by factors other than an increase in productivity.

Senator DOUGLAS. Excuse me, Mr. Chairman. Perhaps I am prolonging this discussion unnecessarily.

Representative PATMAN. It is a very important point.

Senator DOUGLAS. You speak of prices in terms of money. You have got to have an increase in the money supply and in factor prices. If you assume that the banking mechanism determines the total supply of money, then the increase in factor money prices is contingent upon a prior increase in the supply of money, and therefore it seems to me that it is perfectly consistent to have expanding output and stable prices.

The other problem, however, is where you have to have some fever, where you have to have some inflation to get full utilization. I hope this will be very seldom. But it presents a different question. I still see no necessity for falling prices.

Mr. SHAW. No, I would rather expect rising prices, Senator. I would rather expect that if we were to succeed in maintaining consistent full employment, which would mean consistent pressure upon the total available supply of resources, that it would be highly improbable that the prices of those resources would stay stabilized within the limits of rising productivity. I would expect money factor prices to gain more rapidly than physical productivity.

Senator DOUGLAS. Why is that inevitable?

Mr. SHAW. Simply because of the bargaining position on the part of the supply factors as against the demand factors.

Senator FLANDERS. We have here a most important question. Suppose we make mental or physical note of it and continue on, and then come back to it.

Mr. MITCHELL. My first remark, Senator Flanders, would be on one of the two questions you raised, and of course it would be on the same thing that Mr. Shaw and Senator Douglas have been speaking of.

I would like to see if I can't provide one of the little bricks that would fill the chinks in their argument.

Senator Flanders mentioned before lunch those of us who suspect that some inflationary pressure, however mild, is necessary if we are really to maintain full employment. Senator Flanders asked if high levels could be reached and maintained only with inflation.

Now, I wouldn't say it that strongly. It is possible logically and it is historically a fact that for a time at least they perhaps can be maintained without inflation. But I believe that the chances for steady growth are better if a mild but certain upward pressure is kept on prices.

It makes several things possible, for example, that are not possible if we try rigorously to keep a very delicate balance, exactly on keel as far as prices are concerned.

Agriculture, Senator Douglas, is one of the things that appears to me to be chronically depressed even when the general price level is stable. In that year you picked for illustration before lunch, 1951–52, when the general price level was pretty steady, agriculture lost seven points from parity.

Senator DOUGLAS. It shot up tremendously in the preceding year.

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Mr. MITCHELL. Well, that is quite true, but the drop hurt worse than the rise had helped, because marketing margins had become rigid at the higher level. However, I think one of the points that would make me agree with Mr. Shaw is the fact that this Nation isn't a chart like the economists like to draw with such a thing as wages and factor prices falling neatly in place. It is a combination of hundreds of different charts and some major industries behave in quite different ways.

I would say that I am about to be convinced by some figures that I have been studying for the past year and a half——

Senator FLANDERS. You feel it coming, do you?

Mr. MITCHELL. That the general economy must rise about 3½ to 4 percent in physical productivity, and about 1½ to 2 percent on top of that in price inflation for a total of 5 to 6 percent gross national dollar product a year for agriculture to hold its own.

Agriculture, it seems to me, is a chronically depressed industry for a number of factors which I have gone into in the papers I presented before this committee in February, if we try to maintain a very delicate stable price.

Senator DOUGLAS. You mean because of the inelastic demand?

Mr. MITCHELL. That and several other factors, Senator Douglas; for example, the tendency of the marketing margin always to grow.

Another point, we recognize that there will be fluctuations up and down because of the sheer administrative impossibility of keeping national indexes exactly level.

Now in that case there are bound to be some depressed and somewhat underemployed periods, if we try to hold exactly level and avoid inflation as the plague.

If we plan a slightly rising trend for prices in this country, fluctuations would go for a period below the trend line, but can still nevertheless be kept above the line of acute trouble.

What I am saying is that at times when we are above the trend line, we will be overemployed.

I think you all recognize what a flexible thing this full-employment concept is. You can be overemployed by bringing women out of the homes and older people out of retirement, and so on.

There will be periods of somewhat overemployment alternating with periods of less employment, but still well within the limits of reasonably full employment, and the result will average out pretty well, and I think we could still say it would fulfill the requirements of the Employment Act.

Another point, imports are much easier in a long period of gradually rising price levels, and if we mean what we say, that we want to improve our international trade position, if we want to increase our international trade, we have got to find some way to keep business from yelling so hard whenever we make an attempt to open our borders to a few more foreign commodities.

In time of a steadily rising price level, as other economists have pointed out, particularly Sumner Slichter in an August 1951, I believe, Harper's article, "How Bad Is Inflation," Slichter points out, I think correctly, that we cannot really have an increasing international trade in this country unless we have a slightly rising price level.

Our local manufacturers, farmers, laborers, and merchants simply won't allow it.

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Senator FLANDERS. If I may say, the experience of New England with free trade as compared with the South has left us with the distinct impression that it is a very painful thing.

Senator DOUGLAS. Well, since that issue has been injected, may I say that while I sympathize with the plight in which New England now finds itself, and while I would like to see a revival of New England industries and am against the special favors which the South gives, I would like to point out that New England for generations received special favors from the Government by means of the tariffs which the textile and other New England industries were able to impose, and that in a sense New England is now suffering or being punished for the sins of their fathers and grandfathers. They levied tribute upon the United States for decades.

Senator FLANDERS. Those favors were accessible to anyone, and when the South finally began to take advantage of them, New England suffered very naturally, but I still say that it suffered from internal free trade.

Senator DOUGLAS. May I say that from the time of Henry Clay and the foundation of the Whig Party, which later became the Republican Party, New England prospered at the expense of the rest of the United States, and I think in a sense the protection which New England received during that period atrophied their will, their courage, their resolution and desire for experimentation, and combined with the system of trusteeship which they built up in Boston, and which Mr. Marquand has characterized in his novels, this is partially to blame, although not wholly, for the plight that New England now finds itself in.

Now I say that, and at the same time I do not approve of the unfair tax advantages and the excessive protection against wage scales which some of the southern communities hold forth to entice industry from New England.

Senator SPARKMAN. Don't look so straight at me, Paul. We don't do these things in Alabama.

Senator DOUGLAS. My good friend from Vermont, when he enters this piteous plea about the hardships of removing the tariffs, leaves me somewhat cold.

Mr. SHAW. May I come back to the discussion for just a moment?

Senator FLANDERS. Yes.

Mr. SHAW. It seems to me, Mr. Douglas, in illustrating full employment and continuous full employment, the odds favor inflation, and that if it is not New England or the South, then it will be agriculture or trade unions that will be insisting on a larger share than the one they have, a more fair share of the national output. This means a rise in their money returns and inflationary pressures.

Senator DOUGLAS. This is a fundamental point, and it goes back to the issue that Mr. Patman has raised.

In a period of comparatively full employment where the danger is inflation, I would like to have the bankers run the banking system of the country, and I would trust them more than the politicians to determine the total amount of bank credit to be created.

But in a period of recession or depression, if we are unfortunate enough to have a depression, I am afraid that the conservative policies of the bankers would probably not then be adequate to expand

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active purchasing power, and if they did not then I would favor the politicians stepping in.

It is a somewhat humorous way of putting the matter, but I am suggesting a 2-platoon system to run the Federal Reserve System. Let the educated bankers run it during the period of prosperity and the educated politicians run it during the period of depression.

Senator FLANDERS. Who makes the shift?

Senator DOUGLAS. The people.

Mr. MITCHELL. I must disagree with Senator Douglas. I am afraid if we did it that way, the bankers by their action would make certain that there would be a shift.

Senator GOLDWATER. Mr. Chairman.

Senator FLANDERS. Had you finished?

Senator GOLDWATER. I just wanted to ask Senator Douglas if he called that the two-platoon system.

Senator DOUGLAS. That is the two-platoon system.

Mr. SMUTNY. Actually, when you come right down to it, the basic ingredient of prosperity or continuity of prosperity is confidence.

Confidence has been gained by our banking system through, I think, the leadership of the Federal Reserve. Although we have looked at this possibility in a slightly humorous light here, it is a very serious thing.

Confidence in the banking system must depend upon the action of the Federal Reserve, in my opinion.

Mr. CHANDLER. Mr. Chairman, may I make a comment on the implication that general monetary policy should be used to cure structural defects in the economy.

It seems to me that general monetary policy was never designed for that purpose and could never accomplish it.

For example, if it be true today that the farmers are not getting their share of the real national income, I do not see how you can possibly cure their situation by having a continuous and perhaps a cumulative inflation, because this would be a situation in which everybody's money income would be going up, in which everybody's prices would be going up, and I can't see anything about the process that would raise the price of farm products relative to the price of other things. The farmers' trouble is not a low absolute price level; it is a low price level for their products relative to the prices of things they have to buy. And it seems to me it might get continuously worse rather than better.

The other point relates to those American industries that suffer competition from imports.

An inflationary situation would raise costs as well as prices, and the rising costs would be suffered by the American industries competing with imports just as well as by the other industries.

So it seems to me we may get into very great difficulties here by expecting general monetary policy to cure structural defects that require a reallocation of resources.

Some of these adjustments may be made easier if we maintain full employment, but not necessarily by a rise in the price level, and I am not yet pessimistic enough to think you must have continuously rising prices to have something like full employment.

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Senator FLANDERS. May I make just two observations on my own. One is that if the thesis is maintained that a continuously, even though slightly rising price level, is the simplest and best way to maintain a high degree of employment, I think it is also true that anything approaching full employment by the interaction of the labor market leads to higher prices.

Now, the Lord, I think, made the hen before He made the egg, but of that I am not quite sure. Maybe Hen made the egg first, but I think He made the hen first, and this is a hen and egg proposition.

The other thing is just a matter of tactics. It is inadvisable for those who feel that an increase in foreign trade is good in itself to attempt to make great gains except in times of high employment. It just can't be done, so I think that that had better be put down as one of the facts of life.

Mr. WILDE. Mr. Chairman, I wanted to ask, in view of Mr. Mitchell's emphasis on the chronic depression of the farmer, whether that is a correct premise.

Now, our company has been in a farm business, or was in a big way, owning over 1,500 farms, when I became president in 1936, so I have had personal experience.

Commencing with the Second World War, in 1942, the farmer has had a high degree of overall prosperity, and it ran through the fifties, and it is still quite high, relative to any historical periods. In other words, it has been about 12 years where agriculture, instead of chronic distress, has been generally prosperous.

Now, individual farmers through the vicissitudes of weather have not done well, but on an overall basis agriculture has been good. If we have chronic distress, I don't understand the term.

We do have a problem with agriculture which is partly political and partly economic, looking into the future, because of the relative inflexibility of demand, and a great deal of this prosperity that I claim the farmers had arose out of an abnormal demand.

So it was perfectly natural that in the last 2 or 3 years, with a reduced worldwide demand for agricultural products, there would be a reduction in profit, but to say depression and chronic depression, I do not understand.

Senator FLANDERS. Now, I would suggest, since there are 4 who have not been heard from formally and 3 who have not been heard from either formally or informally, that we ask Mr. Mitchell to conclude within the next few minutes, and we will move on.

Mr. MITCHELL. I would like to suggest that I wait until the next time around, because the next question is the one you raised, Senator Flanders, on why I think a great agricultural investment revolution is needed in the face of the apparent surplus.

Senator FLANDERS. You promise to keep that in mind.

Mr. MITCHELL. Right.

Senators FLANDERS. Thank you.

Mr. Land?

Mr. LAND. I would like to address myself first to Mr. Patman's question as to the effect of banks' holding securities on banks' willingness to make loans.

I think under normal conditions there is very little effect, that is, in the sense of restricting a bank's willingness to make loans. Banks,

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if they are going to stay in business, have got to attract and hold depositors, and there is no better way to do that than by making loans.

No bank that I know anything about under normal conditions decides that it will not make a good loan because it wants to retain a Government security.

There is one condition, however, under which banks may tend to turn down loan requests, and that is when the Government securities market is down in price. If Government securities are selling materially below what banks paid for them, then banks may tend to turn down loan requests. But that is exactly the time when that is the right thing to do.

In other words, that is the period of monetary restraint, and that is the right policy for banks to be following. That is the policy which the Federal Reserve intends that they shall follow at that time.

As far as banks taking care of personal loans, that has been developed to a very large extent in this country. Our bank is thought of as being a bank for big business, and it is a bank for big business, but we have gone directly into the personal loan business in the last 8 or 10 years, and indirectly we have gone into it to a very large extent.

By that I mean we make loans to finance companies all over the country. Most of the money which finance companies lend is bank money.

In other words, the finance companies borrow from banks and relend it to customers, so that really a very large amount of bank money is being put out on small personal loans. My question about it is not whether it is enough but whether maybe we are not becoming too adept at it.

Also, I would like to say that I agree very largely with what Mr. Patman had to say about the discount rate. I think within recent years its effect has been mainly psychological. It has had very little practical bearing.

Banks, as a matter of policy, borrow as little from the Federal Reserve and as infrequently as they can, so what the rate is is not too much a practical matter with the banks, but it has a general psychological effect, and that is all it has had in recent years.

In addition to what Mr. Smutny had to say about why low interest rates did not work in the 1930's, I would like to make this observation. The 1930's followed a period in which many people got in trouble by borrowing money.

Most people had a psychology of wanting to stay away from debt, having some very bitter experience in borrowing money. The will to borrow was lacking.

Now, we have had a period of time when practically nobody has got in trouble by borrowing money, and a lot of people have made a lot of money by borrowing money.

We have entirely a different psychology now, and easy money does stimulate business under these conditions, whereas in the 1930's it had substantially no effect.

Senator FLANDERS. May I ask you a question there? The question is: In the case of borrowing money, is there any difference either in the psychology of the borrower or the lender where the project from which the money borrowed is something whose results are easily calculable?

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For instance, a bond issue for a utility plant or a soundly based real-estate operation, on the one hand, or, on the other hand, something in which there is an element of venture or risk.

Doesn't the effect of a low interest rate apply almost wholly to those easily calculable undertakings? What difference does it make as between 2½ and 4 percent on something which, if it works out, will bring in a great deal more? Take a manufacturing operation, not a wildcat operation.

Mr. LAND. I was going to say, as far as business expenditures are concerned, I think the rate of interest has practically no effect.

In other words, whether business pays 3 percent or 3½ percent for money really hardly could be found in the final result, there are so many other factors of so much more importance.

Easy money produces its greatest effect in two areas of the economy, residential construction and State and local public construction. There the interest element is a big part of the total cost, and I think we have seen that working in the last year.

Senator FLANDERS. It becomes more important as the length of the amortization is extended?

Mr. LAND. That's right, where the interest element is a large part of the total.

In business the interest element is not a large part of the total. In residential carrying charges and in State and local carrying charges interest is a very important part.

Mr. SMUTNY. Mr. Chairman, might I interpose there for a moment?

I beg to differ. I think that the interest element is very important, as far as business is concerned.

I can bring out through experience that in 1953, when interest rates started to run up competition for loans on the part of the Treasury we immediately found that industry rushed into the market and did a tremendous amount of financing.

Subsequent to that, this year of 1954, we have seen some instances where industry has called the obligations that were issued in 1954 because they could be refunded at a lower rate, so therefore the interest rate does really become an important factor.

Mr. LAND. Only as to timing.

Mr. SMUTNY. I know there is a great deal of difference when you borrow on money and pay 3¼ percent or 4¼ percent.

Mr. LAND. I have never seen a corporate budget where the rate of interest made one bit of difference. In other words, you see all sorts of corporations laying out budgets for the next year or so.

Senator DOUGLAS. Are you speaking of working capital now or fixed capital? I can see that in the case of working capital a change in the interest rate is not particularly important, but on a long-time investment would not a change——

Mr. LAND. I have never seen a corporation make up two sets of figures, one based on this assumed interest rate, and on the other——

Senator DOUGLAS. But for current operations; isn't it?

Mr. LAND. For working capital?

Mr. SMUTNY. In 1953 we had two instances of the largest corporations of the United States deferring issuance of bonds because of the interest rate.

Mr. LAND. I grant you that a period of disturbed interest rates, a period of disturbed market prices, can affect the timing of business

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expenditures. It can cause things to be put off, but on the question of whether expenditures are going to be made or not made, I think interest rate is almost immaterial.

Mr. WILDE. Mr. Land, I see no evidence in our current experience that interest rates on housing are vital, within quite some range.

A house today is bought as a package. The significant thing is the downpayment and the monthly payment, and the buyer doesn't inquire about the rate of interest. He will buy it at 4½ percent just as quickly as at 4 percent. More houses are being financed this year than when the rate was 4 percent.

It is in the cost, but it is so small spread over the years that the buyer doesn't know it or doesn't bother about it. "How much do I have to pay down, how much do I have to pay monthly?"

Senator FLANDERS. He doesn't inquire, then, as to the period required for amortization?

Mr. WILDE. Not particularly. He is principally interested from the straight merchandising angle, "How much do I have to pay down, how much do I have to pay a month?" He buys his automobile the same way.

Senator FLANDERS. Is he thinking of his monthly payments, really, in terms of rent?

Mr. WILDE. Yes, he does, and that is why he doesn't regard the components of it as important. It is: Can he pay that monthly rent from his paycheck?

Mr. LAND. I grant you he doesn't break up the monthly charge into its components, and yet interest is undoubtedly the largest component.

Mr. WILDE. It is a very large component, but if we hadn't had quite so much easy credit, I think the gross cost of a house wouldn't have been as high and he might have had a better buy.

Senator FLANDERS. Thank you, Mr. Land.

Now, Mr. Harris.

Mr. HARRIS. Senator Flanders, I want to make you a little happy and tell you that here is an economist who agrees with you on New England tariff. I might say you may be interested to know that I am going to Washington next week to represent the six New England Governors on this issue, to point out to the Tariff Commission that the tariff is only one part of national policy, and that when you are doing a job on New England you ought to take into account not only the tariff but everything else the Federal Government has done to New England.

This is the present, Senator Douglas. I am not talking about the past.

Senator DOUGLAS. New England always wants to have the past forgotten.

Mr. HARRIS. And I might say, Senator Douglas, and I think I told you this before, that if New England continues to lose its textile industry at the rate of the last 3 or 4 years, there will be no textile production left in New England in 10 years, and it would be a shame if through a tariff, a reduction of the tariff, the amount of competition the New England textile industry has to face would be increased. Although I still call myself a free trader, I think you can't be too doctrinaire about these issues.

Senator FLANDERS. May I interpose a moment?

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There was a certain watchdog of the Treasury in the House many years ago; I forgot his name and I forgot who made the remark, but he opposed every appropriation in the rivers and harbors bill until it came to an appropriation for the Illinois River, whereupon he favored it, and someone got up and said:

'Tis sweet to hear the watchdog's surly growl turn bark of welcome as we near our home.

You and I are in the same box, but I think we have a modicum of reason on our side.

Mr. HARRIS. I am sure we do—a great deal.

I might say, Senator Flanders, if you will continue in this position you will be ruled out of the trade association of economists, as I am about to be.

Now, getting back to the issue we have been discussing, I think both Senator Douglas and Senator Flanders raise the issue, and several others, of whether we can have both stability and growth. I think Mr. Wilde expressed some doubts on this issue.

Now, I am inclined to think—of course, this is a matter of judgment—you weigh one against the other.

For example, in the campaign—I am not saying this for political reasons, either—the statement was made often in 1952 that the dollar was only a 50-cent dollar. This, of course, was true and was a legitimate charge to make against the Democrats.

On the other hand, nobody did say there were four times as many dollars around, which is also an important part of the whole story. Of course, you don't expect the whole story in campaigns.

At any rate, this is the problem, that inflation does to some extent contribute to growth, and it is very difficult, if you are interested in growth, to draw the line exactly, and assure no price increase. If you go back to 1913 you would find that we have had a price increase of about 125 percent over a period of about 40 years. In that same period we have increased our real income by 4 times, and had 2 major wars.

Now, is this really such a bad record? This amounts to a cumulative compound increase of prices of only a little bit more than 2 percent.

Let me also point out to you that between 1948 and 1954, there has been an increase in prices of only 6 percent, which is quite a remarkable degree of stability, considering all the activity we have had.

Let me also point out that from 1951 through 1953 we had an increase in gross national product of 10 percent, in addition to price stability, and this is also a rather remarkable thing.

Senator DOUGLAS. Mr. Harris, that is just the point that I would like to appeal to, that for 21 months we did have an approximate price stability at approximately full employment and growth, and the question I would like to raise is whether that was purely accidental or whether things weren't done pretty well during that period prior to the change of heart on the part of the Federal Reserve System and the development of a new regime at the Treasury.

Senator FLANDERS. Senator Goldwater.

Senator GOLDWATER. I would like to ask your opinion of whether or not the majority of that gross national product—I won't say the majority, a large portion of it—went into nonconsumer goods, didn't have some effect on that so-called period of stability?

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We were producing, as I recall it, from 14 to 35 percent of our gross national product during that 10-year period for national defense or nonconsumer goods.

Mr. HARRIS. That's correct, Senator Goldwater, and I just jotted down some figures for 1951 to 1953.

Here we had an increase of GNP of $37 billion, increase in consumption was $21 billion, a little more than half; investments were down by $3 billion; Government was up by $21 billion.

There is no doubt about the high level of Government spending having a good deal to do with it, just as I would say the fall of $9 billion in Government spending last year has certainly helped to bring about recession, but this has been offset by a corresponding decline in taxes with a small lag, so you might say the net effect of these Government operations was zero.

There was some small fall-off in investment, so I would say in a general way I don't know, Senator Douglas, whether it was accidental or whether this was all planned.

I think there was certainly some planning in it. We had our President's Council of Economic Advisers.

The thing certainly worked beautifully, and it suggests that the thing is possible, and certainly we had all kinds of fiscal and monetary policies, although I myself feel monetary policies can be pretty powerful on the rise, but not too powerful on the decline. Our experiences seem to indicate this.

Mr. Wilde said a great deal about the danger of inflation. France has had a devaluation of 99 percent in 33 years. Latin America had an increase in prices of 500 percent, on the average, since 1939. People don't save under these conditions, but when you look at our own price history, we have had too much inflation, we could have had less; but, on the whole, considering what we have achieved, the inflation hasn't really been too bad.

I can understand why an insurance man would be worried about inflation, but you have to look at the whole thing, not only the stability of the dollar but the amount of growth and how much the small amount of inflation we have had has contributed toward that growth.

I am sure we have had more growth because of the amount of inflation we have had. I am not trying to defend inflation. I think we have had too much of it, but I don't think we should leave out of account what has accompanied inflation.

Senator DOUGLAS. Mr. Chairman, would I be impolite if I filed a demurrer.

Senator FLANDERS. You don't mean a demurrer—a brief.

Senator DOUGLAS. To the degree that you stimulate growth through inflation, you have done it by transferring purchasing power from those who have fixed incomes, notably the salaried groups, and also those whose incomes come from bonds, pensions, and so on.

Senator FLANDERS. Don't forget the widows and orphans.

Senator DOUGLAS. They are included in these other two categories.

And you have transferred income from them to the adventurous classes of society, with the result that you have undoubtedly stimulated investment, but you have also increased nightclub spending, too, in the same way, and I question whether this is a policy which should be consciously followed.

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It seems to me that it is something that should be avoided, if it is at all possible, and that we should try to hold to a doctrine of price stability, yet substantial, full employment, with investment financed out of savings rather than through transfer of income or the creation of additional short-time capital.

Senator FLANDERS. Senator, not to interrupt, but would you say that again? There were three points. One was maintenance of employment, maintenance of production, and expansion out of savings?

Senator DOUGLAS. Well, price stability.

Senator FLANDERS. Price stability; that's right.

Senator DOUGLAS. Economic growth, and substantially full employment.

Senator FLANDERS. Economic growth and substantially full employment.

And the increase of employment and production that comes from the increase of population, do you expect that to come from savings or would you allow a corresponding growth in the credit money?

Senator DOUGLAS. Oh, you have got to have a corresponding growth in credit money.

Mr. MITCHELL. If it were financed all out of savings, the price would drop, so you have to have an equivalent inflation of credit.

Senator DOUGLAS. That's right. I would not call it inflation, but rather an increase in money to stabilize prices.

Senator FLANDERS. I just wanted to get that clear.

Senator GOLDWATER. Mr. Chairman, isn't it true—and I direct this to you, Mr. Harris—we have only had in our economic history one very short period of so-called stability in prices? We have just gone through that, and that was brought about by very, very unusual circumstances, and I think you and I agree.

I don't think it is an experiment that we want to continue. I agree with these other gentlemen that price stability is something that is rather impossible, just as employment stability has proven to be impossible in the past, but maybe we can work out the secret.

Mr. HARRIS. Senator Goldwater and also Senator Douglas, I would say this:

I think we are all aiming at the same thing. I think, for example, the Federal Reserve is trying to give us growth, high employment, and price stability. I think they have tried to give us price stability but they also have given us some unemployment. This is the issue.

I would be inclined to risk a certain amount of price instability, say, even an increase of 2 or 3 percent, and get rid of, say, one or two million unemployed. I would be ready to take that risk. The authorities don't seem to be ready to take that risk, or they would give us a much higher level of excess reserves, it seems to me.

Senator FLANDERS. Then, in brief, on this question, you feel that the opportunities for the maintenance of employment, and I presume of production and a stabilized standard of living, is improved if there is a slight expansion of inflation?

Mr. HARRIS. That's right; a slight inflation is what we want.

Senator FLANDERS. That is what I wanted to get clearly in mind from you.

Senator GOLDWATER. Mr. Chairman, would that be in excess of what we would consider normal inflation?

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Mr. HARRIS. I wouldn't worry too much about 1 or 2 percent a year. I would certainly try to keep it down to that.

I would say 125 percent over the last 40 years is a little too much, but we must not forget we had these two major wars, and I once made an estimate of how much inflation we had in World War II compared to World War I, on the basis of the percentage of the economy going to war and compared with the Civil War, and our record in World War II is 4 times as good as in World War I, and 12 times as good as in the Civil War.

Senator GOLDWATER. Where did the dangers of inflation come in this last period; during the second war or the second war and Korea?

Mr. HARRIS. It was sort of a postponed inflation which we should have had in World War II, in the absence of controls, so I would count as part of the World War II inflation some of the inflation we had after World War II.

I will try to answer 2 or 3 more questions rapidly because I don't want to take too much time.

Congressman Patman raised an interesting question about whether it would be a good thing for the banks to have a large volume of public securities which kept them from lending money to the public.

I was talking about public securities in terms of giving us an appropriate amount of money. In other words, the banks have to hold adequate earning assets to create adequate surplus of money.

Now, I would agree with Congressman Patman that if they were to do the job by lending to the public, as originally suggested by the Federal Reserve Act, that is one thing, but since they don't seem to be able to do this, I would say it is important to hold a certain amount of public securities, or inadequacy of money will injure the economic system.

On the issue Senator Goldwater raised, why didn't the low interest rates in 1933–39 do us any good, I would say it didn't do us much good, and the reason is there are sometimes factors that are much more important than interest rates.

If businessmen lack confidence, if prices are falling steadily, if their anticipations are very pessimistic, then you can cut the interest rates down to zero and it wouldn't have much of an effect. But it would have a greater effect in the situation we are in now where there isn't this widespread pessimism.

Now, the other point I wanted to make, a point I made this morning, I want to emphasize very much, and I think it is a very fortunate thing, it would be an awfully good thing, for example, one might argue it would be a very good thing if the net result of the Federal Reserve policy was that they control not only the commercial banks but all other lenders of funds, but the fact of the matter is that they don't do a very good job—I seem to have lost a sheet on which I had these notes, but I can give them to you—if you look, for example, at the 1952–53 fiscal year when they were trying to restrict credit, you will find there was an increase of $30 billion in loans and advances, and of these $30 billion the commercial banks provided only $3 billion.

In other words, we had some expansion, fortunately, during this period, despite the attempts to restrict the total supply of financing, and this was because of the fact that the Federal Reserve bank did not control the noncommercial bank lenders, and exactly the same thing has happened in 1953–54.

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In fact, virtually all loans in the fiscal year 1953–54 have been made by noncommercial bank lenders, and this is something we have to keep in mind.

Senator FLANDERS. Are you saying, in effect, that you would like to see the Federal Reserve control expanded over nonmember banks, and perhaps over some other lending institutions?

Mr. HARRIS. I will be a little more subtle than that, Senator. I was trying to say I would like to see them take over this control if they do a good job.

If they don't, I think it is just as well that the control lies with the insurance companies and the savings and loan associations, and so forth, but this is an area, it seems to me, where the Federal Reserve System hasn't really got to first base.

One final point and I will quit, and that is, I was talking to one of the gentlemen of the Federal Reserve right after lunch, and he said: "Don't you know that we know you have to control the rate of interest?"

Well, all I can say is I wish anybody would read page 24 of the answer to the intermediaries in this. I won't bother to read it to you now, and see if you feel it is an adequate statement of what Federal Reserve policy should be on the rate of interest.

I am glad to know that some of the high authorities believe that they should control the rate of interest, but I defy the Congress to read this reply and say that there is a clear statement the Federal Reserve is ready to go out and control the rate of interest, rather than wait until something disorderly happens.

Mr. SMUTNY. Mr. Chairman, may I inject something here, please?

Senator FLANDERS. Yes.

Mr. SMUTNY. That is the following: I don't think any statement has been made here either on the panel or any recognition has been made of the fact that savings are institutionalized now.

Years ago the individual saver was quite a factor in the bond market. Today actually a vast amount of funds available for investment is not through the individual in the bond market, but through institutions of deposit insurance companies, and so forth.

We do not sell bonds to the individual. We sell bonds to the institutions, the savings banks and insurance companies, and a vast change has taken place in our entire investment market, and thereby the effect of the operations of the open-market operations of the Federal Reserve on bond prices is so important because the vast savings of the people have become institutionalized. I think that is a factor that should have due recognition.

Senator FLANDERS. Thank you.

Now, Mr. Clark.

Mr. CLARK. Mr. Chairman, I feel that the concentration of attention upon what monetary policy has done and can do in a period of inflationary danger gives a sense of unreality to this meeting.

No one is bothered about inflation today. We are bothered about the fact that the economy under monetary and other policies has not been progressing since the first of the year, and unemployment has not been cured, and the number of employed has not been rising at all, let alone in step with the large increase in the labor force and the working force.

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Now, the agenda for the meeting bars us from discussing and analyzing the condition today as it may lead to our proposing policies to bring about economic recovery other than monetary policies, but surely we do within the limits here imposed have occasion to consider whether monetary policy during the past year has advanced the cause of prosperity in this country, whether there is now some condition which may be improved by monetary policy, and if so, what monetary policy can do for us.

I have suggested one monetary policy which now might be adopted, that would have terrific impact upon the economy and perhaps would give us the additional drive which we need to get out of the stalemate which has existed since January. We are going to have the industrial production figures for November in a few days. The circumstances which made it possible to bring out these figures before the end of October hardly exist now, so we have to wait until well into December.

And those are going to be tricky figures that you must look at with considerable sophistication. We know that there has been a very large increase in employment in the automobile industry, and we know that there has been an attending increase in steel production, an increase in employment in steel production.

And if the economy otherwise has done nothing more than continue on the dead center which it has occupied since January, we are bound to have a noticeable increase in the industrial production index, and it will fool the casual observer into thinking that it means that long-awaited recovery has finally come around the corner.

Senator FLANDERS. Excuse me just a moment.

Mr. CLARK. Yes, sir.

Senator FLANDERS. But was not the recession in part due to the decrease in unemployment in just these same industries? Why shouldn't you take it on the upturn as well as on the decrease?

Mr. SMUTNY. No, sir.

Mr. CLARK. Now, Mr. Chairman, to answer that, I have to again caution you against the acceptance of bare statistics.

This apparent decreased unemployment, we find, occurs in a situation where the labor force is not expanding. We know actually the working population is growing; we know that in the past 2 years it has increased by a net of more than a million and a half, but we do not find that in the official statistics, and the unemployment figure is merely a residual figure, the difference between the number who say they are hunting for jobs and thereby are qualifying for inclusion in the labor force, and the number of those who say they have jobs.

Why is it that the labor forces does not show an expansion in the statistics? It is because in periods of slow business, many people who otherwise would be looking for jobs, knowing that now there is no need to do it because they cannot get them, do not classify themselves when interrogated, as being people who look for jobs, so that leaves them out of the labor force.

Senator DOUGLAS. Would you amend that statement to say do not so classify themselves or are not so classified by the enumerators?

Mr. CLARK. I do not know that that is just what happens, Senator. I think they are asked; I do not believe the interrogators undertake to classify them, excepting on a basis of their own responses. Maybe that is not what happens.

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Senator FLANDERS. Are you taking into account the seasonal decrease in the labor force on the part of those who seek employment during the vacation, and go back to school?

Mr. CLARK. Well, of course, that is a real reduction in the labor force; we must take that into account. But having consideration for all of these factors, Mr. Chairman, I think that the figures on unemployment are understated.

Senator DOUGLAS. That is correct.

Mr. CLARK. And if we took those real figures, could get the real figures, we would find there has been no improvement in unemployment.

How could there be when production has not been increased? And, along with that, since you asked me to comment upon the subject, I take advantage of the opening, I read the other day a story about a Government release relating to the number of people who are no longer on the list of those continuing claims for unemployment insurance because they have exhausted their rights.

It was a very surprising figure of people who did have unemployment insurance no longer are receiving benefits and, therefore, are not listed in that statistical item, which has been dropping somewhat, and who are, perhaps, not unemployed at this time.

I do not want to overdraw the pessimistic picture of the economy today. A year ago, I think I was, perhaps, the most outspoken of the optimists who saw a fine business year ahead in 1954.

If the agenda permitted us to discuss the situation that, I think, Mr. Chairman, if you will permit me, ought to be engaging the interest of the committee today, I think I could point out the reason for the error in my optimistic view that the slideoff would soon end, and that immediately thereafter, as happened in 1949, business recovery, business expansion, would begin.

Now, perhaps November is going to put us over the hump; perhaps the tremendous impulse to the economy which will come from the combination of increasing production and employment in the automobile industry, increasing production and employment in the steel industry, and the 3 weeks of frantic Christmas shopping which is ahead of us, will give the economy the push it needs. The basic factors have all been there all the time, and I wish that we could see some way to add to these forces of the private-enterprise system, which are now giving us the third chance this year to come out of the doldrums, that we will be able to add to these forces some impulse from Government action.

Senator FLANDERS. Do you see that impulse as coming in the monetary and debt-management field?

Mr. CLARK. I see no sign of it, and that is what I mean.

Senator FLANDERS. I mean, you do feel that it should come from that?

Mr. CLARK. No, indeed. I think the suggestion I made of one monetary policy which would be well worth trying was suggesting to you the poorest of the three major actions which are possible and which, I think, ought to be taken; but it is the poorest. I do not know what would happen—I rather agree with Mr. Shaw, that the effect of increasing free reserves, freeing reserves, would be no increase in lending; there is no indication that bank lending is in any way restricted now by the reserve situation. The banks would simply put the money into Government bonds.

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I do not agree with him that that would mean that the Federal Reserve would have to furnish the bonds. Why should it?

If the banks went into the market and bought the Government bonds, it would mean a substantial increase in the price of bonds, a reduction in the rate of return, and Mr. Humphrey would have that day he has been so eager. He would be able to refund succeeding maturities on a market that would not destroy the 2½ percent rate of the Victories.

Mr. SMUTNEY. In my opinion, this is an endorsement on your part of the policies of the Federal Reserve and the Treasury, in direct contravention of your first statement.

Senator FLANDERS. Now, then, you do feel that so far as the existent or nonexistent recession is concerned, that in the field of our inquiry today, we might well consider the change in the excess reserves of the banking system?

Mr. CLARK. Yes, sir; and that it could not do harm. It would have to create prosperity, full employment, a larger purchasing power before it could reach the point where inflationary danger was appearing. You cannot have inflation——

Representative PATMAN. May I interrupt the gentleman?

Mr. CLARK. Yes.

Representative PATMAN. I agree with Mr. Shaw's statement that reserves should not be reduced to the lowest point, but there should be a point in between so that in the event it was necessary they could be either lowered or raised in the future to take care of the situation.

Mr. CLARK. No; I think if you are going to be daring enough to move, because you feel it is necessary to move, you had better use all your ammunition. I see no advantage whatever in retaining any margin above the legal minimum.

Representative PATMAN. Would you reduce it right down to 7, 10, and 13?

Mr. CLARK. I would, for this reason, Mr. Patman: We can see right now from our experience since last August—and we learned, as Senator Goldwater pointed out, in the thirties, that the action to reduce the rate of interest is of itself of very little significance in a period of depression or recession.

So the only reason that we should preserve for the Federal Reserve some larger opportunity to act would be to enable it to act in the other direction, to impose restraints through the addition to reserve requirements which, I can tell you, is an action that does hurt banks. There is not any difficulty coming to a bank when you reduce the reserve requirements; it is a harmless process, it enables the bank to buy some more Government bonds.

But when you raise reserve requirements, since all banks try to keep fairly close to their reserve limit in their investments and their lending, it means that they have got to dispose of Government securities or they have got to withdraw from some profitable loans in order to meet the new reserve requirements, and there is not any doubt about that being a repressive action.

Let us give the Federal Reserve enough leeway so that they can act that way instead of having them caught, as we were in 1947 and 1948, when some of us were joining the Federal Reserve in approving the Eccles' plan, an action which he had to propose because they were up to their limit already on legal reserve requirements.

Senator FLANDERS. Well, Mr. Clark, we thank you.

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Representative PATMAN. May I ask him one question?

Senator FLANDERS. Yes; you may.

Representative PATMAN. Do you mean to say that we are in for serious trouble if we do not take drastic action like that, Mr. Clark?

Mr. CLARK. No; I said that it may be that this very important additional economic activity in the automobile and steel industries in November will be found sufficient to get us over the hump; but if it is not, there will not be a similar opportunity coming to us for several months, because 3 weeks from today we enter upon a period of seasonal business letdown.

Senator GOLDWATER. Mr. Chairman, I would like to ask just one question.

Senator FLANDERS. Senator Goldwater.

Senator GOLDWATER. What are we talking about in terms of money, in numbers of billions of dollars, in this suggestion of yours?

Mr. CLARK. The decrease to the legal minimum of 3, 7, 10, and 13 percent would mean freeing approximately 40 percent of the present reserves, and that would be $7 billion.

Senator GOLDWATER. What was the amount of the last release, I think, in May or June of 1953?

Mr. HARRIS. The total was 2½ billion, I think, of all releases.

Representative PATMAN. Senator Goldwater, would you yield for just a question there since it is an opportune time?

Senator GOLDWATER. Yes.

Representative PATMAN. You state about $6 billion in reserves that would be released.

Mr. CLARK. $7 billion.

Representative PATMAN. That means a potential $42 billion in added credit then in the banking system. The banking system can expand to minimum of 6 to 1, and it might well be 10 to 1. That would mean a potential credit expansion of about $70 billion.

Mr. CLARK. $70 billion of lending power——

Representative PATMAN. That is what I mean; it is not just $7 billion, it is 10 times that.

Mr. CLARK. It is $7 billion added reserves. You are assuming too much, Mr. Patman, if you convert that directly into increased lending.

Representative PATMAN. What I mean it is possible.

Mr. CLARK. They will not make the loans when they have excessive reserves there today. Why should the addition of excess reserves send them on a spending spree?

Representative PATMAN. They could buy more riskless securities.

Mr. CLARK. They could buy Government bonds, and wouldn't that be a good thing. Let us help the Secretary refund on a long-term basis a lot of these coming maturities.

Mr. SMUTNY. Mr. Chairman, can I ask one question, please, of Professor Chandler because of the fact that he referred in the middle of the talk there about the fact that we were in a recession again, and quoted the figures that the unemployed were somewhere around 3 million people.

After all, we recognize in 1953 that every time we got up to bat we knocked a home run, but you cannot expect to continue that, and in 1954, with 3 million unemployed, against a relationship, if you go

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back to the records, where unemployed persons would run up as high as 9 million, and in 1933, 13 million—3 million with 60 million employables does not seem to me to be too far out of line.

Senator FLANDERS. It is not out of line statistically, but I think whenever we look at statistics of that sort we have to make them human and it is too much.

Senator GOLDWATER. Mr. Chairman, one other question: I was prompted to ask this because of a story in this morning's paper indicating some concern about the situation in the stock market.

Now, I neither subscribe to that nor do not subscribe to it. What do you think that the release of this money would do to the stock market?

Mr. CLARK. The immediate effect would be on the bond market.

Senator GOLDWATER. Yes.

Mr. CLARK. And usually, I think, they believe that the shifting of interest from the one market to the other cools off the first market—the one they are moving out of.

I am not able, though, to add any useful comment upon the relationship of the stock market and its boom to our economic problem.

Within a few weeks, within less than a month, after the first Council of Economic Advisers was appointed, the business world greeted us with a market collapse. We wondered what that portended—that was in September 1946—there was a very serious collapse.

Well, it did not portend anything except great prosperity, and ever since then I have been willing to exclude the stock-market condition from my analyses of economic conditions.

Senator GOLDWATER. Do you think that there should be any concern then today about the stock market's being a little bit on the high side?

Mr. CLARK. Well, I do not feel any myself, Senator.

Senator GOLDWATER. I do not either; I just wondered how you felt about it.

Mr. WILDE. Mr. Chairman, I would venture a guess that, based on historical precedents, if you had a radical change in reserve requirements, it would be interpreted as more inflation out of Washington that tends to drive the stock market higher.

Mr. LAND. I would like to add my agreement to that. I feel that that would be the result.

Senator FLANDERS. Now, there is a patient man at the end of the line, Mr. Chandler. He did dip into the discussion once, but he is entitled to enter it on his own account.

Mr. CHANDLER. Mr. Chairman, I hope I may be pardoned if I do not make any comments on American tariff policy or the policy of the Southern States in attracting industry.

Senator FLANDERS. I also call your attention to the fact that we have not talked about the gold standard yet.

Mr. CHANDLER. I should like to neglect that, too, if I may.

First I should like to make a comment or two about the proposal to reduce reserve requirements to the minimum permitted by law. It has already been brought out that this would add something in the neighborhood of 7 to 7½ billion dollars to the volume of excess reserves which is already well over a half billion, making something in excess of $8 billion in excess reserves.

One thing that shoud be a primary rule in central banking is that you must always leave yourself some way of reversing your policy if the situation calls for it. To try to move from a situation of 8 or 8½

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billion dollars of excess reserves to one of mild restraint, which would call for a degree of finesse that I doubt any central banker has.

I am sure that he could not eliminate that volume of excess reserves by increasing reserve requirements, and do it with such finesse as to avoid adverse results.

This would be using a most inflexible kind of expansionary instrument of a type that could not be used in the other direction without great potential danger.

Senator FLANDERS. In other words, are you saying that you would tend to keep the bank reserves not too far—the bank reserve requirements not too far—away from the actual situation; is that what you are saying?

Mr. CHANDLER. A specific prescription is always dangerous, but I would suggest the thing to do is to leave the reserve requirements where they are today, and if any further easing is necessary, to do that through open-market operations that have high flexibility attached to them.

I would like to make a comment on one other topic which has turned out to be a key to our discussion this afternoon. That is whether full employment and relative price stability are consistent with each other.

There are certain circumstances in which it, obviously—where they obviously contradictory. For example, the situation you had in 1939 was one of widespread unemployment; it was perfectly obvious that one needed not only an increase in demand, but some rise of prices, at least of some prices, to get anything like full employment. In that kind of situation we need some price rise in order to get, or even approach, full employment levels.

But some of our economists, and the public at large, have learned the wrong lesson from that experience. They assume that when you already have full employment you cannot maintain full employment without having further price rises.

Now, it is for that reason that I would dismiss, as largely without meaning, the statistics presented by Professor Harris, indicating the great rise in real income per person today as compared with that in 1939. I do not think there is a person at this table who would want to return to the 1939 level.

Mr. HARRIS. I never gave 1939 figures in my statement, Mr. Chandler; I gave 1914 and 1951.

Mr. CHANDLER. 1914?

Mr. HARRIS. Yes.

Mr. CHANDLER. Well, I would submit that a very considerable part of that increase was achieved during the twenties when you had relatively stable commodity prices.

There were certain other periods of price stability in which the rate of growth was also quite satisfactory.

We come to a much more ticklist question when we approach the one that was uppermost in Professor Shaw's mind: When you already have full employment, can you maintain it without further price inflation?

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We do not have the ability to forecast, yet there is, I think, one real ray of hope in the point that Professor Shaw brought out, namely, the continuing technological improvement and the rising productivity which would give us room for wage increases offset by increases in output, so that we can perhaps have relatively stable prices and rising wage rates at the same time, while maintaining full employment.

I have just one further point on that subject. It is often stated that we would have a better chance of maintaining full employment if we had controlled inflation at the rate of 2 or 3 percent a year or some other relatively modest figure. I do not see any magic in those numbers.

It seems to me that an annual increase of zero percent is, perhaps, just as feasible as 2 or 3 percent.

What reason do we have to believe that we can set up expectations of 2- or 3-percent rises in price levels a year and still maintain full employment? Wouldn't you have exactly the same problem of costs tending to outrun prices, and so on, so that you would get unemployment unless you speeded up the rate of growth?

I do not know of any economist who has analyzed the problem of maintaining full employment while you have automatic escalator clauses in every contract; but I see no reason to believe it would be any easier than operating within the framework of a relatively stable price level.

Senator FLANDERS. Well, we have been through the list.

Representative PATMAN. Mr. Chairman, may I ask if it it would be asking too much of the chairman to find out from the panel by a lifting of hands or some similar way as to how they stand on free convertibility of gold?

Senator FLANDERS. I am sorry I mentioned it.

Representative PATMAN. Well, the chairman mentioned it, and I know from that it is a very important question which should be considered.

Senator FLANDERS. Let me first have an introductory show of hands. How many of those across the table wish to raise their hands on that question? Will you raise your hands to show your willingness to express yourself?

(There was a showing of hands.)

Senator FLANDERS. A majority of them.

Mr. HARRIS. Will you define the term. What does this mean? Do you mean United States present convertibility?

Representative PATMAN. Yes.

Senator FLANDERS. The present convertibility of gold.

Mr. SHAW. May I ask for a more explicit definition? At what price is gold to be freely convertible, and to whom?

Representative PATMAN. The same price as it is now.

Mr. SHAW. And to whom and from whom?

Representative PATMAN. Domestic, of course.

Senator FLANDERS. That expresses itself to me, Mr. Patman, as being able to go to the bank and getting a $20 gold piece for a Christmas present.

Representative PATMAN. That is right.

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Senator FLANDERS. I do not know what the economic significance of that is, but that is what free convertibility means to me.

Representative PATMAN. Just like it was before we did not have it.

Senator FLANDERS. Yes.

We are now taking a poll on that subject. All of those who believe that I ought to get a $20 gold piece to give away at Christmas when I go to the bank, please raise your right hands.

Senator DOUGLAS. Just a minute, Mr. Chairman, you certainly would not limit the convertibility of gold to a desire for Christmas presents, would you?

If you convert money into gold, it could be for any purpose. This is a very apt illustration of it, but it is too restricted.

Senator GOLDWATER. Mr. Chairman, I think Professor Shaw raised a very good point there as to the time element. I know in our discussions last year——

Senator FLANDERS. In my lifetime.

Senator GOLDWATER (continuing). In the Committee on Banking and Currency—in your lifetime, well, that is a long time.

Senator FLANDERS. Thank you.

Senator GOLDWATER. But that was one of the important things raised last year in our hearings, is when. There was not much question——

Mr. SHAW. The price, of course, is a highly critical factor, and also given the price, what collateral changes there may be in the reserve requirements of the Federal Reserve banks, because depending on the price and on these reserve requirements, this can be a highly deflationary operation.

Senator DOUGLAS. I suggest we poll the experts on $35 an ounce.

Senator FLANDERS. I would like to put this question properly.

Representative PATMAN. Leave out the Christmas present.

Senator FLANDERS. All right.

Is this the question that you gentlemen would be willing to express yourselves on:

Can you conceive of any proper action to be taken within the near future which would lead desirably to a free gold, interchangeability of gold with dollars? Is that a good way to state that?

Now, all in favor say "aye," or raise your right hand.

(No response.)

Senator FLANDERS. All opposed, raise their right hands.

(There was a showing of seven hands.)

Senator FLANDERS. I noted there was one person not voting. I do not know what to do about him.

Mr. LAND. I probably was the one not voting; I do not think it makes much difference whether gold-coin convertibility is restored or not.

Mr. SMUTNY. Mr. Chairman, could I bring in something that has not been brought up today?

Senator FLANDERS. Yes.

Mr. SMUTNY. I do not think there has been really any recognition of the extension of maturity of obligation of the United States Government by the Treasury.

In all Treasury refundings in which we participate, there has been an attempt on the part of the Treasury to extend the debt, and to reduce the amount and the number of refundings in each year, and

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with the last refunding operation, December 2's, which, as you know, amounted to some $17 billion, you will find that the average maturity of United States Government marketable securities outstanding now has been increased to the longest maturity period of time that they have had, I think, in quite some years, if you go back to statistics.

At present the average maturity is somewhat over 4 years, being 4 years and 3 months.

Senator FLANDERS. How far does it go back before we again approach that average length of maturity, can you say offhand?

Mr. SMUTNY. You mean how does this compare with what it was in 1933?

Senator FLANDERS. Yes; if that average length of maturity is higher than it has been in the recent past——

Mr. SMUTNY. That is right.

Senator FLANDERS (continuing). How far back do you have to go to find a similar average length of maturity?

Mr. SMUTNY. In 1951 average debt of United States marketable bonds was 4 years and 4 months.

Senator FLANDERS. Well, that is interesting.

Mr. HARRIS. Mr. Chairman, may I make one comment, since Mr. Chandler commented on my views on full employment and the price level? It will take a half minute.

I just want to say that on the basis of experience, where you have a rise of output, whether it is at a low employment level or a high, although greater at a high, there is a tendency for prices to rise.

This is true of our own history, and I simply say let us try to get a stable price level and growing employment, but in practice what you are likely to find, especially as a result of wages to inflation, and despite technological improvement; you are likely to find when output rises, on the average, you are likely to have some price rise. This is one of the costs of progress.

Senator FLANDERS. Now, there is a raised hand. Some of the members of this panel have engagements which they must meet. It had been my plan to adjourn at 4 o'clock; it is 4 now.

I hate to discourage one upraised hand.

Mr. MITCHELL. This is on that agricultural question; I can get it over with in 2 minutes, if you wish.

Senator FLANDERS. Two minutes?

Mr. MITCHELL. I am recognized for 2 minutes?

Senator FLANDERS. You are recognized for 2 minutes.

Mr. MITCHELL. Senator Flanders asked why I was recommending a great agricultural investment surge in the face of our apparent surpluses.

Well, as my paper, presented to this committee in February indicated, I do not think there is any such thing as a surplus in the human sense with regard to food and fiber, only in the economic sense, which means that we have got to find the answer not by cutting down production but by discovering better ways to distribute what American abundance can produce.

America will need a half more dairy food; we will have to get out of butter, but we will have to produce more fluid milk, and get it into the mouths of great numbers of American children who do not have enough of it for good teeth, bones, an adequate diet.

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America will have to have one-third more meat, two-thirds more fruits and vegetables, if decent diets are to be attained, and I assume they will be under a fully employed economy.

Even wheat and cotton, which are export products, will still be needed in the world, and there again it is a problem of distribution, not one of curtailing production.

But consider the credit needs of the agricultural producers, at least half of them, 2½ million farmers. If we aim that way the next 10 years, they need to undergo a virtual revolution in their way of producing, and they are going to have to get out of the cash crops into dairy, fruits, vegetables, and livestock products. They are going to need $5,000 to $10,000 each over the next 10 years in new credit to achieve this kind of revolutionary production change.

Now, banks are not making that type of loan, they do not, they cannot. These are 7- to 10-year loans, and banks cannot, under banking laws and statutes and lending habits.

I wish they could. A number of banks in the Midwest are finally hiring farm managers to help in the revolutionary type of farm-management change that will go with that kind of intermediate credit loan.

In the past, whenever we have needed revolutions in credit for farmers, such as we needed to assist low-income farmers who were bad credit risks for the usual commercial banks, we found that credit, plus supervision, was necessary. I am suggesting that that will be necessary for the middle third of American agriculture, too, in the future. If private banks are not able to revolutionize their own way of doing business, and if they do not change their ideas of the proper length of time; in other words, if they do not change to a 7- to 10-year reorganization loan, there is going to be a demand for Government once again to get into the agricultural credit field.

Senator FLANDERS. I was just going to say that I was about to thank you for your 2 minutes' worth, and you have explained yourself, I think, quite clearly.

Now, I take it, you are not quite through with your explanation?

Mr. MITCHELL. Not quite.

Senator FLANDERS. You can extend it in the record.

Mr. MITCHELL. My article goes into that, so I think that is enough time for me.

Thank you.

Senator FLANDERS. We thank you all.

Representative PATMAN. Mr. Chairman, all of them will be permitted to extend their remarks?

Senator FLANDERS. Yes; all will be permitted to extend their remarks in the record, and I—in fact, it is allowable to extend the debate in the record, to one degree. That is, I do not think we would want to extend it by each one reading what the other had said about him, and coming back twice. Once will do.

We have had a very—for the chairman at least—pleasant and an informative roundtable, and I hope that we may meet again.

Everyone has made a contribution. I am sure that the Representatives and Senators join me in that statement.

The meeting is adjourned until 10 o'clock tomorrow morning.

(Whereupon, at 4:05 p. m., the subcommittee recessed, to reconvene at 10 a. m., Tuesday, December 7, 1954.)

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UNITED STATES MONETARY POLICY: RECENT THINKING AND EXPERIENCE

TUESDAY, DECEMBER 7, 1954

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON THE ECONOMIC REPORT,
SUBCOMMITTEE ON ECONOMIC STABILIZATION,
Washington, D. C.

The subcommittee met, pursuant to recess, at 10:10 a. m., in room 318, Senate Office Building, Senator Ralph E. Flanders (chairman of the subcommittee) presiding.

Present: Senators Flanders (chairman of the subcommittee), Watkins, Goldwater, Sparkman, Douglas; Representatives Talle, and Patman.

Also present: Grover W. Ensley, staff director; and John W. Lehman, clerk.

Senator FLANDERS. The hearing will please come to order.

Yesterday we had a panel of economists and bankers who discussed their various points of view, and I think everyone who was here will agree these points of view were various, on the monetary and credit policies of the two branches of the Government which are most concerned with those questions, the Treasury and the Federal Reserve Board.

Today we pursue the line of thought and the line of questioning introduced yesterday.

Having been informed and stimulated by these widely varying points of view, we will have before us today the two branches of the Government concerned, who have very kindly offered to explain their positions, and defend them to the extent that they believe defense is necessary. We also greatly appreciate the fine cooperation we have had from both the Treasury and the Federal Reserve Board in the preparation of their answers to the questions provided by this subcommittee prior to the hearings. These materials were inserted in the record at the opening of the hearings yesterday (pp. 3, 30).

We are first privileged to have with us this morning, Mr. George Humphrey, Secretary of the Treasury, and with no further introduction, Secretary Humphrey, will you open this discussion.

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STATEMENT OF HON. GEORGE M. HUMPHREY, SECRETARY OF THE TREASURY, ACCOMPANIED BY W. RANDOLPH BURGESS, UNDER SECRETARY FOR MONETARY AFFAIRS; DAVID M. KENNEDY, ASSISTANT TO THE SECRETARY; EDWARD F. BARTELT, FISCAL ASSISTANT SECRETARY; AND ROBERT P. MAYO, CHIEF, ANALYSIS STAFF, DEBT DIVISION

Secretary HUMPHREY. Mr. Chairman, with your permission, I would suggest that we might make more progress if I made a relatively short statement, and then if Mr. Burgess would go through some charts with explanations which he has to offer and then, after having laid out that program, we would both be here and available for questions. I think that, perhaps, we would save time if questions could be postponed until we had finished that, and then the whole matter would be before you, and it would be much easier to answer questions in that way rather than, perhaps, to anticipate some of the things that we may answer as we go along.

Senator FLANDERS. We operated on that basis yesterday; I think we found it satisfactory, although we do hope that there will be a little time left after your uninterrupted flow of information.

We will proceed on that on that basis.

Secretary HUMPHREY. In that case, Mr. Chairman, I will be glad to start with this statement.

We welcome this opportunity to appear before your subcommittee to review the fiscal and debt management policies of the Treasury from the point of view of their economic influence.

At the outset and before considering in detail the activities of the Treasury during the past 2 years, I want to make a few general comments on the direction of our entire fiscal program as well as the principles guiding us in the management of the public debt.

The administration's budgetary and tax policies, along with its debt management policies, have all been designed to promote high employment, rising production, and a stable dollar.

We have in fact been following the policies advocated by your predecessor subcommittees that—as stated in the Douglas report of January 1950, in language reaffirmed in the Patman report of June 1952, as follows: "appropriate, vigorous, and coordinated monetary, credit, and fiscal policies" should "constitute the Government's primary and principal method" of promoting the purposes of the Employment Act, and further, their additional recommendation—

> that Federal fiscal policies be such as not only to avoid aggravating economic instability but also to make a positive and important contribution to stabilization, at the same time promoting equity and incentives in taxation and economy in expenditures.

Government spending programs have been cut by billions of dollars. Waste and extravagance have been eliminated in many areas. Economy in Government and efforts to get the Federal budget under even better control are continuing without letup. These efforts are of great importance to the future of our country and are fundamental in the administration's honest money program.

Major tax reductions and comprehensive tax revisions, along with the ending of price and wage controls, are removing barriers to economic growth and restoring individual initiative and enterprise.

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Savings in Government spending which have been returned to the people in the form of tax cuts are helping sustain the economy, increase employment and production.

Progress is being made toward getting our huge public debt in better shape, so that its maturities can be handled more easily and debt operations will not stimulate either inflation or deflation. Treasury financings have been designed to tie in with action taken by the Federal Reserve System to keep the supply of money and credit in line with the needs of the country.

The principles we have been following in the management of the large public debt are not new. They are, likewise, principles that have been laid down by your predecessor subcommittees after extensive study and careful consideration of the fundamental role they can play in effective monetary policy.

The first principle is that monetary and debt management policies should be flexible. To be effective they must lean against inflation as well as deflation. As put by the Douglas subcommittee and reaffirmed by the Patman subcommittee, and I quote once more:

> Timely flexibility toward easy credit at some times and credit restriction at other times is an essential characteristic of a monetary policy that will promote economic stability rather than instability.

The second principle is that Treasury debt management operations should be consistent with current monetary and credit control policies of the Federal Reserve. This means close cooperation at all times between the Federal Reserve and the Treasury.

The answers which we have already submitted to your subcommittee's questions detail the actions we have taken in cooperation with the Federal Reserve during the past 2 years in carrying out these principles. They show the manner in which our debt operations have been designed to complement monetary action taken by the Federal Reserve to promote economic stability, first by helping to restrain inflation and then later by helping to avoid deflation.

The record has not always been as impressive. As you know, at the time of the earlier congressional hearings on monetary policy and debt management, the economy had been under strong inflationary pressures. Monetary policy had been largely ineffectual in helping to control inflation because of the previous administration's policy of selling mostly short-term securities and using the powers of the Federal Reserve System to hold down interest rates artificially. A fundamental conclusion of both of your predecessor subcommittees was that such action was not in the best interests of the Nation. This was their considered judgment in language used in their report.

This administration has followed these principles because we believe them to be fundamental principles of good government. We believe the record of the past 2 years has indicated their effectiveness in giving us honest money and laying a firm foundation for the sound growth and prosperity of our country.

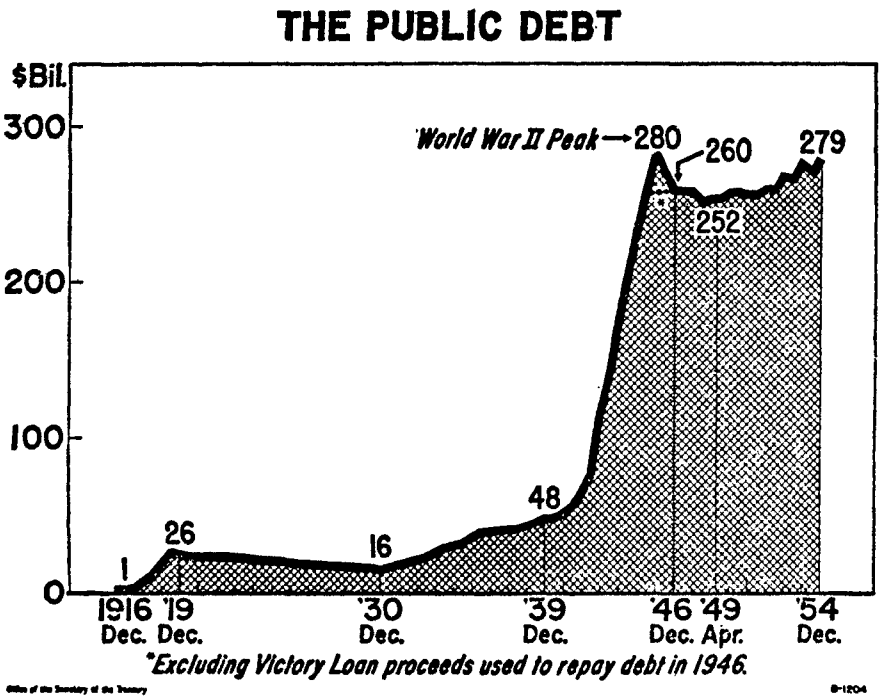
That concludes my statement. I will ask Mr. Burgess if he will take up the matter of his charts with explanations that will illustrate this point.

Mr. BURGESS. Mr. Chairman, I hope this does not look too much like a television show, but it seems to us, perhaps, the best way of presenting the facts of what we have been trying to do so that we can lay them before you.

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The first chart shows what we are dealing with, the public debt, running back to 1916. It went up in World War I as high as $26 billion, and then was reduced by 1930 to $16 billion; then during the depression it worked up to $48 billion, just before the outbreak of World War II.

Chart 1



In World War II the debt shot up to $280 billion. That top figure in a sense was a bookkeeping operation, because you will recall that in the Victory loan of 1945 we borrowed more than proved to be necessary. We did not know that war expenditures were going to taper off so quickly, and so there was $20 billion left on deposit with the banks which was used in 1946 to scale down the debt, so that a figure of $260 billion would be a fairer figure of what it really cost us in terms of the national debt.

The first debt reduction due to budgetary surpluses took place in 1947, 1948, and 1949, and they reduced the debt by $8 billion to $252 billion.

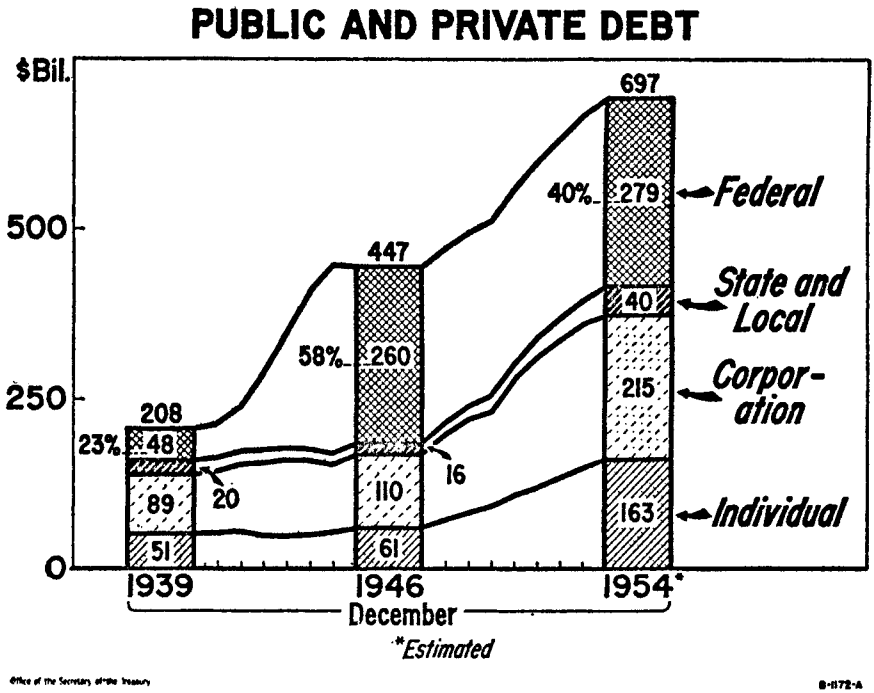
Then came the Korean war, and the $27 billion increase since 1949 represents the Korean war and the efforts to meet the cold war. So we are left at the present time with a debt of close to $279 billion.

Now, there is a way of putting the debt in its setting, and it is interesting to relate the Federal debt to our other debts of the people.

Back in 1939, we had a total debt structure of $208 billion, and the $48 billion of Federal debt was at that time 23 percent of the entire debt structure. The State and local debt was $20 billion, corporation debt $89 billion, and individual debt $51 billion, as shown in chart 2.

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Chart 2



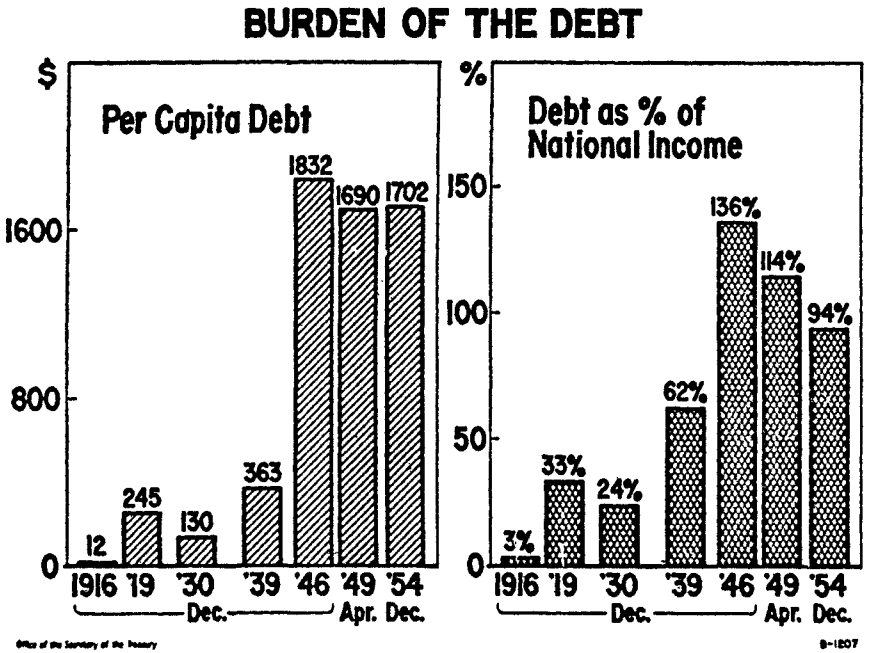
By the end of the war the Federal debt had swelled up to $260 billion, using that adjusted figure, which was 58 percent of the total debt structure in December 1946. During the war the other segments of the debt were held back because of shortage of goods and inability to start building operations, and so on.

Now, since that time, the Federal debt has risen, as indicated here, to $279 billion, which is now 40 percent of the total debt structure; that is, as the other sections have risen, the Federal debt becomes a smaller proportion of the whole debt structure. These others have gone up pretty smartly. The State and local debt is expanding. Of course, that includes these road programs which are in a sense self-liquidating; and then corporation debt has doubled since just after the war, and individual debt has risen much more than that; it includes consumer credit, of course, and the big item is mortgages.

Now, once again in the way of showing the problem of the burden of the debt, the left-hand side of chart 3 shows the debt per capita of the population. Before World War I that was only $12. At the end of that war it had risen to $245. It went down to $130; it was $363 before we entered World War II, and it went up to $1,832 by December 1946. Then it shrank, partly due to payoffs and partly due to the growth of the population, to $1,690, and it is fair to say that since 1949, the increase in the population and the increase in the debt have more or less kept pace with each other, so that the per capita debt is about the same.

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Chart 3



Now, a rather more cheerful way of looking at it—we ought to seize on any aspect of the debt that we can that is cheerful—is to relate the debt to the national income.

After World War I the debt was 33 percent of the national income. Before we entered World War II, it was 62 percent, and it rose so that it was larger than the national income, 136 percent; it was reduced by 1949 to 114 percent; because income was growing and there was some debt retirement.

The debt has come down now to 94 percent of national income. That is due to 2 causes, 1 of which is not so good. That is inflation. Inflation has increased the national income in terms of dollars, so that a part of the adjustment of the debt to national income is due to inflation, so that it has caused in a sense the kind of evil you want to try to avoid.

But part of it is due to good, solid causes, the growth of production and the expansion of the economy.

There is one thought——

Senator DOUGLAS. Mr. Chairman, is Dr. Burgess including in his analysis—would it be appropriate if I asked a question at this time?

Senator FLANDERS. Yes, you may do so.

Senator DOUGLAS. The question I wanted to ask is this: If you take the carrying charges on the national debt as a percentage of national income, isn't the showing still more favorable because what we have had has been, until very recently, a very sharp fall in interest rates?

I made some computations indicating that as a percentage of national income the interest on the national debt in 1933 was a larger percentage than it was in 1952.

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Mr. BURGESS. Yes, we have those figures. The interest rates now, for example, are actually lower, the rate of interest is lower, than it was 2 years ago, so that——

Senator DOUGLAS. I think as a percentage of national income, the cost of the national debt to the community was lower in 1952 than it had been in 1933, because roughly you have had a fall from 4 percent to 2 percent.

Mr. BURGESS. Yes, those figures are in the right area, Senator; I will have the figures inserted in the record.

Computed annual interest charge on interest-bearing public debt as a percent of national income

	Computed annual interest charge (as of June 30)	National income (calendar year) [1]	Interest charge as a percent of national income
	Millions	*Millions*	*Percent*
1932	$672	$42,500	1.58
1933	742	40,200	1.85
1934	842	49,000	1.72
1952	5,981	291,000	2.06
1953	6,431	305,000	2.11
1954	6,298	[2] 298,900	2.11

[1] Rounded to nearest hundred million.
[2] Annual rate for first three-quarters.

It shows that—we have two ways of going at this problem of the debt. It is an ugly thing to have such a big debt. One way is to try to keep it down and try to pay it off, and the other is to grow up to it. This, of course, means that one of the important things we are dealing with in respect to the debt is to encourage a dynamic growing economy.

Now, to come to the debt action in the past 2 years: As Secretary Humphrey has said in his presentation, one of our objectives was to gear our operations with the operations of the Federal Reserve System, and that is in accordance with the recommendation of your two subcommittees.

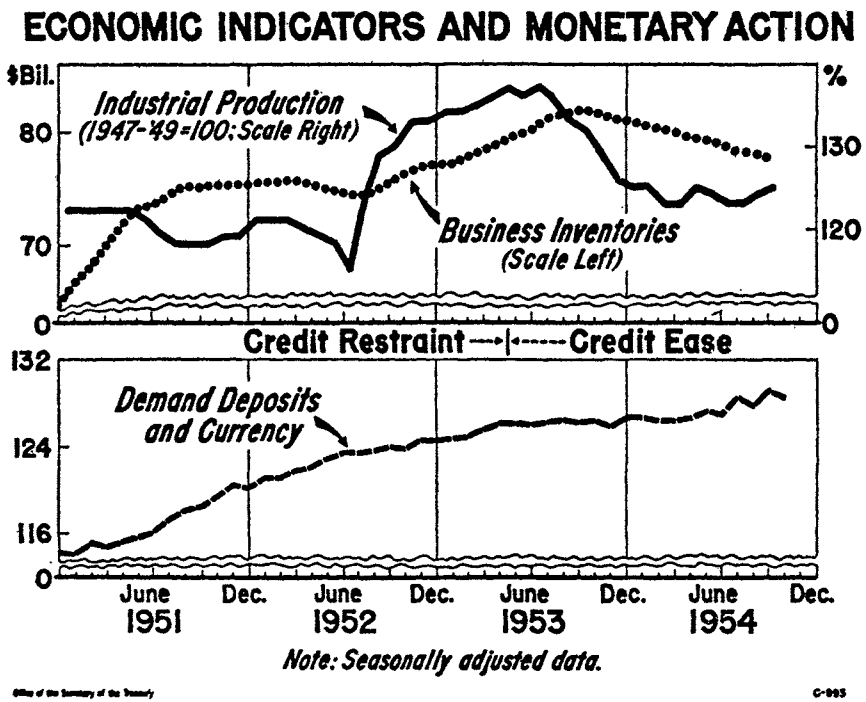
Chart 4 is an attempt to single out from the great mass of economic facts one or two that might shed some light on the situation that we have been facing.

The first thing you will notice is the color on the left side of this chart. The pink color is the area during which the Reserve System was exercising credit restraint. Now, those are the years from 1951 through to May 1953. We put in that color in a gradually deeper shade because they were gradually increasing their credit pressure during that period. The evidence of their policy, of course, is contained in the reports of the Federal Reserve Board, which shows the policies they were following during those years.

Now, what were the economic events against which they were doing so? This solid black line represents industrial production, as shown by the index of the Federal Reserve Board. The dotted line represents business inventories, and this lower dashed line represents the

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Chart 4



volume of money, as shown by adjusted demand deposits and currency.

Now, the interesting thing is that production was going through a great bulge from the middle of 1952 until about August of 1953, a bulge that carried it well above the levels that it had been and is now; in fact, it carried it above the highest level reached during the war.

Now, that bulge represented in considerable measure the increase of inventories, as well as the normal flow of production into consumption; inventories increased something like $7½ billion over that period, and at the same time, you had a period of rapid credit growth.

There was a budget deficit of $9.4 billion in the fiscal year 1953.

At the same time in this period, the wage-price controls were removed so that you had again a question of restraining possible overexpansion.

Now, this area over here on the right represents a period when the Reserve System was operating under a policy of credit ease, again as demonstrated by the reports that they made in the annual reports of the Federal Reserve Board.

One of the things about it is that they turned their policy about very quickly when there was evidence of change in the business atmosphere; even before it showed up in inventory figures and in the production index.

Now, our problem was to adjust our debt action to this sort of a situation.

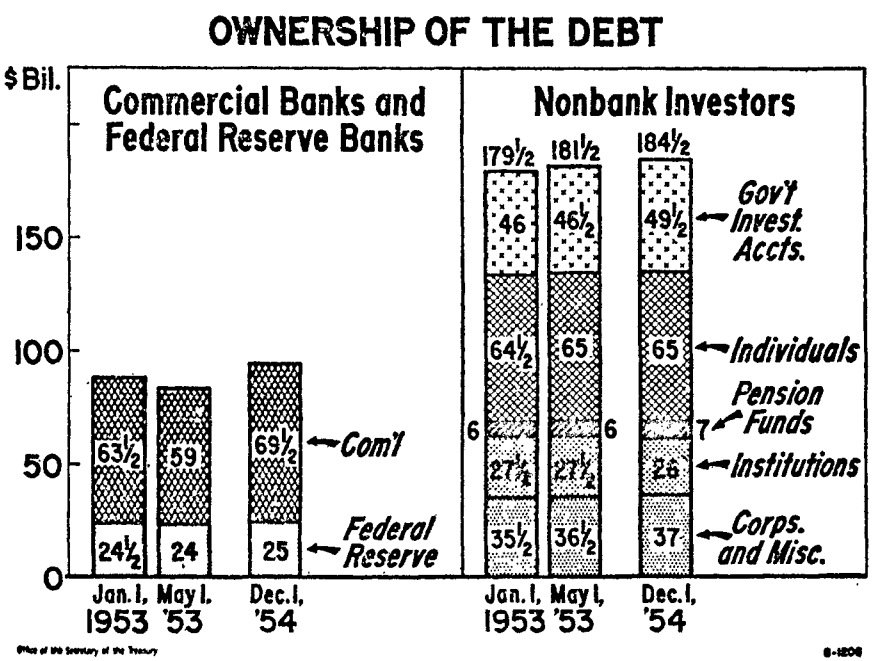
There were two major problems of debt management that we faced. One was to do exactly what the Secretary indicated, to adjust our debt management to the business situation, and to the monetary policy, and the other was gradually over a period to lengthen out the debt so it would not be so heavily concentrated in short-term maturities.

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Now, the first job with the volume of money rising, and with an inflationary situation in the early months of 1953, was to see that our debt operations did not add to the volume of bank credit, that is, that our securities were sold as largely as possible outside the banks; and chart 5 shows that from January 1 to May 1, 1953, bank holdings of governments showed a decline rather than an increase. The Federal Reserve holdings also were down a little.

Then after the change in policy, commercial bank holdings of securities went up; the volume of money increased in accordance with what you would call a classical pattern. It no longer was so important for us to concentrate on selling outside the banks, but on the contrary, some increase in the volume of bank credit was a desirable thing for the economy.

Chart 5



Now, the right-hand side shows the absorption of Government securities by nonbank investors. The corporations and miscellaneous group increased their holdings slightly throughout the period; nonbank institutions, which means insurance companies and savings banks, and so on, decreased their Government holdings over this period, as compared with no change during early 1953. That was in a way a beneficial thing because they were putting the money in mortgages and in industrial securities and in other investments which created employment and offset the recessionary tendencies of the period.

Pension funds held $6 billion of Government securities in that period, and they now hold $7 billion, when those figures are rounded off; that is a steadily growing market for Government securities.

Individuals have increased their holdings slightly, and that is where our savings-bond program comes in, which is a long-term program for getting individuals to buy Government securities, and getting a wide distribution of the debt.

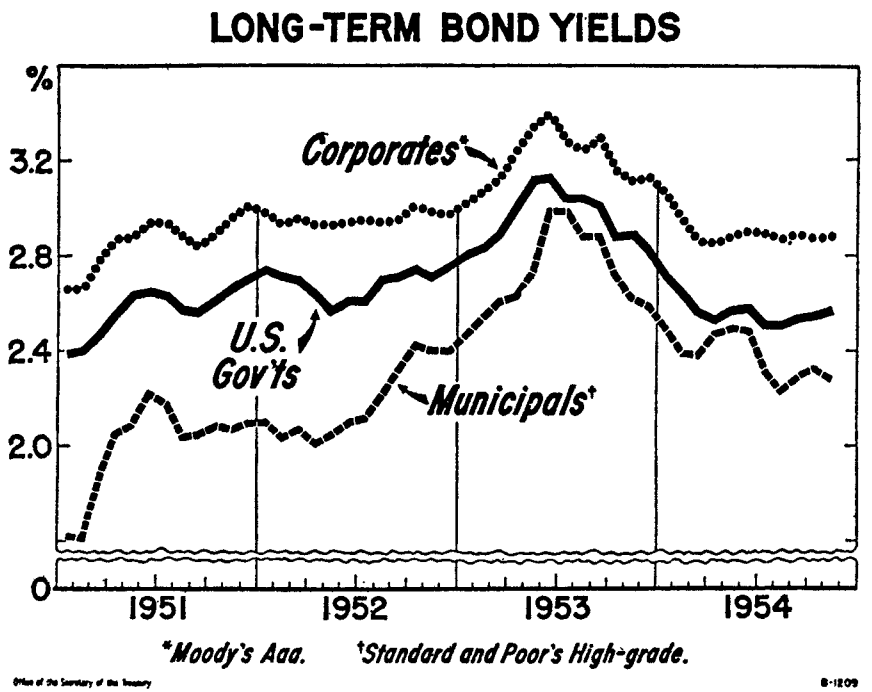
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Another steady absorption of the debt outside the banks is in the trust funds of the Federal Government—social security, unemployment funds, and so on—and that has increased over this period of 2 years by $3½ billion.

In a way, it is a kind of funding of the debt although it is, of course, on call if there is heavy unemployment or other economic situations that may lead to a more rapid withdrawal of social-security funds.

Now, responding to these changes in policy and the change in the pressure on the situation, you have had this change in long-term bond yields (chart 6). They have been going up since early in 1951; in fact, if I projected the chart back further, they would show some rise before then. The rise was, of course, sharper in these last months of the boom period in 1953, when there was more pressure on the situation from the Federal Reserve, and when we were selling a billion dollars of long-term bonds outside of the banking system.

Chart 6



There is one rather interesting thing about this chart, which is that the rate on municipal bonds—and that is the broad figure of the municipal and State, of course, with the big element being State bonds. That has gone up faster than the yield in the other categories, due to the fact that the huge volume of State and municipal issues was pressing on the market and congesting the market during that period. The amounts were so large that they overflowed the true tax-exempt market and had to go over into the life-insurance companies and other investors, so that State and local governments really lost a great deal of the benefit of tax-exemption.

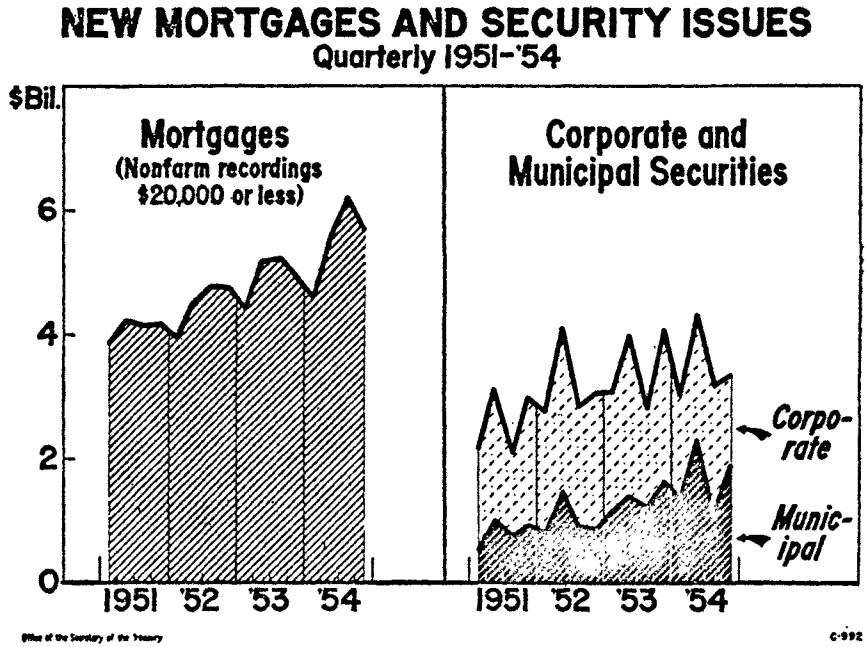
All these yields have come down sharply since that time, and are now lower than they were in the latter part of 1952.

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The corporate yields are about even with what they were in late 1951 and 1952, and the Government yields are somewhat lower.

Now, one thing that we have been watching very intently during all this period in our policy—and the Federal Reserve has been watching it as well—is the flow of money into new investment in the form of mortgages and corporate and municipal securities. The employment of money in those markets has been a great underlying strength in this transition period.

Chart 7



Now, as to the restraining money policies in early 1953, the left-hand side of chart 7 shows the mortgage market, as represented by nonfarm recordings of $20,000 or less; and the right-hand column shows new corporate and municipal securities in separate areas.

The credit restraint policy in 1953 came at a time when there were very heavy offerings of mortgages in the market, and similarly when there were very heavy offerings of these securities.

The higher interest rates and decreased credit availability led to the deferment of a certain amount of mortgage financing, and a certain amount of corporate and municipal financing. This meant that the work represented by that financing was available during the latter part of 1953 and 1954 to help hold things up.

I noticed one of the speakers yesterday said that he believed that the policy took something off the peak, and helped to fill in the valley. That, of course, is exactly what we were trying to do.

We were watching all during this period very carefully to see that money was freely available in these markets, and it is rather interesting that as you look at the charts, you will have difficulty in finding when this credit restraint policy was because the high volume of financing went on rather continuously. The presumption

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is that without the policy of credit restraint and subsequent ease more financing would have been done in early 1953 and less later on.

Now, a few words about the other phase of our financing.

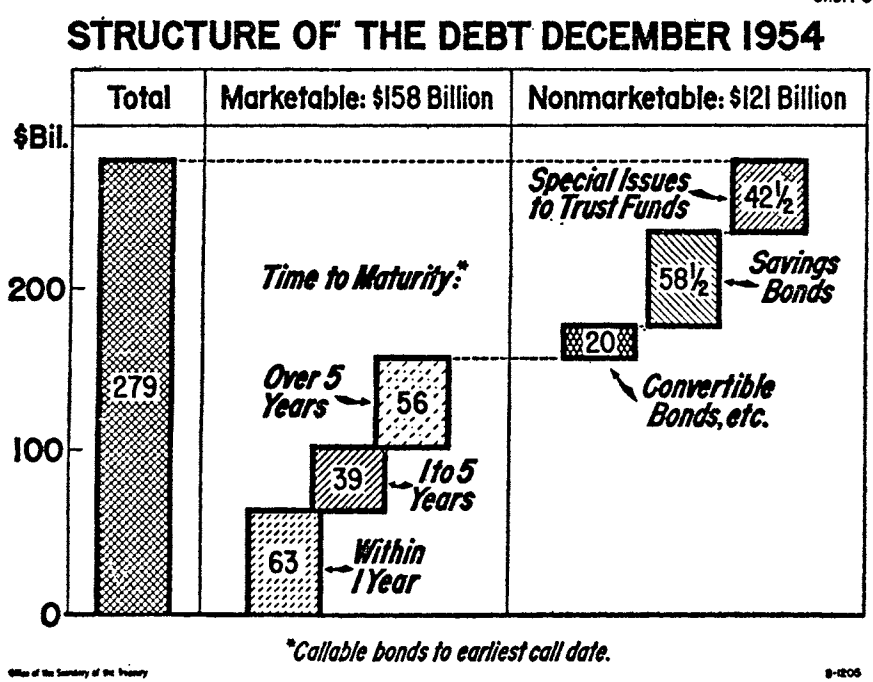
The first and most important phase is to adjust our debt management policy to the business situation and to the policies of the central bank in such a way as to encourage, and not discourage, a high level of employment and honest money.

The other problem, the longer-term problem, is to distribute this debt more widely among the people, and to lengthen the maturities, partly so we will not run into embarrassing jams in having so much financing to do in any one year, and partly also to see to it that the amount held by the banks is gradually reduced because that has a long-term inflationary tendency.

We do not want to reduce it any faster than the economic situation calls for, but some bank reduction is good over a period.

Now, chart 8 is an attempt to show the structure of the debt today. The left-hand column is the total debt, and then a group of blocks are shown to represent the marketable debt of $158 billion. About $63 billion of that now matures within 1 year, and of that close to $20 billion is in the form of Treasury bills. About $39 billion matures in 1 to 5 years, and $56 billion in over 5 years. All callable bonds are considered to their first call date.

Chart 8



The other section of the debt is the nonmarketable debt and that amounts to $121 billion. Of that, $20 billion is convertible bonds, savings notes, and miscellaneous issues. About $12 billion of that is the 2¾ percent bonds which were used in refunding a great big indigestible lump of 2½ percent marketable bonds in the spring of 1951.

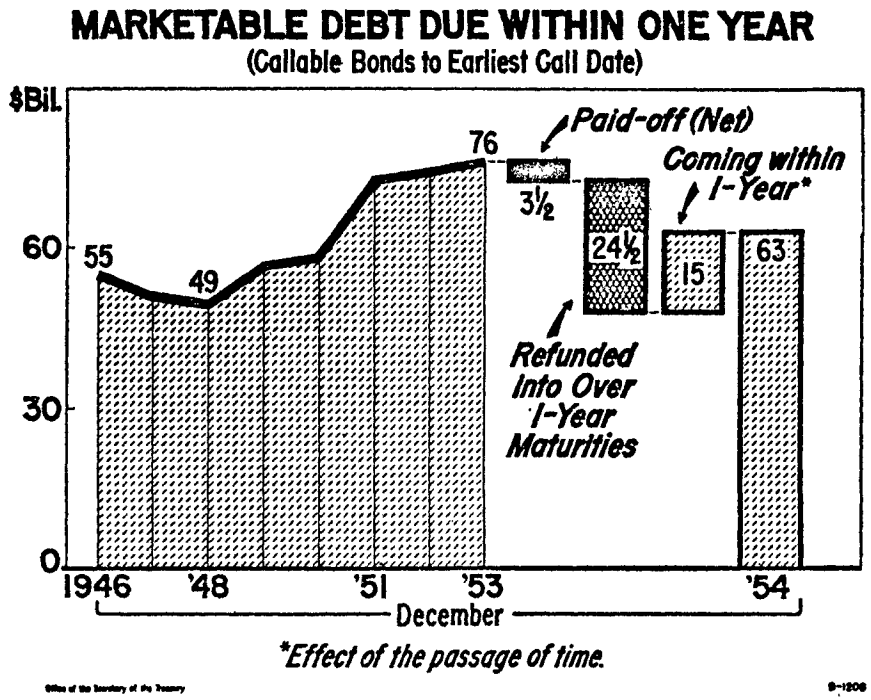
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Savings bonds total $58.5 billion. We think that is a good way to get the debt better distributed.

Then there are the special issues to the Government trust funds. Of the amount held by the Government trust funds, part is in special issues, which we issue directly from the Treasury, and part is in marketable bonds; the figures on the chart are the specials.

Now, I want to show you what we have been trying to do on the short-dated debt. Chart 9 is an illustration.

Chart 9



When we came in, the marketable debt due within 1 year was about $74 billion. Before we got through the calendar year of 1953, it had risen to $76 billion. We had not been able to do as much about it as we would have liked to because we faced, as you know, a deficit of $9.4 billion in 1953, and the credit situation was such that it was not desirable during the summer and early fall of 1953 to put any financing out other than short terms, so we wound up with $76 billion.

Now, over the past year we have gradually reduced that $76 billion due within a year to $63 billion; $3½ billion of debt was paid off; $24½ billion was refunded into issues longer than 1 year; most of that went to the banks, but it stretched out their maturity to put their holdings in more manageable form. Then, as an illustration that you have to run pretty fast in this business to stand still, $15 billion of debt issued in earlier years came within the 1-year total. It had been longer, and time had gone on, and it came within the 1-year period. That brings us out with $63 billion maturing within a year, which is a more manageable figure than at the end of 1953.

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Now, another way of illustrating the change in the debt as to maturities is by figuring out the average length of the marketable debt.

As I say, there has been a period during the last 2 years when we had to temporize with this problem—when we could not go out and try to spread the maturities very vigorously.

We have been criticized for not putting out long bonds this year. I think we were absolutely right in not doing so, because it would have been clearly in competition with the enormous loan funds in the mortgage market and the new issue market. We have had to work within rather narrow limits, and those are the limits set largely by the maturities the banks are interested in. But we have tried to stretch out our maturities.

Chart 10

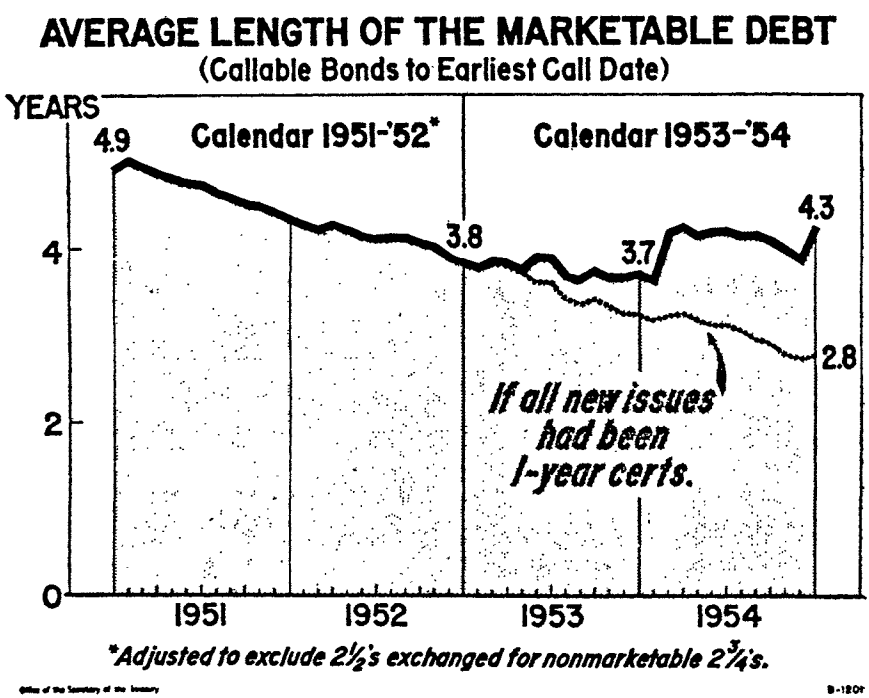


Chart 10 shows the average length of the marketable debt, which was 4.9 years at the beginning of 1951. Then it went steadily down as the Treasury financed itself largely with short-term issues, so that at the beginning of 1953 it was 3.8 years. That is the average length of the entire marketable debt.

Now, as I have indicated before, in 1953 we did reasonably well just to hold even. We came out at the end of the year with about the same figures as at the beginning. This year we have been able to stretch out the debt somewhat in refundings, particularly in February and in our current December financing, so we will finish up the year with an average length of debt of about 4.3 years.

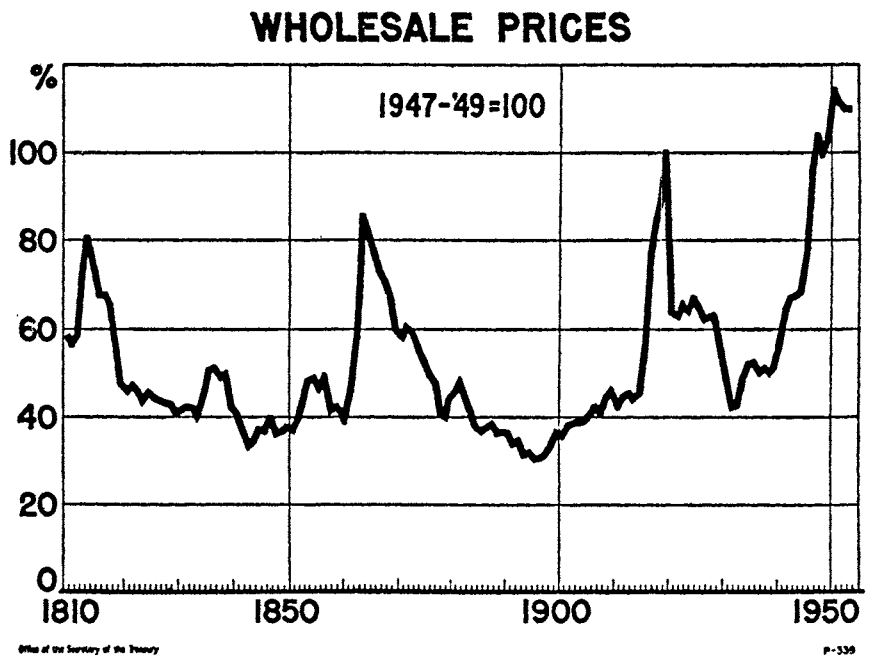
If we had refunded all the securities that matured during 1953 and 1954 in 1-year certificates, the average length of the whole marketable debt would have been only 2.8 years.

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Now, chart 11 is a final chart. That does not draw any conclusions, but it keeps our sights upon the horizon, and relates to where we now are in the economic picture and to where we were in the past.

I present this familiar chart of wholesale market prices running back to 1810, over 144 years, just to have that in mind.

Chart II



In a way, it is not too good an index, as Senator Douglas knows. But it does give a pretty good indication of the trend of prices, although we have to rely on relatively thin data as you go further back. It shows that each war, the War of 1812, the Civil War, the First World War, the Second World War, and the Korean war, and the cold war have tended to produce a rise in wholesale prices.

Another interesting feature of it is that the general trend line, except for those war bulges, was moderately level over the first 125 years or so of that period. After each war we did tend to come back to the old price level, right or wrong, so that when people say, "Well, in my mother's day prices were just so much cheaper than they are now," that is really only true in the last 15 years or so.

Certain prices did go down, and certain others went up. The price of manufactured goods came down over the long span. The prices of many other articles tended to go up.

But here we are with a new kind of thing. We have got one war piled on another, and it leaves us in what is in the history of the past, an inflated position. But we are trying something new this time. We are trying to hold the general level of prices stable rather than trying to go back to any previous level.

Our firm belief is that we should benefit best from a stable-price level rather than trying to go backward and forward. I think it does

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indicate that the inflationary forces are always there, waiting around the corner to leap on us. The fact is that the present high-price level does represent a tragedy for many people who have accumulated savings; but any attempt to readjust it would bring more of a tragedy than you would correct by doing it.

We are trying to do something new; we are trying to use all our forces to give us stability instead of the pattern you see on that chart.

I think, Mr. Chairman, that concludes it.

Senator FLANDERS. Thank you, Mr. Burgess.

I would like to pick up a question which arises from your last few words. Are we to conclude from what you have just said that your main interest in these matters is in price stability? There are other criteria, but price stability seems to be the one that you have emphasized.

Mr. BURGESS. Well, I think if I emphasized that exclusively, it would be a mistake, because what we want is economic stability and growth, Mr. Chairman; the buying power of the dollar is a most important element in that, but it is certainly less important than having a good, sound, solid economic growth.

We believe that a stable dollar is one of the very important desiderata of growth as well, but, as in the old Federal Reserve days, there is not any single measure that you can follow and recognize exclusively as the guide. As the Congress, indeed, demonstrated when it was considering the Employment Act, they found they had to use a pretty broad brush to paint the objectives that they wanted.

Senator FLANDERS. Now, getting it into human terms, we think of high production and consumption. Do you feel that a stable price level leads to those ends?

Mr. BURGESS. Yes, sir.

Senator FLANDERS. One thought came to my mind in connection with your chart No. 4, which showed the rapid increase of industrial production up until the middle of 1953, the rise in business inventories slightly beyond that, and then a gradual decrease.

Would not a drop, not in wholesale prices necessarily, but a drop in the general price level have moved the inventories? It seems as though that used to be considered the old free-market operation, but this time there was not any particular decrease in prices to the consumer, so the inventories dropped off slowly. As they were worked off, production went down.

Mr. BURGESS. That is one of the very extraordinary features of this business movement.

As you indicate, in previous ones, there has tended to be an adjustment in prices which has helped to move the goods. I think that, perhaps, there has been a little more price adjustment than shows in the indices, the sale of cars at discount or white goods, and so on. One can debate that question that you raise at great length. The difficulty is that if you do have a sharp drop in prices it tends to accentuate the whole movement, and may lead you into a spiral downturn.

I think also that the fact that there was no great drop in prices was an indication of confidence in the future that business had, so they thought they would wait it out, and so far it looks as though they may have been right in so doing.

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Senator FLANDERS. Then in business practice and in certain governmental operations we must qualify some of our ideas about the automatic effects of free market supply and demand on production, and employment. We think of that as sort of a norm which we look at occasionally; is that about the size of it?

Secretary HUMPHREY. Well, I think, Mr. Chairman, in connection with this, just from a practical viewpoint, that we had large consumer buying during all this period, and I think that with that large consumer buying, that was the thing that tended to help stabilize the situation, and the goods kept moving, and there was not the pressure, the price pressure, that you otherwise would have.

Further than that, you have not had the great rise in prices immediately preceding it, either, that usually occurs just before this sort of thing.

Senator FLANDERS. Yes.

Secretary HUMPHREY. So that with the combination of rather stable prices on the way up, and with a continuing distribution going on, you did not have the wide price swings that you might otherwise have had during the last 2 or 3 years. I would not say that that phase of our economy was gone for all future time.

Senator FLANDERS. Well, that is a good subject for contemplation; I will not press it further.

Now, there is one element in our debt structure which ought to be perfectly simple to me, but somehow or other I get tangled up every time I look at it. That is the special issues to trust funds; who owes what to whom. These funds flow in from the States and from the beneficiaries into the Treasury; with this money the Treasury buys for its own account some special issues which are put into trust funds as reserves against future payments.

How do these issues get into circulation as Government funds? Are they paid out?

Secretary HUMPHREY. I can illustrate this in a kind of common garden way.

Senator FLANDERS. That is the only way I shall understand it.

Secretary HUMPHREY. And by a little story that I have told before. I had a businessman one day speak to me about these funds, and he said, "Isn't that just crooked? Aren't you just deceiving people by that?"

And I said, "Well, I really don't think so." I said, "You have"—this was a businessman running a large business—I said, "You have a substantial pension fund for your company, don't you?" And he said, "Yes," that they had a big pension fund; that every year they contributed to that pension fund so as to not have a big burden all come at one time, and that they, perhaps, were not actuarilly sound, but they reached toward actuarial soundness in their fund, and they kept putting annual deposits each year in this fund so the fund would be available for use when the occasion required it.

I said, "Now, what have you done with that fund? How have you got it invested?"

He said, "Why, we have our fund invested in Government bonds. That is what we put our fund's investment in."

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I said, "That is exactly what we do. The United States has its funds invested in exactly the same way. We charge to income annually an amount to bring these funds into the realm of actuarial soundness."

You can get into all kinds of arguments about actuarial soundness, but it is in that realm. Then I said, "We invest our money in Government bonds just as you do."

Senator FLANDERS. And the money received for those bonds is available for expenditures?

Secretary HUMPHREY. That is right.

Senator FLANDERS. I have another question.

Secretary HUMPHREY. I will just say one more thing, that I think we should never fail to keep in our minds: That practice—while I do not know what else you can do with your money, or how else you would handle it—does hold this fear that we might just as well recognize. This applies particularly to unemployment funds or other funds that are subject to emergency withdrawal. In the event of an emergency withdrawal, an emergency need for funds, not only the private funds will be wanting to sell their bonds in order to turn them into cash to use the cash currently, but the Government funds—for the same emergency purpose—would do the same thing. So that we might run into a period where you would have the private funds and the Government funds and a number of other people all trying to realize on funds which they have laid aside in bonds for their protection. Then you might have an emergency in which you would have an excess of Government bonds offered on the market which might present a serious problem for the time being.

Senator FLANDERS. One further question on that line: How much interest does the Government pay itself, and does it make any difference?

Secretary HUMPHREY. Well, I think it does make a difference. I think you have to treat these funds just as you would treat the private funds.

Senator FLANDERS. Except that you do not have to market them.

Secretary HUMPHREY. You may have to market them sometime.

Senator FLANDERS. It would then be these very instruments which you put into the trust funds that you would market in an emergency?

Secretary HUMPHREY. No. They would be changed into the kind of thing that would sell to meet the market condition at the time.

Senator FLANDERS. Then the marketability is not a determinant of the interest which you pay yourself?

Secretary HUMPHREY. Not necessarily.

Senator FLANDERS. Well, I have always wondered how you determined the interest you should pay yourself and whether, as debtor, you ever had any arguments with yourself as creditor on that particular subject.

As I say, I personally do not see that it makes any difference.

Secretary HUMPHREY. Many of the interest rates are fixed by law. So that part is settled.

Senator FLANDERS. Yes; I see.

In order to give time for others, I will be as brief as possible in questioning.

We had some discussion here yesterday to indicate that there was something in the nature of a near panic in the money market around

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June 1 last year. Would you say that that was a correct description of what happened?

Mr. BURGESS. Well, Mr. Chairman, I think that is a little exaggerated. There was no doubt about it; the market was disturbed and disorderly for some days. The new 3¼ percent bonds went to a discount of just over 1 percent; it was not very bad. It restored itself reasonably well.

The Federal Reserve put money into the market through the purchase of Treasury bills, and that was taken as an indication of a change in policy. The market cleared itself up over a period of weeks. It undoubtedly was a crisis of sorts.

Of course, most changes from a boom to a leveling off in economic conditions do have some sort of crisis, and in the light of other crises, this was a relatively mild one.

Senator FLANDERS. Do you feel that it would be helpful if the Reserve System went back to the policy of offering some support while securities were being marketed, or are you content to go along with the plan of their holding off during that period?

Mr. BURGESS. Well, I want to say, first, that during these nearly 2 years that we have been working with the debt, we have had very fine cooperation from the Federal Reserve System. We have not been conscious of any deficiency in their cooperative efforts.

Now, I think in the discussion yesterday, and in other discussions, there was a tendency—you may want to ask Mr. Martin about this—to overstate the decision of the Reserve System to stay out of the market.

I think they have always qualified that by saying that if the market became thoroughly disorderly they would be prepared to go in and do whatever was necessary to straighten the market out.

Senator DOUGLAS. Mr. Chairman, before you proceed, might I refer to the previous question asked of Mr. Burgess?

Senator FLANDERS. Yes.

Senator DOUGLAS. Mr. Burgess, you spoke of the fact that in June of 1953 the new bonds fell by only 1 percent, but is it not true that the bonds of older issues had fallen by approximately 10 percent?

Mr. BURGESS. Well, they fell by 10 percent from 1951 to June of 1953.

Senator DOUGLAS. Yes; but I mean was not the sudden decline from March to June of 1953?

Mr. BURGESS. That was not 10 percent, Mr. Senator. As I remember it, it was about 4 points—from 94 to 90. Those bonds had already been declining for 2 years. The decline was sharper, admittedly, in that last period.

Senator DOUGLAS. Excuse me.

Senator FLANDERS. Now, one other question: Is there such a thing as a free market for paper representing debt when, in your chart No. 2, you show that at the present time 40 percent of the total public and private debt is Federal, and back in 1946, 58 percent was Federal?

How can a market be free when so much of it is on the terms of a single issuer?

Mr. BURGESS. Well, Mr. Chairman, of course, it is not entirely free. We are in and out of the market constantly, and the Federal Reserve, with almost $25 billion of governments, is a constant factor in the market. It is a relative term, but the market is certainly freer than

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it was, a great deal freer, and the question is how much leeway there is for the natural forces of supply and demand for money to operate.

Now, we believe that things will be healthier if the natural forces of supply and demand have a good deal of leeway to operate, and that they tend to be self-corrective of difficulties in the market—I say tend to be.

When we are such large factors, the Federal Reserve and ourselves, we always have to be alert to the market, and ready at some point to see that at least we do not upset it, and at times to act as a stabilizing factor, but whatever freedom you can give it we believe is very useful.

Senator FLANDERS. Mr. Patman?

Representative PATMAN. Mr. Secretary, you mentioned the possibility of an emergency arising through the sale of Government securities by these trust funds to take care of their obligations. Don't you consider that a pretty good reason to consider support for Government bonds under certain conditions, at least?

Secretary HUMPHREY. Well, I think that I would answer that just exactly as Mr. Burgess answered the previous question. I think that there are times when there ought to be some attempt to stabilize market conditions; but that, by and large, the best thing we can do is to keep our activities in such shape that we are not influencing the market either way, but to let the market use its natural correctives to the greatest possible extent.

Representative PATMAN. Will you put that first chart back up, about the public debt; that is $279 billion? You do not list Federal Reserve notes in that, do you?

Secretary HUMPHREY. No.

Representative PATMAN. Federal Reserve notes, after all, are obligations of the United States Government, carrying the same obligation as a bond, is that right, Mr. Secretary?

Mr. BURGESS. They are secured obligations; they have gold and the assets of the Federal Reserve System behind them.

Representative PATMAN. But they are obligations. They state on their face, just like a Government bond; they are obligations of the United States Government.

Now, when the Federal Reserve bank, for instance, buys $1 million in Government bonds, and it gives $1 million in Government Federal Reserve notes, that is paying out one form of Government obligation for another.

You are just listing one of them up there now in the public debt. Why should not the Federal Reserve notes be listed because there are $30 billion worth of them outstanding today, and the Government has got to pay every one of them?

Secretary HUMPHREY. Well, you understand this does not attempt to reflect all of the obligations of the Government in any way.

Representative PATMAN. I know, but this is a debt obligation.

Secretary HUMPHREY. There are a whole lot of obligations much larger than that. If we put in all of the contingent liabilities and all the other things, you would have a far different picture than this.

Representative PATMAN. We have an enormous debt, the total debt being $697 billion, public and private.

Now, 1 percent interest on that would be $6,970 million.

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In view of the fact that the public debt—I mean the national debt—represents such a large part of that, don't you think the cost of money should be considered in all the policies that you are adopting, Mr. Secretary? Should it be a major factor?

Secretary HUMPHREY. The cost is an important factor.

Representative PATMAN. It is an important factor, of course.

Now, Mr. Burgess said a while ago that he placed the level of prices, the buying power of the dollar, I believe, No. 1 on your list in importance.

Secretary HUMPHREY. I think that is very important.

Representative PATMAN. What would you list second?

Secretary HUMPHREY. For what purpose? I do not know what——

Representative PATMAN. For the purpose of looking after the public interest and economic interest of the Nation.

Secretary HUMPHREY. Well, I think what we are trying to do is this: We are trying to create stable conditions and conditions that are favorable for the making of jobs. I think this whole thing gets back to the people and the making of jobs.

Representative PATMAN. That is the point I am coming to, Mr. Secretary. Don't you think that full employment is more important than the level of prices?

Secretary HUMPHREY. I think the making of jobs is probably the most important thing that this country has to do. We have a growing population, and I think the basis of our prosperity, of the living of the people in this country, gets back to the making of jobs.

Representative PATMAN. Well, I am glad to hear you say that because that puts the Employment Act No. 1, does it not?

Secretary HUMPHREY. Well, I do not know that I would say the Employment Act, is it?

Representative PATMAN. Well, I mean the policies set forth.

Secretary HUMPHREY. I think I would put it just as I set forth, the making of jobs.

Representative PATMAN. And the policies set forth——

Secretary HUMPHREY. There are certain things that help to make jobs, and certain things that help to discourage that.

Representative PATMAN. I think that is the Employment Act.

Secretary HUMPHREY. And I think we ought to help to make jobs.

Representative PATMAN. Isn't that one of the things in the Employment Act, the making of jobs?

Secretary HUMPHREY. I will not quarrel with you on words; in my point of view it is making jobs.

Representative PATMAN. I think you have dovetailed it in, and I think it parallels the Employment Act. I am glad to hear you say that is more important than the level of prices.

I want to ask you about this 3¼-percent bond issue of last year. When was that issued, April 1 or April 30?

Secretary HUMPHREY. I do not remember the exact day, but it was in April.

Representative PATMAN. I believe it was dated May 1.

Mr. BURGESS. Yes; for payment on May 1.

Representative PATMAN. It was announced in the early part of April.

Secretary HUMPHREY. Some part of April.

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Representative PATMAN. I cannot understand, Mr. Secretary, why you put out that issue at all. You did not have to have the money?

Secretary HUMPHREY. We needed to borrow about a billion dollars, and we wanted to do it that way for a number of reasons. One reason that does not show in the charts I would like to just call to your attention: We had had since early in the Korean war extensive controls in our economy. Those controls covered many prices, wages, and so forth.

We had great bureaus down here exercising those controls. During the latter part of the preceding year there had been some discussion as to whether or not those controls could be taken off.

When we first came into this Government, there was a great division of opinion as to whether or not the controls could be removed. It was thought that it was beneficial by some to get controls off just as rapidly as possible, and let the economy begin again to function freely.

It was said by others that if that were done we would have a runaway inflation, prices would go right through the ceiling, and we would have a lot of difficulties.

That was the atmosphere in which we were operating in the early part of the spring of 1953. We decided that it would be best for the economy if those controls were removed, and removed just as rapidly as possible, to return the economy to a free operating basis.

In order to attempt to keep prices from running away, with the removal of those controls, there were several things that could be taken into account. One of them was the productive power of industry coming up; another was prospective demand; another was some restraint on credit which would help dissuade speculative buying for inventory purposes, and all those things were taken into account, and this issue was part of the program that was used in taking off those controls. We did take off the controls, and all of the calamity howls that we might set off an impossible price rise proved to be false, and our prices did not rise. We went along without the controls, and I am sure the country was much better off because we did so.

Representative PATMAN. I have great respect for your judgment, Mr. Secretary, but I don't think that was related to issuing $1 billion in 3¼ percent bonds.

Secretary HUMPHREY. That was part of the program.

Representative PATMAN. No. 1, it was not necessary to issue them. You had the money.

No. 2, the rate was excessive, as is evidenced by the fact that a purchaser of the 3¼ percent bond at the low point, selling them at the high point within 1 year, would have made more than 15 percent.

Secretary HUMPHREY. Everybody had the same chance. The bonds have always been freely traded in the market.

Representative PATMAN. A windfall.

Secretary HUMPHREY. Everybody had a chance. They were available in the market at par or below all during May and June.

Representative PATMAN. Somebody got an awful windfall in that. That is about the biggest windfall I know of in the history of Government bonds.

Secretary HUMPHREY. The bonds went below par after they were put out and they didn't get above par again until July.

Representative PATMAN. I know, but some people bid on those bonds, their subscriptions were cut in half and the commercial banks

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got them. Mr. Burgess said you were trying to take them out of the commercial banks.

Secretary HUMPHREY. There were plenty in the market for many weeks. Nobody was denied an opportunity.

Representative PATMAN. And another question, Mr. Humphrey: Why did you permit the F- and G-bond holders to exchange their bonds at 3¼ percent, and not permit the E-bond holders to do the same thing?

Secretary HUMPHREY. I will ask Mr. Burgess to answer that.

Mr. BURGESS. Well, the E-bonds are an entirely different kind of bond. The E-bond holder was already getting 3 percent for a bond that is completely protected from all fluctuations in the market.

Representative PATMAN. I know, but this is 3¼. You let the F and G's, getting 2.9 percent, the same that the E's were getting, exchange theirs that were maturing for the 3¼ percent, although you didn't permit the little fellow, the E-bond holder, to do.

Mr. BURGESS. We did permit him, Mr. Congressman. Any E-bond holder that wanted to cash in his bonds and buy the others had the full privilege of doing it. They were available in the market.

Representative PATMAN. If he could get them through a bank or a broker who would be paid a commission.

Secretary HUMPHREY. Of course, he could get them. But the E-bond buyer is a completely different kind of buyer. He is a small buyer who doesn't want to take the risk of the market. He, typically, hasn't any reason to buy 3¼'s or 2½'s, or any other marketables.

Now, for example, suppose you sold 2½'s to the E-bond buyer, he would have suffered, as you indicated awhile ago, 10 percent——

Representative PATMAN. I am not talking about 2½ percent. I am talking about 3¼ percent.

You gave the F and G holders, who are in a higher income class than the E bondholders, an opportunity to exchange their maturing bonds that were drawing 2.9 percent interest for the 3¼ percent without going through any market or anything else, just exchange them, but you did not permit the little fellow with the E bonds, to do the same thing, and that is the point I can't understand.

Secretary HUMPHREY. Well, I just want to insist that the E-bond man could get his money at any time from the banks and invest it in that market if he wanted to.

Representative PATMAN. Why didn't you give him the same privilege you gave the F and G holders?

Secretary HUMPHREY. He had it automatically.

Representative PATMAN. Well, he didn't.

Secretary HUMPHREY. He could cash his bonds and take the money and put it in the other bonds.

Representative PATMAN. E's are held by the little fellows.

Secretary HUMPHREY. Sure.

Representative PATMAN. The F and G's by the big fellows. You specifically stated in your notice that the F and G bondholders could make an exchange directly with the Treasury. They didn't have to go through a broker or a bank. They just made a direct exchange of their 2.9 percent bonds for the 3¼ percent bonds.

You made it very easy for them which was fine, but why didn't you let the E bondholder do the same thing? He had the same type bond,

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2.9 percent. Why didn't you let him exchange them for the 3¼ percent bonds?

Secretary HUMPHREY. He could automatically have done exactly the same thing by redeeming his E bonds.

As a matter of fact, we have given holders of maturing E bonds an even better proposition. They can automatically extend their bonds and get 3 percent interest on an obligation that can be turned into cash on demand without any market risk. The fact that the great majority of holders of matured E bonds did not turn them in to buy the 3¼ percent marketable bond is fairly good proof that they preferred to keep the E bonds.

Representative PATMAN. I know you went to a lot of trouble to do it. You made it easy for one and hard for the other. That is what I can't understand.

Secretary HUMPHREY. No; there wasn't any trouble for anybody.

Representative PATMAN. And brokers' commissions, possibly, and expenses of different kinds.

Secretary HUMPHREY. No. There are no brokers' commissions or anything like that. All those bonds are redeemed without charge.

Representative PATMAN. The reason I say you shouldn't have put this issue out, Mr. Humphrey, is because you had nearly $6 billion in the banks that could have been used and should have been used. There was never a time during that year that you didn't have 2 or 3 times the amount of that issue in the banks, subject to your use, if you wanted to use it, and that is the reason I can't understand it.

Secretary HUMPHREY. Two or three times the amount of issue hasn't got a thing to do with it. What we need to have is cash funds to operate on, and I don't think you can find a business in the country that operates any closer than we do on cash on hand.

Representative PATMAN. I know, but Congress——

Secretary HUMPHREY. We have been operating with less than 30 days' cash must of the time we have been here.

Representative PATMAN. You are overlooking something.

Secretary HUMPHREY. Wait a minute.

We've been keeping less cash than was on hand relative to expenditures at any time for a long time prior to that. We have operated this Government with relatively less money than has been used for years.

Representative PATMAN. You are overlooking something. Congress has very wisely provided for a $5 billion overdraft between you and the Federal Reserve banks.

In other words, if you exhaust these funds, you can get $5 billion directly from the Federal Reserve banks at any time. You have a $10 billion leaway there.

Why should you want over 5 billion? And if you don't want over five, why don't you use this money that is in the banks?

Secretary HUMPHREY. Do you want an answer to that?

Representative PATMAN. I do.

Secretary HUMPHREY. The day you are talking about we had in the tax and loan accounts in commercial banks four billion, nine eighty-three——

Representative PATMAN. What day was that?

Secretary HUMPHREY. That was the last day of March. The end of April, we had $1,589 million in these accounts.

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Representative PATMAN. Well, that is three times as much.

Secretary HUMPHREY. The end of May, we had $2,109 million and so the end of June we had $3,071 million.

Representative PATMAN. I have here on March 31, you had $6,108 million; on April 28, you had $3,627 million.

Secretary HUMPHREY. I think your trouble is you are counting in there a billion dollars of gold that was on hand, and about $500 million in Federal Reserve accounts.

Representative PATMAN. I think that's right. You had $500 million in the till.

Secretary HUMPHREY. I am talking about usable cash in our working accounts in the commercial banks.

The figures I just gave you are the correct figures.

Representative PATMAN. I reiterate according to your own figures, not counting this $1 billion of which you have used about half since you had about $1 billion gold and $500 million usable cash.

Not counting that you still had 2 and 3 times as much money all during that period as the amount of this bond issue, and what I can't understand is why you would issue a bond and at three and a quarter——

Secretary HUMPHREY. It was an amount of——

Representative PATMAN. Wait just a minute. Let me finish. Why you would issue bonds and of the highest rate clear out of reach, as evidenced by the fact that they had gone so high since that time, when you didn't need the money. You could have gotten every bit of that money from the banks and had twice as much left there.

In addition to that, if you needed more money, you could have gotten $5 billion from the Federal Reserve banks as you are permitted to do by congressional law.

Secretary HUMPHREY. Well, now you are saying two things at once. You are saying first we didn't need the money and, second, you are saying we could have gotten the money elsewhere.

Repersentative PATMAN. No. No. 1, I will close right there. You didn't need it.

Secretary HUMPHREY. Whether we got it one place or another is not what you are now talking about. You are now saying we didn't need the money.

Representative PATMAN. That's right.

Secretary HUMPHREY. I am saying we did need the money, as shown by our balances where, at the end of April, we had $1.8 billion in the tax and loan accounts. Do you know how long that lasts? We were spending $6 billion a month at that time.

Representative PATMAN. That doesn't make any difference, Mr. Secretary. Why keep on saying that?

Secretary HUMPHREY. We had on hand about 10 days of cash. You pretty nearly have to write checks——

Representative PATMAN. That is not alarming at all, when Congress has very wisely provided that you can get $5 billion instantly from the Federal Reserve banks. It is in the law. You asked for the law to be renewed here a while back.

Secretary HUMPHREY. You have got to have it right now if you are going to write checks against it.

Representative PATMAN. You can get it right now, draw it on the Federal Reserve. That is the only bank you draw on, anyway.

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Secretary HUMPHREY. Wait a minute. Now you have switched again. Now you are talking about where you get the money, not whether we need it or not. Let's talk about one thing at a time.

Representative PATMAN. That came up.

Secretary HUMPHREY. As to whether we needed it?

Representative PATMAN. That came up, assuming you did need it. I don't say you needed it, you didn't need it.

In other words, you put out an issue to give somebody—you didn't do it deliberately, I am not charging you with that. There is nothing personal in this, Mr. Secretary—you gave these fellows a big windfall. It gave these people a big windfall equal to about 15 percent in one year on the finest and best securities on earth.

It has never happened before, I don't think in any country on earth, and when you didn't need the money and you had twice that much in the banks that you could use, as to why you would do it, I still can't understand, to save my life.

Secretary HUMPHREY. I think if you will look at the figures, you will understand it much better.

Representative PATMAN. Furthermore, why should you keep those deposits in these banks at all, anyway? You don't have to.

Secretary HUMPHREY. There is another subject, and we will be very glad to talk about that.

Representative PATMAN. All right, now, I have your very fine comprehensive report on that, for which I now want to express my thanks. The report is very full and very complete. I ask that it be inserted in the record at this point.

(The report referred to is as follows:)

THE SECRETARY OF THE TREASURY,
Washington, October 29, 1954.

Hon. WRIGHT PATMAN,
House of Representatives, Washington 25, D. C.

DEAR MR. PATMAN: In response to your letter of September 3, which I acknowledged on September 13, I am enclosing herewith a memorandum giving you the history of the depositary practice of the Treasury Department, legislative authority therefor, and other information concerning the maintenance of deposit accounts by the Government in commercial banks.

I trust that this memorandum will furnish the information you desire.

Very truly yours,

G. M. HUMPHREY,
Secretary of the Treasury.

WHY THE FEDERAL GOVERNMENT KEEPS FUNDS IN COMMERCIAL BANKS

This memorandum has been prepared in response to Congressman Patman's letter to the Secretary of the Treasury, dated September 3, 1954, regarding the practice of the Federal Government in keeping funds in the commercial banks of the Nation. The memorandum presents the following information requested by Congressman Patman:

1. History of depositary practice of the Treasury Department.
2. Legislative authority.
3. Complete and definitive statement explaining the operations of, and reasons for, this practice.
4. Specific terms on which banks accept these deposits.
5. Precisely how decisions are arrived at as to leaving funds on deposit and to transferring them.
6. Why these funds are not transferred to the Federal Reserve banks immediately upon receipt.
7. What the high, low and the average balance carried in commercial depositaries has been during the fiscal year ending June 30, 1954.
8. Same information for each of the 12 Federal Reserve districts.

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1. History of depositary practice of the Treasury Department

Except for brief intervals the United States Government has throughout its history followed a practice of depositing its public funds in the banks of the Nation. Among the first acts of Alexander Hamilton as Secretary of the Treasury was the designation of the Bank of North America and the banks of New York, Massachusetts, and Maryland as depositaries of Government funds.

The First Bank of the United States, chartered in 1791, served as a Government depositary and fiscal agent. When the bank was not rechartered, the Government funds were transferred to State banks. The act authorizing the chartering of the Second Bank of the United States in 1816 specifically authorized the Secretary of the Treasury to deposit Government funds "in places in which the said bank and branches thereof may be established." When the Second Bank ceased functioning as a national institution in 1836, the Government again relied upon State banks to act as depositaries.

In 1846 a system was set up to separate, as completely as possible, the Government's financing operations from the money market. Congress passed a law establishing the Independent Treasury System, and the Government became its own banker. This act created four subtreasuries, located in New York, Boston, Charleston and St. Louis. Their duties were to receive deposits of public moneys, to make disbursements, and to transfer money from one point to another, functions theretofore performed by commercial banks.

The financial history of the ensuing years proved the inadequacy of the Independent Treasury System to meet the needs of a growing country. This System received a serious setback at the beginning of the Civil War when the attempt to collect in specie the money which the Treasury needed to finance the war forced the suspension of specie payments. The result was the establishment in 1863 of the National Banking System, which provided for the designation of these banks as depositaries of public funds.

One of the disadvantages of the Independent Treasury System, not fully met by the National Banking System, was its inability to supply business with sufficient note circulation whene needed and to avoid overexpansion when speculation reached the danger point. It was not capable of keeping pace with the growth of business in the United States and had become obsolete by the time the Federal Reserve System was established in 1914.

The Federal Reserve Act contained authority for the Federal Reserve banks to act as fiscal agents for the United States Government and to hold deposits of Federal funds. In order to give the Federal Reserve banks time to become organized, the Treasury did not appoint them as fiscal agents until January 1, 1916. The Independent Treasury System was abolished by act of Congress, approved in May of 1920, when the remaining duties of the subtreasuries were taken over by the Federal Reserve banks. However, it was necessary for the Treasury to continue to utilize commercial banks as depositaries in those principal cities which did not include Federal Reserve banks or branches.

In the Second Liberty Bond Act of 1917, the Congress provided for the establishment of Treasury war loan accounts to take care of the financing of the Liberty loans. These accounts were originally established to enable the banks to retain, until withdrawn by the Treasury, the proceeds arising from sale of Liberty bonds to such banks or their customers. Later authority for use of these accounts was extended to the sale of other Government securities, including United States savings bonds and Treasury savings notes. Under the Current Tax Payment Act of 1943, and later legislation, withheld income taxes, certain quarterly income and profit-tax payments, social-security taxes and excise taxes are deposited in these accounts which have become known as tax and loan accounts.

2. Legislative authority

The legislative authority for deposit of Government funds in commercial banks is provided under several basic acts of Congress. Citations of these acts and the pertinent provisions are as follows:

(1) Revised Statutes, section 5153, derived from the act of June 3, 1864 (13 Stat. 113, as amended), relating to the designation of national bank associations as depositaries of public moneys:

"All national banking associations designated for that purpose by the Secretary of the Treasury, shall be depositaries of public money, under such regulations as may be prescribed by the Secretary; and they may also be employed as financial agents of the Government; and they shall perform such reasonable duties, as depositaries of public money and financial agents of the Govern-

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ment, as may be required of them. The Secretary of the Treasury shall require the associations thus designated to give satisfactory security, by the deposit of United States bonds and otherwise, of the safekeeping and prompt payment of the public money deposited with them, and for the faithful performance of their duties as financial agents of the Government: * * *" (12 U. S. C. 90).

(2) The Federal Reserve Act of December 23, 1913 (38 Stat. 259) as amended on May 7, 1928 (45 Stat. 492), relating to the designation of member banks as depositaries:

"All banks or trust companies incorporated by special law or organized under the general laws of any State, which are members of the Federal Reserve System, when designated for that purpose by the Secretary of the Treasury, shall be depositaries of public money, under such regulations as may be prescribed by the Secretary * * *" (12 U. S. C. 332).

(3) The act of September 24, 1917, with regard to authority to deposit the proceeds of sales of bonds, certificates of indebtedness, and war savings certificates (40 Stat. 291, as amended):

"The Secretary of the Treasury, in his discretion, is authorized to deposit, in such incorporated banks and trust companies as he may designate, the proceeds, or any part thereof, arising from the sale of the bonds and certificates of indebtedness, Treasury bills, and war-savings certificates * * * and arising from the payment of internal-revenue taxes, * * *" (31 U. S. C. 771).

(4) Act of June 19, 1922 (42 Stat. 662), relating to depositaries in foreign countries, territories, and insular possessions:

"The Secretary of the Treasury may designate such depositaries of public moneys in foreign countries and in the territories and insular possessions of the United States as may be necessary for the transaction of the Government's business, under such terms and conditions as to security and otherwise, as he may from time to time prescribe: *Provided*, That in designating such depositaries American financial institutions shall be given preference wherever, in the judgment of the Secretary of the Treasury, such institution is safe and able to render the service required" (31 U. S. C. 473).

(5) Act of June 11, 1942 (56 Stat. 356), relating to insured banks:

"All insured banks designated for that purpose by the Secretary of the Treasury shall be depositaries of public moneys of the United States * * * and the Secretary is hereby authorized to deposit public money in such depositaries, under such regulations as may be prescribed by the Secretary; and they may also be employed as financial agents of the Government; and they shall perform all such reasonable duties, as depositaries of public money and financial agents of the Government as may be required of them. The Secretary of the Treasury shall require of the insured banks thus designated satisfactory security by the deposit of United States bonds or otherwise, for the safekeeping and prompt payment of public money deposited with them and for the faithful performance of their duties as financial agents of the Government * * *" (12 U. S. C. 265).

(6) The Current Tax Payment Act of 1943 (57 Stat. 126) with respect to the designation of depositaries for withheld taxes:

"The Secretary may authorize incorporated banks or trust companies which are depositaries or financial agents of the United States to receive any taxes under this chapter in such manner, at such times, and under such conditions as he may prescribe; and he shall prescribe the manner, times, and conditions under which the receipt of such taxes by such depositaries and financial agents is to be treated as payment of such taxes to the collectors" (26 U. S. C. 1631).

(7) Section 6302 (c) of the Internal Revenue Code of 1954 (derived from the act of August 27, 1949, 63 Stat. 668), with respect to depositaries for collections:

"Use of Government Depositaries.—The Secretary or his delegate may authorize Federal Reserve banks, and incorporated banks or trust companies which are depositaries or financial agents of the United States, to receive any tax imposed under the internal revenue laws, in such manner, at such times, and under such conditions as he may prescribe * * *."

3. Complete and definitive statement explaining the operations of, and reasons for, this practice

The Congres has vested in the Secretary of the Treasury authority to utilize the services of the Federal Reserve banks and the commercial banks of the country as depositaries and fiscal agents of the Government. Not only has the Congress granted authority to the Secretary to utilize the services of banks but it has also established, by law, the basic procedures for handling the receipts and expenditures of the Government.

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The 12 Federal Reserve banks are now the principal fiscal agents of the United States Government. Each Reserve bank maintains an account in the name of the Treasurer of the United States. Into these accounts virtually all Government receipts eventually are credited, and from them nearly all payments are made.

Implementing the Treasurer's accounts at the Federal Reserve banks is a nationwide network of deposit accounts in commercial banks. Most of the money collected by the Government feeds into the United States Treasurer's accounts at the Reserve banks through the banking system of the country. Any incorporated bank is eligible to qualify as a Government depositary. All Government deposits in banks must be secured by a pledge of collateral security, this collateral usually being in the form of United States Government securities.

(*a*) *Operation of Special Depositaries (Tax and Loan Accounts).*—The system of "special depositaries" originated during World War I. The first Liberty Loan Act of 1917 provided that banks purchasing securities issued under terms of the act, for their own accounts or for the accounts of their customers, could deposit the proceeds from such purchases into special accounts known as war loan accounts. Until 1935, deposits in these accounts were not subject to reserve requirements. Originally the banks were required to pay 2 percent interest on such deposits. However, this was considerably below prevailing interest rates at that time. In the early 1930's, this interest rate was lowered and then eliminated entirely along with interest payments on other demand deposits in keeping with the provisions of the Banking Act of 1933.

During the 1930's, receipts from the sale of Government securities were relatively small and comparatively little use was made of the war loan accounts.

The heavy borrowing requirements of the Federal Government accompanying World War II provided a need for the Treasury to utilize more fully the war loan accounts. The act of April 13, 1943 (57 Stat. 65), suspended, for the duration of hostilities plus 6 months, against balances in these accounts, all reserve requirements and Federal deposit insurance assessments. The reserve and insurance requirements were reimposed after June 30, 1947.

Following World War II, the Congress provided for wider use of these accounts by authorizing the Treasury to use them for processing certain tax receipts. Beginning with March 1948, the banks were permitted to credit to these accounts their receipts of withheld income taxes, which previously had been turned over to the Federal Reserve banks monthly or more frequently. On January 1, 1950, the Treasury revised the system for deposit of withheld income taxes and extended the provisions for deposit to war loan accounts to include deposits of payroll taxes from the old-age insurance program. The war-loan accounts were renamed tax and loan accounts on January 1, 1950.

Other appropriate taxes have since been made eligible for deposit in these accounts. Under a special arrangement, large quarterly payments (checks of $10,000 or more) of income and profits taxes, may be deposited in tax and loan accounts when, and to the extent, that the funds are not immediately needed by the Treasury. This arrangement was first provided for quarterly tax payments of March 1951.

Beginning in July 1951, railroad retirement taxes became eligible for deposit to these accounts. In July 1953, certain excise-tax payments became eligible.

It must be borne in mind that deposits are not made by the Treasury into these accounts. Deposits to the tax and loan accounts occur in the normal course of business under a uniform procedure applicable to all banks whereby customers of banks deposit tax payments and funds for purchase of Government securities. In most cases the transaction involves merely the transfer of money from a customer's account to the Government's account in the same bank. On occasions, to the extent authorized by the Treasury, banks are permitted to deposit in these accounts proceeds from subscriptions entered for their own account as well as for the account of their customers.

The working cash of the Treasury is held mainly in the Federal Reserve banks and branches. The Treasury draws upon these balances for its daily disbursements. As these balances become depleted they are restored in part through various receipts deposited to the Treasurer's account at the Federal Reserve banks. However, the larger part of receipts to these accounts is derived by calling in funds from the tax and loan accounts. Well over half of the Government receipts now flow through tax and loan accounts.

In order to reduce the administrative cost to the Treasury by avoiding making frequent withdrawals from small accounts, Treasury has classified special depositaries into group A and group B. The present classification places in group A those banks whose Treasury tax and loan account balance as of Febru-

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ary 16, 1954, was less than $150,000. Banks with balances in excess of this amount on that date are classified in group B. Banks are regrouped at least once a year. Still another classification in use is what is known as X balances. These are the balances derived from deposit of large quarterly payments of income and profits taxes. These balances are usually depleted more rapidly than those of the A and B accounts. These X balances may be held by banks of both group A and group B.

Calls for withdrawals from group B depositaries and on X balances are usually announced on Monday or Thursday and payments scheduled for several working days subsequent thereto. Withdrawals from group A depositaries are made less frequently, usually only once a month.

The tax and loan accounts are very active, and the flow of deposits and withdrawals is rapid and continuous. As a result of the uneven flow of the Government's receipts and expenditures the balances fluctuate considerably. (See attachments 1 and 2.) Using end-of-the-month figures, the balances in these accounts fluctuated during the fiscal year 1954 from $6,690,000,000 on July 31, 1953, to $2,406,000,000 on January 31, 1954. The volatility of these accounts is indicated by the frequency and size of withdrawals made against uncalled balances in the group B accounts. (See attachment 3.) Withdrawals from these larger accounts are usually made twice weekly and frequently reach 25 to 50 percent of the balance in the account as of a particular date. The single monthly withdrawals on the smaller accounts usually equal or exceed 50 percent of the balances.

The volume of receipts and disbursements flowing through the tax and loan accounts has increased almost steadily during the past 7 years as follows:

[In millions of dollars]

Fiscal year	Receipts	Withdrawals	Fiscal year	Receipts	Withdrawals
1948	$8,575	$7,765	1952	$36,492	$37,066
1949	15,231	15,233	1953	41,267	43,302
1950	16,876	15,380	1954	41,645	39,880
1951	24,128	21,716			

Out of approximately 14,500 eligible banks in the United States, nearly 11,000 have qualified as tax and load depositaries.

(*b*) *Operation of other depositaries.*—While the principal balances are held in the tax and loan accounts of special depositaries, relatively small amounts (aggregating about $500 million) are held in other types of depositaries which are designated by the Treasury to hold balances of Government funds and to perform certain services for the Government. It is the policy of the Treasury to utilize the facilities of the Federal Reserve banks and branches to the fullest extent possible for these services. However, as these facilities are available at only 36 points in the United States, it has been necessary to supplement them by designating banking institutions as depositaries at other points when justified by the volume and character of essential Government business. These depositaries, which extend to all areas of the United States, our Territories and insular possessions, and foreign countries, are briefly described as follows:

General depositaries: There are approximately 1,420 general depositaries which hold about $400 million of Government deposits exclusive of balances they may have in tax and loan accounts. This type of depositary is authorized to maintain on its books an account in the name of the Treasurer of the United States. It is maintained only at points where there is a necessity to meet cash requirements of Government officers for payrolls or other expenditures, or to receive deposits of cash from depositors of public moneys. General depositaries are given a stated balance which is fixed in relation to the volume of business in the Treasurer's account and which may be retained until the need therefor no longer exists. All moneys received in excess of the authorized amount must immediately be remitted to the Federal Reserve bank of the district.

Limited depositaries: Limited depositaries are designated at such points as are required to receive up to specified maximum amounts deposits made by postmasters, officers of United States courts, and other officers in special cases for credit in their official checking accounts with the depositary. As a general rule, no Treasurer's balances are maintained in limited depositaries for this purpose.

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Bank draft depositaries: These depositaries are designated by the Treasury to issue bank drafts to Government officers in exchange for funds received by the officer for the account of the United States. These designations are made when the volume of business does not justify a general depositary. Small Treasurer's balances are maintained in these depositaries. The balances are fixed in relation to volume of business handled.

Depositaries for State unemployment compensation accounts (social security) and veterans' unemployment compensation benefit payment accounts: Depositaries for State unemployment compensation accounts are designated for the purpose of handling receipts and payments for social security unemployment compensation under arrangements with the Social Security Board. Likewise, depositaries for veterans' unemployment compensation are those designated to handle the receipt of Government funds and the payment of unemployment compensation to veterans under arrangements with the Veterans' Administration. In both instances payments are made by checks signed by State officials. Treasurer's balances are maintained in these depositaries.

Banking Facilities: Banking facilities are those offices provided by commercial banks, primarily at military posts, to render certain necessary banking services to the post and its personnel. These services include cashing Government checks, furnishing cash for payrolls, receiving deposits of Government funds, and similar services. The facilities are located at Army posts, Air Corps installations, naval stations, military and veterans' hospitals, Atomic Energy Commission plants, and other Government establishments where regular banking services are not readily available. Treasurer's balances are maintained with the banks designated to operate banking facilities.

Check-Cashing Facilities: Because of the large concentration of Government employees in the District of Columbia and adjoining area, certain banks have been designated for cashing of Government payroll checks for noncustomers. Treasurer's balances are maintained with these banks.

Territorial and Insular Depositaries: These may be either general or limited depositaries located in the Territories or insular possessions of the United States.

Foreign Depositaries: Banks in foreign countries may be designated as general depositaries, limited depositaries, or depositaries of foreign currency. Substantial amounts of foreign currency are acquired from foreign governments without payment of dollars in connection with various economic, technical and military foreign-aid programs, as well as in settlement for lend-lease, surplus property, etc. Foreign branches of American banks are given preference when available and able to render the service required.

As a basis of offsetting expenses incurred by the banks in handling Government business of this nature the Government has long followed a practice of maintaining Treasurer's balances with the depositaries, or, as with limited depositaries, authorizing Government officers to maintain minimum operating balances in their official checking accounts.

Briefly, the procedure followed in establishing these depositaries and in determining the balances to be authorized for handling Government business is as follows:

The request to establish a particular depositary is generally initiated by a Government officer in the field, who presents to his administrative officer in Washington the reasons for needing a Government depositary in the particular area. An estimate is made of the amount of business the depositary would be called upon to perform. If the Washington headquarters of the agency agrees with its field officer that a depositary is necessary, the agency requests the Treasury to designate such depositary. In addition to considering the volume of business to be transacted and the possibility of utilizing other depositary facilities already established, the Treasury will usually estimate, or call upon the banks under consideration for designation to estimate, the cost of performing such service. Any possible earnings accruing to the bank as a result of serving as a Government depositary must be shown as an offset against cost.

If, in view of all factors concerned, it is believed to be in the best interests of the Government to establish a depositary, the Treasury will issue the necessary designation. A Government deposit will be made to the depositary in an amount sufficient to offset the expenses incurred by the bank for servicing the Government. The initial allotment of a Treasury balance to a depositary must be based upon an estimate. Each depositary is advised that the initial allotment will be subject to adjustment upon the basis of the volume and character of the Government business actually handled. Depositaries

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submit monthly analyses of business handled and their costs. Due to differences in the size and location of banks, nature and volume of business handled, etc., it is not practicable to adopt uniform standards which may be applied to all banks. However, based upon experience gained in reviewing analyses submitted by banks throughout the Nation, and even in foreign countries, and a day-to-day review of cost studies made by banking associations and individual banks, certain guides have been established for use in determining reasonableness of bank costs.

Treasury balances maintained with these depositaries are generally time deposits. They are subject to both reserve requirements and Federal deposit insurance assessments. Depositaries at present are required to compute the earning value of the average daily loanable balance in the Treasurer's account at the rate of 2 percent per annum for analysis purposes. Depositaries may, if they so desire, purchase 2 percent depositary bonds, in amounts equal to their authorized Treasury balances. The depositary bonds are held as collateral security for the Treasury balance. If the depositaries do not purchase depositary bonds, they must pledge other acceptable collateral.

(*c*) *Reasons for this practice.*—The Treasury uses commercial banks as depositaries of Government funds for two reasons: (*a*) The system provides the most efficient and most economical way of transacting the Government's business and (*b*) it reduces to a minimum the effect of Treasury financial operations on the economic stability of the country. These advantages will be discussed in turn.

There have already been described those services which are performed for the Government by the commercial banks and for which the Treasury authorizes maintenance of Government balances as an offset to bank costs. In addition, the banks incur expenses in rendering a number of other important services for which no reimbursement is made.

One of the most important public services the banks render is the sale and issuance of United States savings bonds, either by direct cash sales or through the servicing of payroll savings plans. They do this work without charge to the Treasury, notwithstanding the fact that in many cases it is necessary to employ full-time employees on the work. The banks distribute announcements and receive subscriptions for the purchase of marketable securities, and they handle matured marketable securities for redemption or for exchange into new issues, all without reimbursement by the Government.

Commercial banks render considerable assistance to the Treasury in the weekly sale and distribution of Treasury bills. Treasury bills are usually issued with maturities of 91 days, with an issue maturing each week for 13 consecutive weeks. The proceeds of these bills are not deposited in tax and loan accounts. In bidding for Treasury bills, many subscribers submit their tenders through commercial banks. The banks check with dealers on possible bid ranges and enter their customer's bid for the amount requested. This work is done without compensation to the banks.

In World War I and again in World War II the banks played a major role in the success of the war-loan drives. Three-quarters of the dollar volume of war-loan campaign sales were made through commercial banks.

Banks handle without charge to the Government remittances from employers in connection with the deposit of withheld income and social-security taxes. As a means of assisting the Treasury in preventing or reducing tax evasion, banks furnish the Internal Revenue Service, without charge, information regarding large currency transactions. They report to the Internal Revenue Service interest paid on savings accounts and the payment of dividends where banks act as financial agents for corporations. They cooperate with the Government's foreign funds control activity in order to prevent leakage of American assets into certain foreign hands, requiring the keeping of supplemental records and the filing of many reports with the Treasury.

There are only a comparatively few areas where banks receive fees for services such as the redemption of savings bonds and the servicing of Commodity Credit Corporation crop loans. These services entail risks of loss as well as expense which the Government could hardly expect the banks to assume without reimbursement. For instance, when a bank redeems a United States savings bond, it is liable for any loss resulting from an error in identification.

Thus the banks perform for the Government, and particularly for the Treasury, a number of indispensable services. Most of these services are performed free of charge, either as a public service or in the interest of fostering good customer relations. Without such services a large increase in the number of Federal employees would be necessary and a large expense to the Government would be

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entailed. Even though the Government did perform these services itself, and at a great cost, it could not provide many of these services as expeditiously and as conveniently for the public as can the banking system. By having the commercial banks perform certain fiscal agency functions of the Federal Government in conjunction with serving the regular business needs of their customers these functions can be handled most efficiently and most economically for the Government. This arrangement works to the mutual advantage of the Government, the public, and the banking system.

The second reason for depositing Government funds in the commercial banks of the Nation is that this practice provides the most effective method yet devised for maintaining a smooth flow of funds from the banking system into the Treasury and back again into the channels of trade through Government disbursements.

Nearly all Government disbursements are made from funds held on deposit in the Federal Reserve banks. This means that virtually all funds, both receipts and expenditures, sooner or later, flow through the Treasurer's accounts with the 12 Federal Reserve banks. When checks drawn on the commercial banking system for payment of taxes or purchase of Government securities are deposited in the Treasurer's accounts at the Federal Reserve banks, there is an equivalent drain on member bank reserves, since the member banks pay the checks by drawing the amounts from their reserve balances held in the Federal Reserve banks. Each payment from the public into a Federal Reserve account involves a corresponding reduction in bank reserves. Each disbursement by the Treasury from a Federal Reserve account causes an equal increase in member bank reserves. The impact of these money flows could be held to a minimum if each day's inflow of funds into the Federal Reserve accounts were approximately offset by a corresponding amount of disbursements. Obviously it is not possible for the Government to time its borrowing operations and to make its tax collections in such a manner that daily receipts will equal the Government's daily disbursements. The uneven flow of Government receipts and expenditures and the need for spacing cash borrowing operations make such perfect balancing impossible. However, the likelihood of abrupt changes resulting in intense stringency in the money market can be lessened immeasurably by Treasury's practice of initially funneling a considerable part of its receipts from borrowing and taxation into its deposit accounts at the commercial banks. In this manner, reserves are not withdrawn from the banking system until such time as they can be returned by Treasury disbursements. Through the utilization of its tax and loan accounts the Treasury can largely neutralize the money market impact of the flow of funds through its accounts and can so regulate the impact of Treasury financing operations on the money market as to avoid disruption to the market.

If the special depositary system did not exist there would be heavy drains on bank reserves during periods of heavy taxpayments or of large-scale borrowing operations. The banks would have to draw down their reserves to transfer funds to the Treasurer's accounts at the Federal Reserve banks. In order to meet this drain on their reserves the banks would have to liquidate Government securities previously purchased, restrict normal extension of credit to their customers, or obtain credit from the Federal Reserve System. As the balances built up in the Federal Reserve banks were disbursed by the Government they would be deposited by the customers of the commercial banks and bank reserves would be built up again. The Federal Reserve System would then have to absorb the resulting excess reserves. These fluctuations in bank reserves would have an extremely disrupting effect on the money market and the Nation's business.

Not only does the system of tax and loan accounts make it possible to leave funds in the banking system until such time as they are required for Government disbursement, but it also permits such funds to be retained in the communities from which they come. For example, assume that a commercial bank in Panhandle, Tex., sells $100,000 of savings bonds to its customers. This money is left on deposit in Panhandle until such time as it is needed to pay the Government's bills. If this money should be immediately deposited in the Federal Reserve bank before it can be returned to channels of trade through Government disbursement, the money in the community of Panhandle would be transferred to Dallas. Without the tax and loan accounts there would be during periods of heavy taxpayments or during borrowing operations tremendous shifting of funds between banks and communities.

On occasion, the Treasury, in anticipation of heavy tax receipts during heavy tax months, will, under statutory authority, replenish balances at Federal Re-

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serve banks by borrowing directly from such banks through the issuance of special certificates of indebtedness, rather than withdrawing funds from Treasury tax and loan accounts. These funds are borrowed for only a few days and enable the Treasury temporarily to make disbursements in excess of its current receipts thus providing the banks with additional reserves in advance of a later unavoidable drain. Such an operation is, of course, consistent with the overall policy of smoothing out the effects on bank reserves of the Government's financing operations.

The tremendous growth of the Federal Government budget and of the public debt in recent years has made Treasury operations the largest and most important single influence on the flow of funds through the money market. Federal fiscal operations growing out of an annual budget of more than $60 billion and a public debt of more than $275 billion also underscores the importance of the Treasury maintaining a sufficiently large cash operating balance to be able to meet any unusually heavy drains upon the Treasury. The Federal Government, like any private corporation or business, cannot be prudently managed if its cash operating margin is so close that every time unexpected bills come in, it has to rush out and borrow the money to cover them.

In the case of the Federal Government it seems reasonable to carry an operating reserve at least equal to a month's expenditures. Not only are there great fluctuations in the Government's receipts and expenditures within the year, but, in addition, there is a huge volume of demand debt outstanding—such as savings bonds—which adds to both real and potential demands on the Treasury. Many of these fluctuations are predictable and cash can be built up ahead of time. But the timing of many of the demands cannot be anticipated exactly and the Treasury has to be prepared to meet them. By providing an effective mechanism for smoothing out the impact of the Government's financial operations on the banking system and the economy, the Treasury tax and loan accounts render a service of inestimable value.

4. Specific terms on which banks accept deposits

Specific terms on which banks accept deposits are spelled out in Treasury circulars, the more important of which are Circulars 92 and 176. However, for the major types of depositaries the most important terms are: (1) The banks must be designated by the Treasury subject to qualifications set by the Treasury, (2) the banks must pledge collateral at least equal to deposits, (3) deposits may not exceed limitations set by the Treasury, (4) deposits are subject to reserve requirements and Federal deposit insurance assessments, (5) the banks must perform the services stipulated in the designation and submit such reports as prescribed by the Treasury. All deposits to tax and loan depositaries are of a demand nature and can be called by the Treasury at any moment.

5. Precisely how decisions are arrived at as to leaving funds on deposit and to transferring them

Treasury's calls for withdrawals of funds are based upon its cash requirements. Balances with the Federal Reserve banks are maintained at a fairly constant level adequate to cover expected daily cash needs and to provide for a proper regional distribution of funds. A day-to-day analysis is made of these balances, of anticipated direct deposits to the Federal Reserve accounts, and of estimated disbursements. Calls for withdrawals are issued on tax and loan accounts to the extent that additional funds will be required to meet Treasury's daily cash requirements.

As pointed out earlier the calls generally provide that payments be made several days subsequent to date of call. The calls provide for withdrawal of a specified percentage of the balance within the account. All accounts are treated uniformly except that withdrawals from banks holding balances in excess of $150,000 are made more frequently than from banks holding balances in smaller amounts. The Treasury does not take money from one bank to put into another. It draws out money as needed for Government expenditures.

6. Why these funds are not transferred to Federal Reserve banks immediately upon receipt

There are two principal reasons why funds are not transferred to Federal Reserve banks immediately upon receipt. The most important one is that such a procedure would have damaging effects on the economy of the country. The second reason is that it would result in no financial gain to the Treasury—on the contrary, it could easily result in increased overall costs of Government financing.

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As discussed at considerable length earlier in this memorandum, the immediate transfer of Government funds from commercial bank accounts to Federal Reserve accounts would disrupt the even flow of money and the Nation's system of bank reserves. Serious dislocations would occur if the Government receipts should be transferred immediately from local communities to the Federal Reserve banks, perhaps long before the money is returned to channels of trade by Government disbursements. This action would, in fact, remove the economic stability advantages now derived from the use of tax and loan accounts.

There would be no financial gain to be derived from such action inasmuch as it does not cost the Treasury any more to keep the money on deposit in commercial banks than in the Federal Reserve banks. While no interest is received from the commercial banks on their Government deposits, neither would interest be received if the money were immediately deposited in the Federal Reserve banks. Moreover, all Government deposits in Treasury tax and loan accounts are fully protected by collateral pledged by the commercial banks.

On the other hand, such action would likely result in substantially increasing the Government's general financing costs. The transfer of the funds immediately to Federal Reserve banks might affect commercial banks' decisions to buy Government securities and banks might feel that they should be reimbursed for the numerous services the Treasury now receives free of charge, such as issuance of savings bonds and assistance in the sale of marketable issues.

7. *What the high, low, and the average balance carried in commercial depositaries has been during the fiscal year ending June 30, 1954*

The high, low, and average balances in the tax and loan accounts by months for fiscal year 1954 are shown in the following table:

Tax and loan balances fiscal year 1954

[In millions]

	High	Low	Average		High	Low	Average
July 1953	$7,493	$1,649	$4,944	January 1954	$3,114	$2,081	$2,536
August	6,448	5,758	6,095	February	3,659	2,507	3,129
September	5,642	3,984	4,957	March	4,546	2,450	3,450
October	5,164	2,812	3,698	April	4,727	2,698	3,541
November	5,177	2,573	4,268	May	4,574	1,902	3,303
December	4,194	2,302	3,223	June	4,836	1,722	3,297

The tremendous fluctuations occurring in these balances is well illustrated for the month of July 1953, when the balance ranged from a high of $7,193 million down to $1,649 million.

The above figures do not include balances in general and limited depositaries. These balances are fairly consistent running usually slightly below $500 million (see attachment 4). If balances in these depositaries exceed certain stated maxima the excess is immediately sent to the Federal Reserve banks.

An important yardstick in assessing whether Treasury tax and loan balances appear to be unduly high or dangerously low is to measure the Government's cash operating balance (which is made up primarily of tax and loan balances but also includes our deposits in Federal Reserve banks and gold in the general fund) in terms of average monthly budget expenditures. As pointed out previously, to be on the safe side this operating reserve ought to be at least equal to 1 month's operating expenditures. For the 1954 fiscal year as a whole, for example, budget expenditures averaged $5.6 billion a month and the end of month cash operating balances averaged about $5.4 billion—less than a month's expenditures. Furthermore, the fiscal year average hides the fact that there were many times during the year when the balance was under $3½ billion, or less than two-thirds of a month's outgo.

Viewed historically, the Treasury's cash balance margin in relation to budget expenditures has been much smaller recently than earlier years. Obviously, it was necessary to carry unusually high balances during World War II, but even in the 1930's the average balance was well over double the average monthly expenditures. (See attachment 5 for table and chart showing Federal expenditures and the operating cash balance for fiscal years 1932–54.)

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8. Same information for each of the 12 Federal Reserve districts

Tax and loan balances fiscal year 1954 by Federal Reserve districts

[In thousands of dollars]

Federal Reserve district	High balance		Low balance		Average balance
	Date	Amount	Date	Amount	
Boston	July 16, 1953	$286,805	June 15, 1954	$91,024	$182,961
New York	do	2,905,084	do	407,287	1,219,953
Philadelphia	Aug. 24, 1953	322,799	July 14, 1954	88,265	204,344
Cleveland	July 17-19, 1953	543,362	May 12, 1954	135,992	325,170
Richmond	July 16, 1953	282,285	July 14, 1953	77,253	160,855
Atlanta	July 17, 1953	310,802	do	59,499	156,795
Chicago	July 21-23, 1953	1,231,064	June 15, 1954	344,189	744,767
St. Louis	July 17-19, 1953	228,094	July 14, 1953	64,721	137,914
Minneapolis	July 16, 1953	197,628	Jan. 11, 1954	57,467	102,020
Kansas City	July 17-19, 1953	232,659	July 14, 1953	68,502	152,002
Dallas	July 16, 1953	179,397	do	56,593	114,557
San Francisco	July 18, 19, 1953	840,138	July 10, 1953	166,437	370,189

LIST OF ATTACHMENTS

1. Treasury tax and loan accounts—deposits and withdrawals and balances by A, B and X accounts (table).
2. Treasury tax and loan accounts—analysis of deposits, withdrawals and balances (table).
3. Calls on Treasury tax and loan accounts (table).
4. Deposits in banks (table).
5. Federal expenditures and operating cash balance (table and chart).

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ATTACHMENT No. 1.—*Treasury tax and loan accounts—Deposits, withdrawals and balances in A, B, and X accounts*

[In millions]

Period	Deposits [1]	Withdrawals [2]	Balance [3] (at end of period)			
			Group A banks	Group B banks	"X" accounts [4]	Total
Fiscal year:						
1941	$767	$911	$661			$661
1942	6,902	5,884	1,679			1,679
1943	33,231	27,243	[5] 7,667			7,667
1944	54,018	43,678	[5] 18,007			18,007
1945	50,102	45,487	[5] 22,622			22,622
1946	27,007	36,609	$575	$12,447		[6] 13,020
1947	7,430	19,488	231	731		962
1948	8,575	7,765	272	1,501		1,772
1949	15,231	15,233	160	1,611		1,774
1950	16,876	15,380	347	2,921		3,270
1951	24,128	21,716	285	2,404	$2,991	5,680
1952	36,492	37,066	327	1,915	2,865	5,106
1953	41,267	43,302	217	1,527	1,328	3,071
1954	41,645	39,880	553	1,944	2,339	4,836
Fiscal year 1954:						
1953:						
July	7,336	3,718	422	6,268		6,690
August	2,545	3,410	324	5,501		5,825
September	3,110	3,681	476	4,779		5,255
October	1,969	4,331	368	2,524		2,893
November	4,404	2,752	461	4,084		4,545
December	2,339	3,526	428	2,930		3,358
1954:						
January	1,349	2,301	382	2,024		2,406
February	2,369	1,316	391	3,067		3,458
March	4,607	3,685	264	2,321	1,794	4,379
April	2,494	3,601	336	2,936		3,273
May	4,486	3,656	652	3,451		4,103
June	4,636	3,903	553	1,944	2,339	4,836

[1] Deposits consist of proceeds from sales of securities, deposits on account of withheld taxes, beginning March 22, 1948, deposits on account of taxes withheld under the Federal Insurance Contributions Act, beginning Jan. 1, 1950, deposits on account of Railroad Retirement taxes, beginning July 1, 1951, and deposits on account of excise taxes, beginning July 1, 1953.

[2] Includes calls by Treasury and voluntary prepayments accepted by Treasury.

[3] Effective May 11, 1943, Federal Reserve banks were instructed to establish subsidiary controls so as to classify war loan depositaries in their districts into two groups, group A including all depositaries having balances of $300,000 or less and group B those having balances of more than $300,000. Various amendments have since been made to the original disposition, the current dividing line being $150,000.

[4] Represents income taxes deposited under a special procedure, first adopted in March 1951, for crediting in tax and loan accounts the proceeds of checks of $10,000 or more. This procedure is usually followed in quarterly tax payment periods.

[5] Breakdown into A and B banks not available.

[6] Does not agree with daily Treasury statement. Breakdown based on telegraphic reports for last day of fiscal year which was a Saturday.

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ATTACHMENT No. 2.—*Treasury tax and loan accounts—Analysis of deposits, withdrawals and balances*

[In millions]

Period	Credits to tax and loan accounts						Withdrawals	Balance at end of period	Outstanding calls at end of period
	Proceeds from sales of securities			Taxes		Total credits			
	Savings bonds	Savings notes	Other	Income taxes not withheld [1]	Other [2]				
Fiscal year:									
1941	(3)	(3)	(3)	----	----	$767	$911	$661	----
1942	(3)	(3)	(3)	----	----	6,902	5,884	1,679	----
1943	(3)	(3)	(3)	----	----	33,231	27,243	7,667	(4)
1944	(3)	(3)	(3)	----	----	54,018	43,678	18,007	----
1945	(3)	(3)	(3)	----	----	50,102	45,487	22,622	----
1946	(3)	(3)	(3)	----	----	27,007	36,609	13,020	$2,103
1947	[5] $4,493	[5] $2,937	----	----	----	7,430	19,488	962	291
1948	[5] 3,931	[5] 2,024	$804	----	$1,820	8,575	7,765	1,772	796
1949	4,879	3,878	----	----	6,473	15,231	15,233	1,774	804
1950	3,755	5,834	----	----	7,287	16,876	15,380	3,270	310
1951	3,390	3,347	----	$6,971	10,331	24,128	21,716	5,680	1,400
1952	2,227	4,678	2,738	13,270	13,581	36,492	37,066	5,106	1,475
1953	2,667	2,231	10,285	10,227	15,858	41,267	43,302	3,071	934
1954	3,457	2,333	11,164	4,791	19,899	41,645	39,880	4,836	1,233
July 1953	240	378	5,874	136	708	7,336	3,718	6,690	938
August	211	363	----	----	1,971	2,545	3,410	5,825	1,825
September	211	911	----	----	1,988	3,110	3,681	5,255	1,728
October	222	681	----	----	1,066	1,970	4,331	2,893	888
November	208	----	2,150	----	2,046	4,404	2,752	4,545	1,782
December	263	----	----	----	2,077	2,339	3,526	3,358	1,261
January 1954	389	----	----	----	961	1,349	2,301	2,406	345
February	339	----	----	----	2,029	2,369	1,317	3,458	1,501
March	396	----	----	2,134	2,076	4,606	3,685	4,379	1,101
April	349	----	996	180	969	2,494	3,601	3,273	1,487
May	300	----	2,144	----	2,043	4,486	3,656	4,103	1,688
June	330	----	----	2,341	1,966	4,636	3,903	4,836	1,233

[1] Represents income taxes deposited under a special procedure, first adopted in March 1951, for crediting in tax and loan accounts the proceeds of checks of $10,000 or more. This procedure is usually followed in quarterly tax payment periods.

[2] Represents withheld income taxes, beginning Mar. 22, 1948; taxes withheld under the Federal Insurance Contributions Act, beginning Jan. 1, 1950; Railroad Retirement taxes, beginning July 1, 1951; and excise taxes, beginning July 1, 1953.

[3] Breakdown not available.

[4] Not available.

[5] Partly estimated.

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ATTACHMENT No. 3.—*Calls on Treasury tax and loan accounts, fiscal year 1954*

[In millions]

Date	A accounts [1]			B accounts [2]			X accounts [3]		
	Calls		Uncalled balance	Calls		Uncalled balance	Calls		Uncalled balance
	Percent	Amount		Percent	Amount		Percent	Amount	
1953									
July 2				10	$161	$1,450	(4)	$424	
July 6				22	387	1,211			
July 9				22	413	916			
July 13	50	$133	$133				(4)	106	
July 16				8	541	6,214			
July 20				4	278	6,136			
July 23				5	336	5,967			
July 27				5	325	5,698			
July 30				10	613	5,181			
Aug. 3				5	313	5,016			
Aug. 6				6	350	4,981			
Aug. 10				9	501	4,554			
Aug. 13				4	216	4,518			
Aug. 17	50	245	245						
Aug. 20				9	496	5,019			
Aug. 24				6	352	5,369			
Aug. 27				16	928	4,355			
Aug. 31				16	897	4,498			
Sept. 3				7	365	3,580			
Sept. 10				16	694	3,258			
Sept. 14				6	254	3,102			
Sept. 21				6	251	3,924			
Sept. 24	50	230	230	6	280	4,135			
Sept. 28				13	648	3,927			
Oct. 1				18	860	3,271			
Oct. 5				6	283	3,241			
Oct. 8				24	993	2,574			
Oct. 13				13	480	2,221			
Oct. 15				8	268	2,106			
Oct. 19				8	251	2,133			
Oct. 22				8	220	2,149			
Oct. 26	50	177	177	14	370	1,925			
Oct. 29				12	298	1,819			
Nov. 2				6	151	1,811			
Nov. 5				9	211	1,886			
Nov. 9				8	197	1,902			
Nov. 12				10	441	3,559			
Nov. 16				5	217	3,483			
Nov. 19				8	364	3,821			
Nov. 23	50	219	219	9	427	3,731			
Nov. 25				18	812	3,093			
Nov. 30				18	760	2,437			
Dec. 3				19	723	2,049			
Dec. 7				10	350	1,923			
Dec. 10				15	398	1,662			
Dec. 22				10	274	2,465			
Dec. 28	50	202	202	12	358	2,348			
Dec. 30				24	702	1,730			
1954									
Jan. 4				20	587	1,288			
Jan. 21				15	321	1,821			
Jan. 25				6	133	1,769			
Jan. 28				5	101	1,786			

See footnote at end of table.

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ATTACHMENT No. 3.—*Calls on Treasury tax and loan accounts, fiscal year 1954*—Continued

[In millions]

Date	A accounts [1]			B accounts [2]			X accounts [3]		
	Calls		Uncalled balance	Calls		Uncalled balance	Calls		Uncalled balance
	Percent	Amount		Percent	Amount		Percent	Amount	
1954									
Feb. 1				12	$243	$1,679			
Feb. 4	50	$206	$206	4	99	2,033			
Feb. 11				4	93	2,224			
Feb. 15				6	144	2,168			
Feb. 18				15	429	2,287			
Feb. 23				6	199	2,545			
Feb. 25				27	871	1,870			
Mar. 1				14	429	1,566			
Mar. 4				15	400	1,550			
Mar. 11	75	363	121						
Mar. 15				55	1,081	884			
Mar. 18							25	$115	$313
Mar. 25							14	226	1,391
Mar. 29							16	294	1,318
Apr. 1							45	807	692
Apr. 5							30	569	226
Apr. 8				21	580	2,183			
Apr. 12							[4]	237	56
Apr. 15				[7] 10	[7] 259	2,090			
Apr. 19				5	122	2,055	[5]	71	
Apr. 22	50	188	188	10	246	1,962			
Apr. 26				30	722	1,316			
Apr. 29				33	1,001	1,311			
May 3				7	203	1,250			
May 6				32	274	1,274			
May 10				24	487	864			
May 13				10	150	861			
May 17				18	281	766			
May 20				15	563	2,834			
May 24	50	313	313	4	158	2,946			
May 27				24	845	2,331			
June 1				11	380	2,068			
June 3				12	386	1,891			
June 7				15	430	1,673			
June 10				40	979	844			
June 14				10	221	725			
June 17				15	196	890			

[1] Accounts with balances of $150,000 and under (approximately 8,000 banks).
[2] Accounts with balances over $150,000 (approximately 2,500 banks).
[3] These accounts are used during heavy tax-payment periods to avoid excessive strain on bank reserves. Income-tax checks of $10,000 and over are deposited in them.
[4] 100 percent of uncalled balances.
[5] 100 percent of remaining balances.
[6] 80 percent of uncalled balances.
[7] Includes $8.7 million special call of 28 percent on New Orleans district only to adjust for error made by that bank on previous B call.

NOTE.—Banks are segregated into groups A and B in the interest of economy. Calls are made usually twice a week upon the group B banks (the larger banks but smaller in number) and about once or twice a month on the group A banks.
Source: Office of the Fiscal Assistant Secretary.

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ATTACHMENT No. 4.—*Deposits in banks*

(End of month figures) on basis of daily treasury statement [1]

[In millions]

End of month or fiscal year	Federal Reserve banks (available)	Commercial banks				Total
		General depositaries	Special depositaries (tax and loan accounts) [2]	Foreign depositaries	Total	
June:						
1941	$1,024	$63	$661	----------	$724	$1,748
1942	603	69	1,679	$53	1,801	2,404
1943	1,038	228	7,667	51	7,946	8,984
1944	1,412	235	18,007	12	18,254	19,696
1945	1,500	225	22,622	16	22,863	24,363
1946	1,006	227	12,993	5	13,225	14,231
1947	1,202	215	962	14	1,191	2,393
1948	1,928	213	1,773	20	2,006	3,934
1949	438	238	1,771	27	2,036	2,474
1950	950	270	3,268	33	3,571	4,521
1951	338	319	5,680	37	6,036	6,374
1952	333	397	5,106	52	5,555	5,888
1953	132	413	3,071	49	3,533	3,665
Fiscal year 1954:						
July 1953	548	423	6,690	102	7,215	7,763
August	496	420	5,825	102	6,347	6,843
September	642	466	5,255	119	5,840	6,482
October	662	440	2,892	121	3,453	4,115
November	451	420	4,545	122	5,087	5,538
December	346	409	3,358	89	3,856	4,202
January 1954	404	484	2,406	86	2,976	3,380
February	548	422	3,458	89	3,969	4,517
March	722	459	4,379	87	4,925	5,647
April	579	427	3,273	91	3,791	4,370
May	422	426	4,095	88	4,609	5,031
June	875	433	4,836	88	5,357	6,232
Fiscal year 1955:						
July 1954	727	480	2,538	88	3,106	3,833
August	511	399	4,078	86	4,563	5,074
September	704	416	3,469	89	3,974	4,678
October	----------	----------	----------	----------	----------	----------
November	----------	----------	----------	----------	----------	----------
December	----------	----------	----------	----------	----------	----------

[1] These figures do not include Saturday transactions when Saturday falls on last day of reporting period.
[2] Prior to Jan. 1, 1950, these accounts were designated as war loan accounts.

NOTE.—There are approximately 14,000 banks eligible to hold Government deposits. As of Aug. 31, 1954, there were 1,422 general depositaries; 11,113 special depositaries; and 34 foreign depositaries.

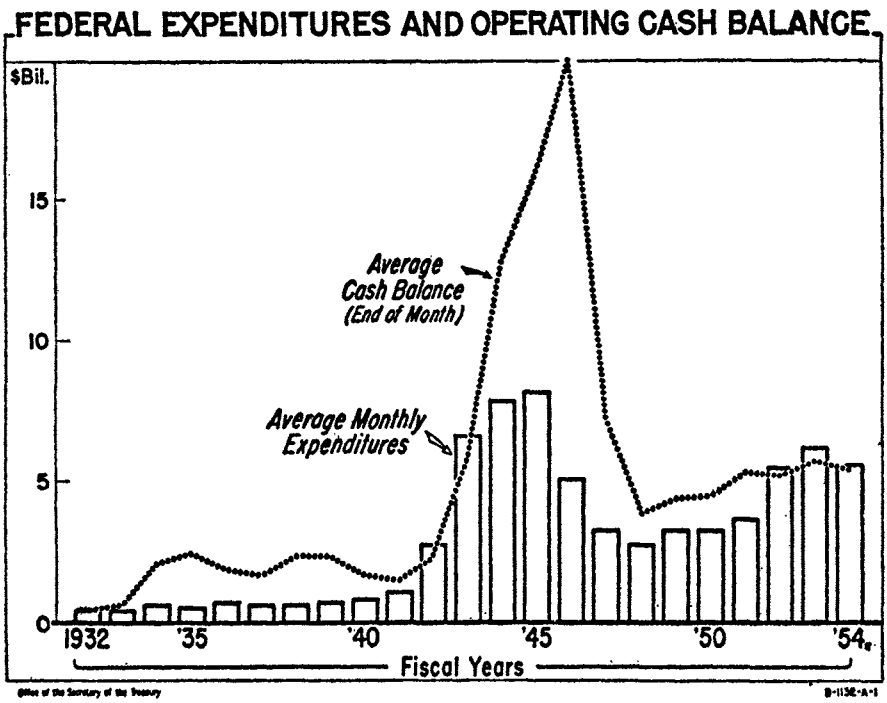
ATTACHMENT No. 5.—*Treasury operating cash balance and average Federal budget expenditures fiscal years 1932–54*

[In billions of dollars]

Fiscal year	Average operating cash balance [1]	Average monthly budget expenditures	Fiscal year	Average operating cash balance [1]	Average monthly budget expenditures
1932	0.4	0.4	1944	12.9	7.9
1933	.6	.4	1945	16.0	8.2
1934	2.1	.6	1946	20.1	5.1
1935	2.4	.5	1947	7.2	3.3
1936	1.8	.7	1948	3.9	2.8
1937	1.6	.6	1949	4.4	3.3
1938	2.3	.6	1950	4.5	3.3
1939	2.3	.7	1951	5.3	3.7
1940	1.7	.8	1952	5.2	5.5
1941	1.5	1.1	1953	5.7	6.2
1942	2.3	2.8	1954	5.4	5.6
1943	5.8	6.6			

[1] 13-month average of end of month figures.

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Representative PATMAN. But you say essentially in your memorandum that it is necessary to do this—I am not trying to use your language, or put words in your mouth, but the impression I received is—it is necessary to do that because the banks went to a lot of trouble in selling bonds.

Secretary HUMPHREY. No. That is not right.

Representative PATMAN. And rendering other services, and that you wanted to compensate the banks by leaving these deposits there a certain time.

Secretary HUMPHREY. No.

Representative PATMAN. Was my conclusion correct or was it incorrect?

Secretary HUMPHREY. It is incorrect.

Representative PATMAN. All right, why did you want to leave all this five or six billion dollars there all the time?

Secretary HUMPHREY. We have to have it for working funds that move in and out. When you are spending as we are anywhere from four and a half to six billion dollars a month, you have to have cash on hand to pay your bills with, to meet your checks as your checks are presented.

Representative PATMAN. Let's analyze that.

Secretary HUMPHREY. So we have to keep a working balance on hand to meet our bills.

Now, the reason we do it through the banks is because with the money coming in and the money going out, if we keep this money spread throughout the country and run tax and loan accounts in the commercial banks we have less dislocation of funds througout the country and we don't pull one area way down and build another area way up.

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Private deposits in a bank are just shifted to Government deposits in the same bank until we have to pay our bills. We don't put most of that money there ourselves, you know. It gets there as people pay their taxes or buy bonds. That's all explained in the material I sent you in October, and again in the answer to question 8 of the subcommittee's questionnaire.

Representative PATMAN. That is the object of the Federal Reserve. Let the banks go to the Federal Reserve and borrow temporarily.

Secretary HUMPHREY. By doing it this way we avoid that difficulty.

Representative PATMAN. But you are going around the Federal Reserve.

Secretary HUMPHREY. We keep an even flow of money throughout the country and we do not dislocate bank reserves or bank balances by doing it in this way. It is the way you get the most even flow you can possibly work out, and that is very desirable.

Representative PATMAN. I don't want to take up too much time, Mr. Chairman.

There is nothing personal in this, but there is just 2 or 3 New York banks that had a quarter of a billion dollars all the time that you were putting out this issue, and I venture to say that there wasn't a time that the banks, just a few banks in New York City, didn't have as much as $1 billion on deposit, and I can't understand why you would keep that money on deposit when it is unnecessary.

Secretary HUMPHREY. We don't discriminate among banks. Why don't you come up, Mr. Patman, and sit——

Representative PATMAN. Wait just a minute, please. If the banks render service, pay them for it. I want them adequately compensated.

I am not trying to take anything away from them, but I don't believe in just having those accounts there, keeping that money there idle and unused. You don't even check on it.

Secretary HUMPHREY. Do you keep a personal checking account?

Representative PATMAN. You don't even check on these banks.

Secretary HUMPHREY. Do you keep a personal checking account?

Representative PATMAN. I try to.

Secretary HUMPHREY. You try to keep a balance in it, don't you, so your checks are good?

Representative PATMAN. That's right.

Secretary HUMPHREY. And that balance has something to do with the amount of checks you are going to write.

Representative PATMAN. But you don't check on these banks, you check on the Federal Reserve.

Secretary HUMPHREY. The effect is the same as checking on the banks.

Representative PATMAN. Don't you call on them for a certain percentage?

Secretary HUMPHREY. That's right.

Representative PATMAN. In other words, you check on the Federal Reserve.

Secretary HUMPHREY. It is the same thing as checking on the banks, because we are constantly transferring funds, day by day from those accounts to our accounts at the Federal Reserve were the checks are paid.

Representative PATMAN. And I just wonder if some person were charged for failing to pay his taxes and the defense lawyer should

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contend before the jury that the charge really is that this taxpayer didn't turn it over to the corner national bank so that the corner national bank could use it, it might have some weight on the jury in the collection of taxes, and this money is powerful money, every dollar of it; they expand six times.

In other words, if they have $1 billion on deposit, they can make loans aggregating $6 billion, and if they charge them 6 percent like the Small Business Administration charges, that you happen to be connected with, 6 percent, that would be 36 percent interest there.

Secretary HUMPHREY. The fact that we have a billion dollars on deposit in the banks certainly does not mean that they can turn around and expand their lending power by $6 billion. These are deposit liabilities; they aren't reserves, which are assets. It's the reserves that enter into the expansion of lending power—not the deposits.

I think it might be very helpful to you if you would come up and sit with Ed Bartelt for a while and see this actual operation and see how fast you have to move when you are trying to pay $6 billion worth of bills with only $4 billion worth of money.

Representative PATMAN. Well, that is the reason Congress very wisely provided that you had that $5 billion cushion there, $5 billion, and that is a fine cushion, and that could take care of any of these temporary upsets, or upsets that are not temporary.

Secretary HUMPHREY. The authority given the Treasury to borrow up to $5 billion directly from the Federal Reserve was never intended to cover anything but situations where temporary borrowing is helpful, as around tax dates. Its purpose is to smooth out the effect on the economy of short-run peaks in the Government's cash receipts and disbursements. Now the Treasury and the Federal Reserve have never used this borrowing authority on other than a temporary basis and have no intention of doing so. If we did, I think the Congress would properly object.

Representative PATMAN. Now, another thing, and I shall be through, Mr. Chairman, about the interest rates on the housing, and particularly the veterans' loans, the Veterans' Administration, and the FHA.

There was pressure brought to bear to raise those interest rates. Do you have coordination between the Treasury and the Federal Reserve?

You know what they are doing, don't you? They have been telling you all the time.

Secretary HUMPHREY. We have very cordial relations with them, and we try to keep informed as well as we can.

Representative PATMAN. You knew that the Federal Reserve was going to take an about-face on May the 6th last year and reverse their policy and take the easy-money road instead of the hard-money road, didn't you?

Secretary HUMPHREY. I knew that they were buying some bills in the open market at some point, but I can't tell you exactly when.

Representative PATMAN. That was May the 6th.

On Saturday, May 2, 4 days before that, the Veterans' Administration raised the interest rates on veterans loans. The FHA raised interest rates on FHA mortgages.

Now, if you have liaison between the Treasury and the Veterans' Administration and the FHA, why didn't you warn them not to raise

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those interest rates, that the Federal Reserve was going to change its policy in a few days, and there would be no need to raise them?

The excuse was—and it was a good excuse—that the mortgage lender is entitled to a 1½-percent spread, and, as long as the long-term Government rate was 2½ percent, he was satisfied with 4 percent. That was a 1½-percent spread.

But, when the long-term Government bond rates went up under this hard-money policy and they kept going up and got to 3, with a great deal of logic and reason, and it is very persuasive, the mortgage lenders said, "We are entitled to a 4½-percent rate to make that spread 1½ percent."

It is irresistible logic and reason, so the VA and FHA were persuaded to raise that rate on the theory that the long-term rate was going to remain 3 percent. I am not trying to say that it was bad faith or you did anything that was wrong. However, you, or someone in your organization, failed to exercise due diligence in stopping that tremendous raise which went into effect. Four days later the necessity for it was changed but the increase has never been rescinded. They are continuing to pay that high rate.

Secretary HUMPHREY. As soon as you get through, I will tell you why.

Representative PATMAN. I am through now.

Secretary HUMPHREY. What happened was this, that with these interest rates as they were, veterans were not able to get their loans because the loans didn't pay enough interest.

Representative PATMAN. I explained that. It was partly because the long-term interest rate was increasing and partly because an increase was expected after you issued the 3¼ percent 30-year bond.

Secretary HUMPHREY. That's right, and that is what the interest rates were then, and that is what the interest rates were for months later. Investors wouldn't lend them enough money at 4 percent. We wanted the veterans to have the benefit of getting that money to use, and so they changed the interest rate, so that veterans could have the benefit of the law and actually build some houses, rather than having something on the books that wouldn't work.

Representative PATMAN. I am in sympathy with the objective of building homes for veterans.

Secretary HUMPHREY. That is why it was done.

Representative PATMAN. But why do that just before you knew that the policy——

Secretary HUMPHREY. Because we wanted them to be able to build some houses.

Representative PATMAN. That the policy that caused the 3 percent long-term rate, which would justify 4½ percent for mortgages, that policy was going to be changed in a few days?

Secretary HUMPHREY. And it didn't change in 3 days, and you knew it wouldn't work in 3 days.

Representative PATMAN. It didn't even go into effect in 3 days.

Secretary HUMPHREY. That's right, and the veterans have had the benefit all the rest of the time of having something that would work.

Representative PATMAN. Why haven't you reduced it since? Why don't you reduce it now? Why don't you reduce it today?

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Secretary HUMPHREY. Because it is still working in the right way.

Representative PATMAN. But you are getting a 2-point spread when they never did want but 1½-point spread.

Secretary HUMPHREY. The veterans are getting the benefit of it right now.

Representative PATMAN. They are getting a 2-point spread.

Secretary HUMPHREY. And one of the great things that has happened has been this great building going on, and that is one of the reasons for it.

Representative PATMAN. It looked like just increased interest, Mr. Secretary, and you know 1 percent interest is a lot of money.

You take 1 percent on $697 billion, it is $6.7 billion a year.

That is about $50 per person. That's about $200 per family of 4 a year.

That means that they have got to divert that much purchasing power, at least that much purchasing power is diverted from comforts and conveniences of life to the family to paying interest.

Secretary HUMPHREY. Mr. Patman, you know perfectly well——

Representative PATMAN. That is a lot of money.

Secretary HUMPHREY. That the real interest cost depends not only on the dollar amount of interest but also on the amount of principal. If you have to cut your principal to make the rate fit, you might better adjust the rate and keep the principal.

Now, that is the way it was done. The home builders began to get the money they needed, they began to go forward, they began to build things, and we have had the benefit of that, and they have had the benefit of it ever since.

Representative PATMAN. They would have still gotten it if you hadn't raised it, because the monetary policy was changed.

Secretary HUMPHREY. No.

Representative PATMAN. And the direction was 2½ percent long-term, and they were perfectly satisfied with the 1½ percent spread. Under your policy they are not only getting 1½, they are getting a 2 spread which they never asked for.

Secretary HUMPHREY. One is theory and the other is practice. One won't work and the other did.

Representative PATMAN. I would like to yield my time for the present, and when the others get through I have another question or two I would like to ask.

Senator FLANDERS. Before calling on the next member of the subcommittee, I am reverting to a suggestion made by Mr. Patman a few minutes ago to the effect that there might be some correspondence between a Federal Reserve note and a Government bond, each of them representing an obligation.

Now, I have on my bedside table a book called the Treasury of American Humor. I read it when I get distraught.

I have here in my hands another document which I would call Humor of the American Treasury, and I think it is decidedly humorous, Mr. Secretary. It says: "Federal Reserve note, the United States of America will pay to the bearer"—I am the bearer—"on demand $20."

I turn it in, they hand it back. Now, I think that is Humor of the American Treasury.

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Representative PATMAN. But don't overlook the fact that you can pay debts, including taxes, with that, and they don't hand it back.

Senator FLANDERS. But it says that in the fine print, print so fine that I have difficulty in reading it. The humorous part is the way in which it is redeemed.

Representative PATMAN. Well, you are making it humorous, Mr. Chairman, when the fact is you turn it in on taxes and they keep it. They don't give it back to you.

Senator FLANDERS. Senator Goldwater.

Senator GOLDWATER. I don't have a question at this time, except one that might clear the record a little bit.

Mr. Secretary, during the last colloquy with Representative Patman, I am sure he didn't want to indicate this but, nevertheless, he did, that your actions in the spring of 1953 added 1 percent to the total debt of the country. Now, what portion of the total debt did that 1 percent actually apply to?

Secretary HUMPHREY. Oh, it was a very, very small percent.

Senator GOLDWATER. It wouldn't add $50 to $200 per family, as might be indicated by the question?

Secretary HUMPHREY. Oh, no, no.

Representative PATMAN. I said it was creeping in that direction. It would have finally gone clear across the board.

Secretary HUMPHREY. It is almost infinitesimal when you take it as you have indicated.

Senator GOLDWATER. Thank you.

Senator FLANDERS. Senator Sparkman.

Senator SPARKMAN. Thank you, Mr. Chairman. I am not a member of the subcommittee. I pass.

Senator FLANDERS. Senator Douglas.

Senator DOUGLAS. Mr. Secretary, there is a question which Congressman Patman raised as to whether the May issue should have been issued at all. The question I should like to raise is whether however it was wise to raise the interest rate as rapidly and as quickly as you did, namely, from 2¾ to 3¼ percent. I would like to ask whether it was the fact that you wanted to check past inflation of prices, which caused you to raise the interest rate by this amount, which was half a percent in absolute terms, and relatively almost one-fifth.

Secretary HUMPHREY. No, Senator. The reasons we put out a long-term issue at that time were that we were trying to stretch the debt out and trying to help Federal Reserve in its monetary restraint policy.

Senator DOUGLAS. Mr. Humphrey, that goes back to the question Mr. Patman raised. It does not deal with my question.

Secretary HUMPHREY. Now, that is as to the reasons for putting out the issue. Now, as to the interest rate which you are now speaking about——

Senator DOUGLAS. That's right.

Secretary HUMPHREY. As to the interest rate itself, the thing that determines the interest rate itself is this, and it determines the interest rate almost always: We have quite wide markets in bonds, in these Government bonds. Every day somebody is buying and selling Government bonds.

Every day the public is fixing the interest rate that will be paid on Government bonds, and as you go through the list, you will find what

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the public is willing to pay for certain maturities of these bonds daily, so that the Treasury doesn't fix the interest rate.

The public fixes the interest rate, and we have to adopt a rate, when we have an issue to sell, which is what the public is demonstrating daily that they are willing to buy bonds at.

Senator DOUGLAS. In other words, you need to give 3¼ percent in order to issue the bonds at par?

Secretary HUMPHREY. That is right.

Senator DOUGLAS. What are they selling for now?

Secretary HUMPHREY. They are selling considerably above that figure.

Senator DOUGLAS. Aren't they selling for 110?

Secretary HUMPHREY. Yes.

Senator DOUGLAS. May I say this. To err is human. We all make mistakes.

Secretary HUMPHREY. Sure.

Senator DOUGLAS. Senators make mistakes, Secretaries of the Treasury make mistakes, and so on.

Secretary HUMPHREY. Sure, lots of them.

Senator DOUGLAS. But in view of the fact that a year and a half after issuing this 3¼ percent interest rate has produced price of bonds at 10 percent higher than par, if you could have foreseen what was going to happen, would you have put it up at 3¼ percent?

Secretary HUMPHREY. Yes; let me put it this way:

Let's go back to when we took off the controls. I think to leave the controls on would have been a very bad thing. If when we took the controls off we had had runaway prices, that would have been bad, too. I think either one of those would have hurt the public so much more than any possible change in this relatively small amount of interest rate that there is no comparison.

Senator DOUGLAS. Now you are going back to the price question.

Secretary HUMPHREY. That was the price at the time.

Senator DOUGLAS. You mean, the price of bonds or the price of commodities?

Secretary HUMPHREY. The price of interest. The price of borrowed money, as fixed by the market at that time, was that price. That is where it came from. We didn't pick it out of thin air.

Senator DOUGLAS. Just a minute, Mr. Humphrey.

In view of the tremendous importance of Government issues, you certainly cannot say that the Government merely accepts the interest rate fixed by the market.

You helped fix that interest rate. The raising of the interest rate from 2¾ to 3¼ percent caused all interest rates to move up.

Secretary HUMPHREY. No. The interest rates——

Senator DOUGLAS. When the public debt was only a small fraction of the total debt, then perhaps you could argue that the Government merely has to accept the interest rate dictated by the market, but when, according to your own figures, it forms such a large percentage of the fluid capital, certainly the terms upon which you issue Government bonds affect other interest rates.

You do not merely accept the market. You help to determine the market, and that was evidenced in what happened to the price of previous issues at lower rates of interest, which went down because you were raising the interest rate. It is what happened in interest rates

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where other flotations had to be issued immediately afterwards. I don't think you can say you merely accept conditions. You help frame conditions.

Secretary HUMPHREY. Let me see if I can explain that to you as we see it, and let's get it into very simple terms.

We are selling eggs, and the current price that eggs are selling for is 50 cents a dozen. Now then, we come along and we have some eggs to sell. If we go out and offer those eggs at 55 cents, nobody is going to buy them, so if we have a dozen eggs to sell, we have to offer them at a price that the market will take. If we come out and offer them at above the market, nobody is going to buy them. If we come out and offer them approximately at the market, we have a chance to sell them.

Now then, we do affect the market somewhat by the amount of eggs that we do offer. If we came out with thousands of cases, we would present an oversupply of eggs and it would tend to push the market down. If we came out with a very little bit and there was a strong demand, we would have to come at approximately the market.

Now, the same thing is true of bonds. These bonds, the rate that people were buying bonds for at the very day we put these bonds out was, as nearly as we could figure it, about 3¼ percent. Now, by coming out and adding some more bonds to the supply we, of course, did to some extent affect the rate.

That is why we put out as small an issue as we did, because we didn't want to affect the rate any more than we could help, so we met the market with as small an amount as we could that we thought would not affect the rate, and in that way did not increase interest rates by these bonds over what they then were.

Senator DOUGLAS. Well, Mr. Humphrey, the analogy which you draw between the housewife who sells eggs, a few dozen eggs, on the market of millions of dozens of eggs, and therefore sells only an infinitesimal proportion to the total eggs sold, and hence has to accept the price, is not applicable to the Government, which sells a large proportion of the securities which are issued.

Secretary HUMPHREY. Now, wait just a minute.

Senator DOUGLAS. There is a difference. You are assuming perfect competition in the egg market and carrying it over into the bond market, which doesn't apply.

Secretary HUMPHREY. No, I don't think that is correct, Senator. We sold just a little over $1 billion, and compared with the Government debt outstanding at that time in the hands of the public—leaving out the Government accounts—it looks very small. We put out $1 billion or a little better, and there was outstanding in the hands of the public at that time about $220 billion. Now, when you put 1 out in 220, it isn't such a large proportion, after all.

Senator DOUGLAS. Then you were treating this as purely an extraordinary occurrence raising the interest rate on this one issue?

Secretary HUMPHREY. We didn't raise it.

Senator DOUGLAS. But it didn't indicate any permanent policy? Is that what you are now saying?

Secretary HUMPHREY. We didn't raise the interest rate. We accepted the interest rate as the market had it determined that day, and we took that interest rate and offered to sell our goods at the price the market was paying at that time.

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Senator DOUGLAS. The previous issues of comparable bonds, as I remember it, drew some 2¾——

Secretary HUMPHREY. I don't know what their market yield was.

Senator DOUGLAS. Is that not true, that they drew 2¾ percent?

Secretary HUMPHREY. No, it is not true, and the reason is this: Interest is a function of both principal and rate, and unless you take into account both principal and rate you can't figure interest. Interest of $2 on $100 of principal is 2 percent. That same $2 on a principal of $50 is 4 percent.

Senator DOUGLAS. Then let me ask you this——

Secretary HUMPHREY. So you always have to take two things into account to figure what interest is.

Senator DOUGLAS. What was the yield on comparable Government securities at the time?

Secretary HUMPHREY. It was approximately this same rate.

Senator DOUGLAS. 3¼ percent?

Secretary HUMPHREY. That's right.

Mr. BURGESS. There is a difference in maturity.

Secretary HUMPHREY. For that maturity.

Mr. BURGESS. There weren't any Government bonds that long outstanding at that time. The longest bonds were 2½'s which had become medium-term maturities. They were selling around a 3 percent yield basis.

Senator DOUGLAS. Three?

Mr. BURGESS. That's right.

Senator DOUGLAS. That is what I understood.

Secretary HUMPHREY. But that was for a shorter maturity.

Senator DOUGLAS. May I just finish?

Secretary HUMPHREY. You have got to take maturity principal, and interest into account in figuring what a new interest rate should be.

Senator DOUGLAS. Now you have introduced a third dimension.

Secretary HUMPHREY. That is always true.

Senator DOUGLAS. May I say I can understand your raising the rate to 3 percent, but I have thought that that extra quarter of a percent was a mistake; that the yields were 3 percent on comparable securities.

Secretary HUMPHREY. No, they weren't comparable. Those were medium-term maturities, and were much shorter.

Now, we thought, based on all those rates——

Senator DOUGLAS. How long is this issue?

Mr. BURGESS. The longest marketable bonds outstanding then were December 1967–72's, so you were stretching this new issue very substantially into an area where there was no marketable debt outstanding. The new issue was more than 10 years longer.

Senator DOUGLAS. That raises the question immediately as to whether you should have issued it for so long a period.

Secretary HUMPHREY. All right. We thought that it was the right thing to do, and I still say that I believe it was the thing to do if it was helpful in deterring runaway markets in commodities, and I think it was.

Senator DOUGLAS. Now, when you speak of deterring runaway markets in commodities, I think there has been a lot of—I won't say issued by you, Mr. Humphrey, but a lot of—misapprehension on this point.

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Sometimes this rise in the interest rate has been spoken of as a move to check price inflation. I am happy to see that this morning neither you nor Mr. Burgess have advanced that argument.

I have here a sheet of wholesale prices and consumer prices, and they indicate that wholesale prices fell from 116.5 in March 1951 when the accord between the Treasury and the Reserve was negotiated, to 109.6 in December of 1952, and approximately to 110 in March of 1953, so that there has been a fall in wholesale prices.

There had been a slight increase in consumer prices from 110.4, 110.3 in March 1951, to 113.6 in March of 1953, but if you take the two together, there was roughly price stability. In fact, there was a slight price decline, so that I do not think it can be maintained as some have maintained in their speeches that this was necessary to check price inflation, and I hope the record is clear that whatever the justification may have been for it, that this was not a justification. Would you agree with that?

Secretary HUMPHREY. Let me put it this way, Senator, I have to get these things into very simple form or I don't understand them myself.

Senator DOUGLAS. You are a very clever man, Mr. Humphrey, to be able to put them in a simple form.

Secretary HUMPHREY. To just be simple about it, when you take controls off there are several things that have to be taken into account in judging where prices will go.

In the first place you have to judge as best you can looking ahead, and it is always easier to be a Monday morning quarterback than it is to do the job Saturday afternoon. Looking ahead you have to judge how the relative increase in productivity was coming up in production of goods. That was increasing.

There was a lot of plant capacity that was coming in, and it was increasing. You also had to look at what the demand probably was going to be.

Now in addition to all of that, there was the question of how purchasing agents throughout the country thought things were going. They don't study economics particularly; they just go the way you and I go along in judging how things are going to go. If they think prices are going to go up, they want to raise their inventories to protect themselves. If they think prices are going down, they cut down on their inventories somewhat.

If it costs them a little more money to carry an inventory, they are not quite so apt to speculate with it.

So that with all of these things, with the production, gaging the production that would probably be available, gaging the demand that would probably be made, and with it costing a little more to carry a speculative inventory, all those things converged to a point where you didn't have an increase in speculative inventory.

And it was the most fortunate thing in the world that we didn't get it because we were accumulating inventory at that time, anyhow, and if we had added substantially to our inventory accumulation at that time we would have had a much farther down curve in business, which was what you were predicting yourself only a few months ago.

Senator DOUGLAS. Mr. Humphrey, for the record I have never made any predictions. I have never made any predictions about the future. The record is perfectly clear on that point. I merely stated what was occurring, namely a decline in industrial activity or a recession.

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Secretary HUMPHREY. In any event, we didn't have that severe down curve partly because we had not had that speculative inventory buying.

Senator DOUGLAS. Now, Mr. Humphrey——

Secretary HUMPHREY. All these things contributed to stop that, and I think that by and large the whole thing did stop the inventory accumulations that would have driven us further down had it occurred.

Senator DOUGLAS. Then what you were afraid of was not past increases in prices, but anticipated increases in prices.

Secretary HUMPHREY. That is right.

Senator DOUGLAS. Resulting from the removal of controls.

Secretary HUMPHREY. That is what many people said. That is what the big argument was, and there are many people who argued very sensibly that if those controls were removed, there would be an immediate rise in prices that would be uncontrolled.

Representative PATMAN. Would you permit an interruption there?

Senator DOUGLAS. Certainly.

Representative PATMAN. He said if those controls were removed.

Secretary HUMPHREY. That is right.

Representative PATMAN. Indicating that you were going to take them off.

Secretary HUMPHREY. That is right.

Representative PATMAN. The 83d Congress in 1953—isn't it a fact, Mr. Secretary, that the Defense Production Act of 1952 passed in the 82d Congress provided for the automatic decontrols that went into effect, and practically all of them had been removed before April 1953?

Secretary HUMPHREY. Only because we took them off.

Representative PATMAN. They were automatic.

Secretary HUMPHREY. And if they had been taken off earlier, we would have been better off. If that had been done in the fall before, we would all have been better off.

Senator DOUGLAS. As a matter of fact, Mr. Humphrey, even under the imposition of controls, what we had was a fall in wholesale prices. The controls pegged prices at their peak, of January–May 1951 but did not appreciably impede the rise in prices. The trouble had occurred by the time controls were imposed, and a business fall of 7 points.

Secretary HUMPHREY. Of course, you don't know what the peak would have been if you hadn't had them. When a control is put on, it will always peg it at the peak because that is where you stop the rise.

Senator DOUGLAS. What I am trying to say, is I see no evidence that there was any pent-up inflationary movement at the time the interest rate was raised so sharply, and that this was taken as an indication of Government policy.

The rise was not merely an isolated occurrence. It was said to be the shape of things to come, and the result was that it was not merely a coincidence that the yield on municipals went up, that other yields went up as well due to the falling of prices of securities already issued. It had a profound effect, and the very fact that it was not needed was shown in that within a month you reversed yourself. I wish that as public men we didn't always have to take the position that we are infallible. It is possible that we make mistakes, honest mistakes.

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Secretary HUMPHREY. I am not taking that position at all, but if we had to do it again tomorrow, I would do exactly the same thing, and let me tell you why.

I think that one of the greatest things that has happened has been the stabilization that has resulted during this period, the maintenance of that stability, the stopping of inflation. We had been for 15 years in a period of self-imposed inflation that was fostered and carried on, and it was depreciating the value of the dollar very rapidly.

Now the value of the dollar stopped depreciating. It all has to do with the reduction of Government expenditures, with the handling of the taxation, with all of these things that all contributed, and it is not a bookkeeping fetish or anything of the kind.

The stopping of this inflation saved the people of America, the savers of America, the people of America a great deal of money, and it has stabilized the economy. It has helped to make jobs for them to work at, and I think it is the foundation of the conditions that we have today.

Senator DOUGLAS. It is always impertinent to play the role of amateur psychiatrist, Mr. Humphrey, but I would say that your subconscious has oozed out in your reply, because now you are making emphasis upon the checking of inflation, which a few minutes ago you disavowed.

Secretary HUMPHREY. No; I didn't disavow it. I never disavowed it. I have said right straight along that our objective has been to stop these inflationary pressures. Our objective has been to stop this depreciation of the dollar, and so far we have done it.

Senator DOUGLAS. This is my point: That had already been done by the Federal Treasury Reserve Board in March 1951, as indicated by what happened after that.

Secretary HUMPHREY. No; that is not the whole story.

Senator DOUGLAS. What I think happened is you carried over your impression of what existed prior to that accord into a period in which it no longer applied.

Secretary HUMPHREY. No; I don't think so. In any event, it has worked.

Senator FLANDERS. Will the Senator yield?

Senator DOUGLAS. I have taken up too much time.

Senator FLANDERS. I would just like to express this situation as I see it. I may not be seeing it rightly.

In the first place, inflation was checked before you, sir, came to the Treasury. In the second place, a new factor entered after you came to the Treasury in that controls were removed. The assumption you are making, which seems to me a valid assumption, is that positive action on your part was required to maintain an already existing situation in the face of the removal of controls.

That, at least, is the way I see the picture. And just one other point, and that is this: that you have disavowed the direct fixing of interest rates by saying that you put that issue out at the market.

There had to be an element of judgment in your case because there were no Government issues of that length of maturity in the market. You had to make a judgment as to what the market was for maturities for that length. It would seem to me then that your policy is either approved or disapproved on the basis of your decision to issue securities of greater length than any that were present in the market.

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Secretary HUMPHREY. That is right, Mr. Chairman. You might want to add that there were, of course, other influences that also bore on this.

We inherited a $9½ billion deficit that year, which was an inflationary pressure in itself, so that to say that inflationary pressures were all removed is not correct.

We were under many inflationary pressures at that time. Consumer credit was rising rapidly. New issues of corporate and municipal securities were running very high and credit demands were threatening to spill over at a time when our productive capacity was already fully utilized. We felt it necessary to resist those pressures so that we would not have a runaway rise in prices, and we could stabilize the dollar.

Now, the proof of the pudding is in the eating. What was done did stabilize prices.

It did arrest the threatened rise and it continued stabilization and the value of the dollar didn't depreciate further. That is very beneficial for the American people in the form of jobs, in the form of savings, in the form of insurance, in the form of pensions, in all the things that the American people want to have.

Senator FLANDERS. Senator Douglas, you still have the floor.

Senator DOUGLAS. I don't want to monopolize the questioning, but I would say this.

I think this argument that it was necessary for stabilization is very dubious. It is true that the money supply was increasing, but it is also true that production was increasing, and it is important to view those two together in relationship to each other.

If you have the normal increase in production of 3 percent a year, and as a matter of fact, it was going up close to 5 percent a year during the preceding year, you can have some increase, a corresponding increase in the money supply without any inflationary effect on prices, and that is precisely what had been happening.

The Federal Reserve had allowed the money supply to increase in absolute terms, but not in relative terms. This is something that I think monetary managers should consider, not merely the question of absolute increases, but relative increases, and it is only when the relative supply of money is increasing more rapidly than the index of production or physical production that you get into danger.

Our good friends at the Treasury, I think erred in just being frightened at the absolute increase, and disregarded that increase in production which counterbalanced the increase of money, and had enabled stable prices to be maintained, which would have continued.

And the very fact that it wasn't necessary is shown in that within a month the Treasury had to beat a retreat, that interest rates were lowered, that this issue now stands out as a sore thumb at a price of 110, that the verdict of the market to which the Secretary has appealed has been that that was not necessary.

Now, I say it was a bad mistake, but I believe it was an honest mistake. But I know how hard it is for public figures to admit mistakes. I sometimes find it difficult myself, Mr. Secretary. But I think nothing is gained by trying stubbornly to maintain a position that you are correct, when history indicates you were wrong.

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Secretary HUMPHREY. Senator, I have made a great many mistakes in my life, and I expect to make a lot more, and I have never been a bit backward in admitting them.

On the other hand, when you are looking forward and making judgments and those judgments work in practice, that is the test after all, I am not much of a theoretical economist. I don't care too much about the theory of it as long as it works.

This one worked, and it worked well, and therefore I think it was all right.

Senator DOUGLAS. Now, Mr. Secretary, I have kept off of this question of whether it worked, but since you have raised it, I want to address myself to that very point.

You say it has worked because prices have been stable, but there is no doubt that that rise in interest rates checked production, checked volume of output during the second half of 1953 and contributed to the recession and contributed to the employment of human beings.

Now, I do not say that it was the sole factor in the recession. I have never argued that. But I do say the rise of one-half percent in interest rates helped it along.

Secretary HUMPHREY. It is a mighty good thing it did check inflation.

Senator DOUGLAS. Did you consider the increase in unemployment, which has been very severe in many regions of this country? If you took that into consideration, then I think you would not be quite as self-satisfied with this decision that you say "worked."

Senator FLANDERS. May I interrupt a moment, Senator?

Senator DOUGLAS. Certainly.

Senator FLANDERS. It seems to me that one part of the production that it checked was the flow of production into inventories.

Secretary HUMPHREY. That is right; that is exactly right.

Senator DOUGLAS. Well, did it?

Senator FLANDERS. Yes.

Secretary HUMPHREY. Yes; it did, and if it hadn't we would have been in a lot worse trouble.

Senator DOUGLAS. But for about 5 months inventories continued to increase despite the rise in interest rates

Secretary HUMPHREY. And think how bad it would have been if it hadn't helped to check it.

Senator DOUGLAS. Your own chart shows that the inventories did not begin to decline until October, and you had placed your increase in interest rates into effect in May.

Secretary HUMPHREY. That is simply illustrating your point that we did need a check.

Senator FLANDERS. Now, I am anxious that Mr. Talle, if you will excuse me, shall have an opportunity, and so it is his turn now.

Representative TALLE. Thank you very much, Mr. Chairman. I will not take any time.

Senator FLANDERS. Well, now it lies between those who have already spoken. Let's see if Senator Sparkman would like to ask any questions.

Senator SPARKMAN. No, Mr. Chairman, don't save any time for me. I am a visitor, not a member of this subcommittee.

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Senator FLANDERS. You are welcome as a member of the full committee.

Mr. Goldwater?

Senator GOLDWATER. Mr. Chairman, I have one question to ask, brought about by the chairman's first suggestion that possibly the law of supply and demand hasn't been working during this period of inventory adjustment. Isn't it true that temporary price reductions are not noted in price indexes?

Secretary HUMPHREY. That is right.

Senator GOLDWATER. Isn't it true that there has been in this country a great deal of price reductions, particularly in the automobile field and appliance field in the past 9 to 10 months?

Secretary HUMPHREY. In almost every field, Senator, there have been sales involving price reductions moving substantial quantities of goods that have tended to reduce inventory, and those price decreases are not noted in the figures.

Senator GOLDWATER. So wouldn't you say it would be safe for me to assume that the fact that the law of supply and demand has been allowed to operate with a minimum of Government interference has been the dominant factor in the present economic condition of the country?

Secretary HUMPHREY. That is exactly right, and price concessions have been effective in that operation.

Senator GOLDWATER. Thank you.

Senator DOUGLAS. Mr. Chairman, before we break up could I give a Biblical quotation which I think is applicable.

Senator FLANDERS. Well, now just before we have the Bible, I want to say that I, not quite tacitly, have offered Mr. Patman a chance to say something more.

Representative PATMAN. I will certainly yield to a Biblical quotation.

Senator FLANDERS. I don't believe you can quote the Bible indefinitely, so let's——

Senator DOUGLAS. I was going to only use the Bible as a jumping-off point.

Senator FLANDERS. Just give us the jumping-off point, anyway.

Senator DOUGLAS. Mr. Secretary, it finally comes down to this. You believe this increase in interest rates, or at least the extra quarter of a percent, was necessary to check increases in prices which had not yet occurred but which might do so, or increases in inventories which had not yet occurred but which might.

In other words, it was a faith that there would have been inflation in the future if this had not occurred.

That reminds me of St. Paul's definition of faith. It is the substance of things hoped for, the evidence of things not seen. But in this connection I would like to point out that despite the rise in the interest rate, inventories continued to accumulate until October, and on a seasonal basis even until November, and that within a month almost the Treasury and the Reserve, finding that they had made a mistake, though they did not wish to admit it publicly, had reversed their policies, and it was after the fall in the interest rates that the inventory ceased being accumulated.

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Secretary HUMPHREY. These curves, Mr. Senator, as you know begin to show up long afterwards. If you don't live way ahead of the curves, you are going to be in a lot of trouble.

Senator GOLDWATER. Mr. Chairman, a question on that point.

Isn't it true that new orders in both retailing and manufacturing at that particular period were at quite a high point, and they had to be filled.

Secretary HUMPHREY. That is right.

Senator GOLDWATER. A businessman just can't cancel orders because he thinks something is going to happen.

Secretary HUMPHREY. If you wait until you see it on the chart, you will go broke.

Senator GOLDWATER. That is right.

Representative PATMAN. I raised the question of permitting the banks to have so much of the Government's money on hand all the time, an amount which in the recent past has been around 6 or 7 billion dollars.

Secretary HUMPHREY. I think our average is about 4 billion, but I won't quarrel with you over a billion or 2.

Representative PATMAN. I want the banks to be profitable. I am not going to do anything that will keep them from making money because they are so important in our entire economy.

But it occurs to me in permitting them to hold so much of the Government's money, every dollar of which has a potential credit of $6—in other words, if they have $6 billion, they can extend loans of $36 billion, that we are doing a lot for them that could possibly make them become a little indifferent toward talking to small-business people who want local loans.

The point is this, Mr. Secretary. I just feel like it is just doing too much toward making these banks a little bit indifferent and careless toward local loans, and I just wanted to invite that to your attention.

The value of the dollar today is about the same as it was in early 1953?

Secretary HUMPHREY. Yes.

Representative PATMAN. Now, during that time the gross national product has gone down; hasn't it?

Secretary HUMPHREY. It has gone down a little, a very small percentage.

Representative PATMAN. Dr. Burgess said you have to run awfully fast in this game to stand still.

Now, I think that is a good statement, but in our economy if we just stand still, if that line is just even, it doesn't go up, it goes just exactly like it has been, we are going backward; aren't we?

Secretary HUMPHREY. Mr. Patman, we have a growing economy. This country is growing right now. We have got to make more jobs for more people all the time.

Representative PATMAN. That is right, that is what I am talking about.

Secretary HUMPHREY. And this country is going to have a continual growth. I am a great believer in America. We are not going to stand still.

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Representative PATMAN. Now, gross national product is the index; isn't it?

Secretary HUMPHREY. You aren't going to keep making new records every day. You are going to catch your breath now and then, and then run again.

Representative PATMAN. When are we going to start running?

Secretary HUMPHREY. We are on the way up right now.

Representative PATMAN. Right now? It must have been the last month.

Secretary HUMPHREY. It started last month and the month before.

Representative PATMAN. Mr. Clark yesterday made a very interesting statement. He seems to be concerned that if the economy does not respond adequately to the current automobile and steel expansion, this, coupled with the usual post-Christmas letdown, may not leave our economy in good condition. He suggested then that we should take a drastic step.

We should reduce reserve requirements of banks down to the bare minimum. Of course, that would release a lot of reserves and that would increase the potential lending power of the banks by possibly $75 billion. I would be afraid of it. I think it is too much.

But if the country doesn't respond to this stimulation via expanded automobile the steel production and doesn't come back after the seasonal letdown anyhow, do you not think we should do something drastic?

Secretary HUMPHREY. There is nothing in the present situation that would lead me to believe we should do anything drastic now.

I have no idea of it, and I don't think it is worthwhile to speculate on a lot of thoughts that nobody knows whether they are going to come true or how they will work out.

Senator FLANDERS. Are there any other questions that any of the members of the panel or any members of the committee here wish to ask?

If there are no other questions, we will call this hearing adjourned, and we are particularly grateful to the Secretary and the Under Secretary. We meet again at 2 o'clock when we have a most remarkable aggregation of talent. Never before has the entire Federal Reserve System faced a group of Senators and Representatives.

(Whereupon, at 12:20 p. m., a recess was taken until 2 p. m., the same day.)

AFTERNOON SESSION

Present: Senators Flanders (presiding), Goldwater, Sparkman, Douglas, and Watkins; Representatives Patman and Talle.

Also present: Grover W. Ensley, staff director, and John W. Lehman, clerk.

Senator FLANDERS. The hearing will come to order.

Congressman Patman?

Representative PATMAN. Mr. Chairman, the Federal Reserve System, made up of the regional banks and the central governing board in Washington, has been established for 41 years.

The Open Market Committee, with its broad powers over the economy, has been in existence for 20 years. In all that long history, this is the first time that any congressional committee has had the opportunity of meeting face to face with the men who, through their

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position in the Reserve System and their control over the availability of credit and purchasing power, have more power than almost any group, in shaping the destinies of the economy of the Nation.

While the Chairman of your Board and some of the presidents of individual banks have appeared before Congress from time to time, never before has the top management of the Reserve System appeared as a group before representatives of the Congress, as you are appearing today.

In many ways, this is strange and, I believe, an unfortunate fact. It is strange and unfortunate because however one may choose to describe the relationship between Congress and the System, the fact is that under the Constitution, the powers to coin money and regulate the value thereof are expressly placed in the Congress.

The fact that Congress has seen fit, as a practical matter, to entrust or delegate the day-to-day exercise of this power to the Reserve System, does not lessen the ultimate power or responsibility of the Congress in this respect, nor does it make the functions which you and the Reserve System perform any less public governmental functions.

Congress, recognizing that restrictive monetary policies must sometimes be strongly stated to control inflation, has chosen to endow the System with a considerable degree of independence. But under the Constitution this independence can never rise above the relationship of a faithful and trustworthy servant and a responsible, watchful master, in this case the Congress.

Since the country cannot prosper without a sound basic economy and sound credit conditions, since the economy cannot exist without an adequate medium of exchange by which goods and services change hands, the powers which the Congress has delegated to the System are in many ways closer to the destiny of the country than many of the other congressional powers.

In many respects, the actions which you take at your regular meetings of the Open Market Committee are thus more important to the well-being of the plain citizen and to business, labor, and agriculture than most of the actions taken by a long session of the Congress itself.

I am sure that as individuals you fully appreciate this responsibility, but there can be no harm in its reiteration and emphasis.

In a dynamic and delicately balanced economy, such as we have, actions taken by monetary authorities must be constantly sensitive to economic changes and threatened instability.

Yours is thus a day-to-day task as well as a sensitive vital one.

Since it is such a sensitive and serious responsibility, it is appropriate that those entrusted with it should report frequently to the Congress, whose constitutional powers they exercise through delegation.

It is true that the Board of Governors does file an annual report with the Congress. Ideally this report should be even more complete than it is. For example, it should contain details on the volume of open-market purchases and sales which have to be made in pursuance of the policies determined upon.

It should report the success of the operation undertaken and explain fully the thinking behind the decisions and policies. Faithful and full reporting to the principal is expected of every agent.

It might indeed well be that reports should be made more frequently than once a year.

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I hope that this hearing today will establish a precedent which will lead to similar meetings and your appearance before congressional committees regularly.

I certainly hope and feel sure that none of us want another 41 years to go by before repeating a meeting similar to this.

Thank you, Mr. Chairman.

Senator FLANDERS. Congressman Patman referred to the fact that this is an unusual occasion. It is a fact that a group of Congressmen and Senators who have the kind of responsibility that is laid upon the Joint Economic Committee have never before asked this group as a whole to appear before us.

I might remark, parenthetically, that in the 41 years of the Board, and in the 20 years of the Open Market Committee, it took a Republican Congress and the Republican chairman to get this result achieved, and——

Senator SPARKMAN. You just did get under the wire, Mr. Chairman.

Senator FLANDERS. There is an old hymn about the prize:

> The prize secure, the wrestler nearly fell, bore all he could endure, and bore not always well.

But the idea is that he won nevertheless.

Now, this is an unusual occasion. I think it is very much to the advantage of the Open Market Committee, the Board and the other members and the group of presidents and this committee to be personally acquainted with each other.

I assume there are opening statements to be made by Mr. Martin, the chairman, and by Mr. Sproul the Chairman of the Open Market Committee. That being the case in order not to take any further time from the statements we will want to begin with Mr. Martin immediately.

Let me first say that we greatly appreciate the care and thought which have gone into the preparation of the answers to the series of questions propounded by this subcommittee to the Federal Reserve Board prior to the hearings. These materials were inserted in the record at the opening of the hearings yesterday (p. 3).

Mr. Martin?

STATEMENT OF WILLIAM McCHESNEY MARTIN, JR., CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, ACCOMPANIED BY MEMBERS OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM AND RESERVE BANK PRESIDENTS

Mr. MARTIN. Mr. Chairman, this is the first time that I have ever really felt comfortable in appearing before a committee of Congress, because I have a lot of artillery with me today.

Usually, I am up here all alone, although I am flanked by my very able staff assistants; but it seems to me very helpful for us to have a meeting of this sort, and I would like to reiterate what Congressman Patman has said.

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I have no prepared statement today, but I would like to make a few comments on the Federal Reserve System, along the lines that are contained in the opening statement that Mr. Patman has given us.

The Federal Reserve System, I have tried to emphasize, has the word "System" in its title, and I believe that to be the most important word in its title.

In the history of credit and money policy in this country, it is obvious that the Congress has struggled to know how best to administer this great power that it has. The Congress has evolved, in accordance with the American way of life, an institutional concept, recognizing that decisions on money and credit policies are like the decisions of the judiciary, in that they depend for their effective exercise upon freedom to analyze the problems and act on the problems that, as Mr. Patman rightly says, occur from day to day and week to week and month to month and year to year, free of political pressures on the one hand, and of private pressures on the other hand. Therefore, in establishing the Federal Reserve System, after long and careful discussion, the Congress determined that they would not have a single bank with many branches, but that they would have a regional system, and that that regional system would be knit together by a governing board in Washington. You have today at this table the operating heads of the 12 Federal Reserve banks and the 24 branches under those 12 banks, as well as the members of the Board of Governors that knit the System together in Washington.

We might also have had here today the Federal Advisory Council, a statutory body which the Congress provided for in the Federal Reserve Act, and we might have had the chairmen of the 12 Federal Reserve banks and the some two-hundred-and-fifty-odd directors of the Federal Reserve banks, who are also an integral part of the System.

Now, this System represents a trusteeship over money which the Congress has granted to the Federal Reserve System under a trust indenture, which is the Federal Reserve Act.

That trust indenture can be changed at any time by the Congress, but it is under that trust indenture that we are acting, and what I am outlining as the regional system of the Federal Reserve is in accord with the trust indenture which you have given us to operate under.

Now, it is my firm conviction that credit and monetary policy has to be conducted not on a one-man basis, but by bringing together from all over the country, a country as large as this, a composite of views in such a way that they will be brought to bear on policy so that we will have some understanding of what we are trying to do, as well as some recognition of the nature of the problem.

And so, today it gives me a great deal of pleasure to be here and to be surrounded by my artillery, and to be in a position so that I do not have to answer all of the questions.

Now, I would just like to make one further comment, and that has to do with the questions which have been asked us by Mr. Ensley and the very able staff of your committee. They are very good questions; they are very searching questions, and they are questions that we welcome having the opportunity to answer at this time and put in the record.

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We think they are deserving of study and careful consideration, and we welcome your comments and your judgment on them because only in that way can we be helpful.

I want you to know that the Board and the staff and many of the people in the System have worked as diligently and as faithfully as they can to give you the best answers that we can to these questions.

Thank you.

Senator FLANDERS. Thank you, Mr. Martin.

With regard to the artillery which you have massed here, I may say that they are not arranged in any respect with regard to their bore or the weight of the projectiles; they go alphabetically from Mr. Balderston, Mr. Bryan, Mr. Earhart, and then, take a great leap, and end up with Mr. Williams and Mr. Young.

I thought it would be interesting to know that we use the alphabet instead of protocol.

Without objection, we will insert in the record at this point brief notes on the members of the Board and the presidents, and a listing of the present members of the Federal Open Market Committee. In response to a request from Congressman Patman there is also included the membership of the Federal Open Market Committee and of the executive committee of the Federal Open Market Committee, March 1951 through February 1954, and a list of the present members of the Federal Advisory Council.

(The documents referred to follow:)

MEMBERS OF BOARD

William McChesney Martin, Jr., Chairman: Effective date of appointment April 2, 1951; term expires January 31, 1956; formerly president of New York Stock Exchange, chairman and president of Export-Import Bank; and at the time of his appointment was Assistant Secretary of the Treasury.

M. S. Szymczak: Effective date of appointment June 14, 1933; reappointed effective February 3, 1936, and February 1, 1948; term expires January 31, 1962; formerly engaged in banking; professor, DePaul University, Chicago, Ill.; and at the time of his appointment was comptroller of the city of Chicago.

James K. Vardaman, Jr.: Effective date of appointment April 4, 1946; term expires January 31, 1960; formerly engaged in business and banking in St. Louis, Mo., and at the time of his appointment was naval aide to the President of the United States.

James Louis Robertson: Effective date of appointment February 18, 1952; term expires January 31, 1964; formerly special agent of FBI, Counsel to the Comptroller of the Currency, and at the time of his appointment was First Deputy Comptroller of the Currency.

Abbot L. Mills, Jr.: Effective date of appointment February 18, 1952; term expires January 31, 1958; formerly engaged in banking since 1920, and at the time of his appointment was first vice president of the United States National Bank, Portland, Oreg.

C. Canby Balderston: Effective date of appointment August 12, 1954; term expires January 31, 1966; formerly director and deputy chairman of Federal Reserve bank of Philadelphia, and at the time of his appointment was dean, Wharton School of Finance and Commerce, University of Pennsylvania.

RESERVE BANK PRESIDENTS

J. A. Erickson, president, Federal Reserve Bank of Boston, since December 15, 1948. At the time of his appointment as president he was executive vice president of the National Shawmut Bank of Boston, having been associated with that institution since 1920.

Allan Sproul, president, Federal Reserve Bank of New York, since January 1, 1941. He has been associated with the Federal Reserve System since 1920, first serving as head of the division of analysis and research and assistant Federal Reserve agent at the Federal Reserve Bank of San Francisco until 1930 when he

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came to the Federal Reserve Bank of New York as assistant deputy governor and secretary.

Alfred H. Williams, president, Federal Reserve Bank of Philadelphia, since July 1, 1941. At the time of his appointment as president he was dean of the Wharton School of Finance and Commerce of the University of Pennsylvania, having been a member of the faculty of the Wharton School since 1915.

Wilbur D. Fulton, president, Federal Reserve Bank of Cleveland, since May 14, 1953. He began his service with the System as an examiner at the Federal Reserve Bank of Cleveland in 1933, advancing through the positions of chief examiner, vice president in charge of the Cincinnati branch, and first vice president.

Hugh Leach, president, Federal Reserve Bank of Richmond, since March 12, 1936. He began his service with the Federal Reserve System in 1920 as a clerk in the auditing department of the Federal Reserve Bank of Richmond and advanced to positions of auditor, managing director of the Charlotte and Baltimore branches, and first vice president.

Malcolm Bryan, president, Federal Reserve Bank of Atlanta, since April 1, 1951. He taught economics at the University of Georgia, 1925–36; economist with Board of Governors of the Federal Reserve System, 1936–38; vice president of the Federal Reserve Bank of Atlanta, 1938–41, and first vice president, 1941–46; vice chairman of Trust Company of Georgia, 1946–51.

Clifford S. Young, president, Federal Reserve Bank of Chicago, since March 1, 1941. He began his service with the Federal Reserve System in 1921 as an assistant examiner at the Federal Reserve Bank of Chicago, advancing through the positions of examiner, assistant Federal Reserve agent, and vice president and secretary.

Delos C. Johns, president, Federal Reserve Bank of St. Louis, since February 1, 1951. He was in general law practice in Kansas City until 1945 when he was appointed general counsel and secretary of the Federal Reserve Bank of Kansas City.

Oliver S. Powell, president, Federal Reserve Bank of Minneapolis, since July 1, 1952. He has been associated with the Federal Reserve Bank of Minneapolis in various official capacities since 1920, except for his service as a member of the Board of Governors from September 1, 1950, to July 1, 1952.

H. Gavin Leedy, president, Federal Reserve Bank of Kansas City, since August 28, 1941. Engaged in the general practice of law prior to 1924, at which time he became counsel for the Federal Reserve Bank of Kansas City. Prior to his appointment as president, he served as general counsel, vice president, and first vice president.

Watrous H. Irons, president, Federal Reserve Bank of Dallas, since February 15, 1954. Professor of banking and finance at the University of Texas prior to coming to the Federal Reserve Bank of Dallas in 1945 as director of research. He was a vice president of the Dallas Reserve Bank at the time of his appointment as president.

Cecil E. Earhart, president, Federal Reserve Bank of San Francisco, since October 17, 1946. He began his service with the Federal Reserve System in 1917 as an auditing clerk at the Federal Reserve Bank of San Francisco, advancing through the positions of cashier, vice president, and first vice president of that institution.

Present Members of the Federal Open Market Committee

William McC. Martin, Jr., chairman (Chairman, Board of Governors of the Federal Reserve System)
Allan Sproul, vice chairman (president, Federal Reserve Bank of New York)
C. Canby Balderston (member, Board of Governors)
Malcolm Bryan (president, Federal Reserve Bank of Atlanta)
H. G. Leedy (president, Federal Reserve Bank of Kansas City)
A. L. Mills, Jr. (member, Board of Governors)
J. L. Robertson (member, Board of Governors)
M. S. Szymczak (member, Board of Governors)
James K. Vardaman, Jr. (member, Board of Governors)
Alfred H. Williams (president, Federal Reserve Bank of Philadelphia)
C. S. Young (president, Federal Reserve Bank of Chicago)

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Present Membership of Executive Committee of Federal Open Market Committee

William McC. Martin, Jr., Chairman
Allan Sproul, Vice Chairman
J. L. Robertson
M. S. Czymczak
Alfred H. Williams

Federal Advisory Council

William D. Ireland, Boston district
Henry C. Alexander, New York district
Geoffrey S. Smith, Philadelphia district
George Gund, Cleveland district
Robert V. Fleming, Vice President, Richmond district
Wallace M. Davis, Atlanta district
Edward E. Brown, President, Chicago district
W. W. Campbell, St. Louis district
Joseph F. Ringland, Minneapolis district
Charles J. Chandler, Kansas City district
Geo. G. Matkin, Dallas district
John M. Wallace, San Francisco district
Herbert V. Prochnow, Secretary

Membership of Federal Open Market Committee, March 1953 through February 1954

(Note.—March 1 is the beginning of the committee's organization year.)

William McC. Martin, Jr., Chairman (Chairman, Board of Governors of the Federal Reserve System)
Allan Sproul, Vice Chairman (president, Federal Reserve Bank of New York)
J. A. Erickson (president, Federal Reserve Bank of Boston)
R. M. Evans (member, Board of Governors)
Ray M. Gidney (president, Federal Reserve Bank of Cleveland) [1]
Delos C. Johns (president, Federal Reserve Bank of St. Louis)
A. L. Mills, Jr. (member, Board of Governors)
Oliver S. Powell (president, Federal Reserve Bank of Minneapolis)
J. L. Robertson (member, Board of Governors)
M. S. Szymczak (member, Board of Governors)
James K. Vardaman, Jr. (member, Board of Governors)

Members of Executive Committee of Federal Open Market Committee, March 1953 through February 1954

William McC. Martin, Jr., Chairman
Allan Sproul, Vice Chairman
J. A. Erickson
R. M. Evans
A. L. Mills, Jr.

Membership of Federal Open Market Committee, March 1952 through February 1953

William McC. Martin, Jr., Chairman (Chairman, Board of Governors of the Federal Reserve System)
Allan Sproul, Vice Chairman (president, Federal Reserve Bank of New York)
Malcolm Bryan (president, Federal Reserve Bank of Atlanta)
C. E. Earhart (president, Federal Reserve Bank of San Francisco)
R. M. Evans (member, Board of Governors)

[1] On June 11, 1953, W. D. Fulton (president, Federal Reserve Bank of Cleveland) assumed his duties as a member of the Federal Open Market Committee, succeeding Ray M. Gidney, whose resignation was effective Apr. 16, 1953.

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Hugh Leach (president, Federal Reserve Bank of Richmond)
A. L. Mills, Jr. (member, Board of Governors)
Oliver S. Powell (member, Board of Governors) [2]
J. L. Robertson (member, Board of Governors)
M. S. Szymczak (member, Board of Governors)
James K. Vardaman, Jr. (member, Board of Governors)
C. S. Young (president, Federal Reserve Bank of Chicago)

MEMBERS OF EXECUTIVE COMMITTEE OF FEDERAL OPEN MARKET COMMITTEE, MARCH 1952 THROUGH FEBRUARY 1953

William McC. Martin, Jr., Chairman
Allan Sproul, Vice Chairman
Hugh Leach
Oliver S. Powell [3]
James K. Vardaman, Jr.

MEMBERSHIP OF FEDERAL OPEN MARKET COMMITTEE, MARCH 1951 THROUGH FEBRUARY 1952

Thomas B. McCabe, Chairman [4] (Chairman, Board of Governors of the Federal Reserve System)
Allan Sproul, vice chairman (president, Federal Reserve Bank of New York)
Marriner S. Eccles (member, Board of Governors)
R. M. Evans (member, Board of Governors)
Ray M. Gidney (president, Federal Reserve Bank of Cleveland)
R. R. Gilbert (president, Federal Reserve Bank of Dallas)
H. G. Leedy (president, Federal Reserve Bank of Kansas City)
Edward L. Norton (member, Board of Governors) [5]
Oliver S. Powell (member, Board of Governors)
M. S. Szymczak (member, Board of Governors)
James K. Vardaman, Jr. (member, Board of Governors)
Alfred H. Williams (president, Federal Reserve Bank of Philadelphia)

MEMBERS OF EXECUTIVE COMMITTEE OF FEDERAL OPEN MARKET COMMITTEE, MARCH 1951 THROUGH FEBRUARY 1952

Thomas B. McCabe, Chairman [6]
Allan Sproul, Vice Chairman
Marriner S. Eccles [7]
M. S. Szymczak
Alfred H. Williams

Mr. Sproul, we would now like to have a few remarks from you.

Mr. SPROUL. Mr. Chairman, if I heard you correctly, you spoke of me as the Chairman of the Federal Open Market Committee. I am only the Vice Chairman. The Chairman of the Board of Governors is also Chairman of the Federal Open Market Committee.

I share with Chairman Martin the pleasure in having my associates here, having undergone, as he has, at times, the dubious privilege of being here alone without the support of these associates.

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[2] Resignation of Oliver S. Powell as a member of the Board of Governors was effective June 30, 1952, at which time he ceased to be a member of the Federal Open Market Committee.

[3] As of July 1, 1952, A. L. Mills, Jr., as first alternate, succeeded Oliver S. Powell.

[4] In April 1951, William McC. Martin, Jr., succeeded Thomas B. McCabe as Chairman of the Board of Governors and as Chairman of the Federal Open Market Committee.

[5] Edward L. Norton resigned as a member of the Board of Governors effective Feb. 1, 1952, and as of that date ceased to be a member of the Federal Open Market Committee.

[6] In April 1951, William McC. Martin, Jr., succeeded Thomas B. McCabe as chairman of the executive committee.

[7] In July 1951, Oliver S. Powell, as first alternate, succeeded Marriner S. Eccles.

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I am going to speak of something which I am sure is not the major concern of your hearing, just as it is not the major concern of the Federal Open Market Committee, but nevertheless it is something which I do not think was covered, from my point of view, in the answers submitted to you by the Chairman of the Board of Governors and, therefore, if I may take your time, I would like to refer to it. It is, perhaps, what might be called the negative, in answer to your question No. 3.

Your subcommittee addressed five questions to the Chairman of the Board of Governors, and his answers have been made available to other participants in these hearings, as well as to the public.

With respect to the answers to questions 1, 2, 4, and 5, I am in general and substantial agreement, even though there might be some shades of difference of opinion or degrees of emphasis in answers to the same questions which I might prepare.

This suggests the first point I would like to make: So far as general credit policy is concerned, there has been a high degree of unanimity within the Federal Reserve System throughout the period covered by your inquiry, that is, since March 1951.

Our differences, or my differences with other members of the Federal Open Market Committee, have related to the techniques of open market operations, not to general credit policies.

It is to these questions of techniques that your question No. 3 is directed. Here again I can express a good deal of agreement with much that is included in the answer of the chairman. It is a persuasive and stimulating discussion of the issues involved. Yet there is also a good deal with which I disagree, and my conclusions as to the most effective use of open market operations, to implement credit policy and to promote economic growth and stability, diverge quite sharply from those set forth in the answer of the Chairman.

His answer is, of course, responsive to the question of the subcommittee, which asked for affirmative support of the actions of the Federal Open Market Committee to which it refers, not for the arguments for and against such actions.

Obviously, there is not time here for a full-dress presentation of the negative side of the question. I should like to make certain points which, I think, are significant to an understanding of the problem, however, and I should be glad to submit to the committee later, if it so desires, a written statement of views which might match the answer of the chairman in completeness and I would hope, in persuasiveness.

First, as a matter of background, I think I should say that I am not for pegging Government security prices nor for trying continuously to determine the structure of interest rates by means of open market operations. As one of the principals in the fight to free the Federal Reserve System from the pegging of prices of Government securities, throughout a difficult period of controversy on this point, beginning in 1946, I think I have the right to make this clear. And, as one who has a great deal of respect for the operations of the market place, I would not want to be classed with those who believe that a continuously better result can be obtained, so far as the structure of interest rates is concerned, by completely substituting the judgment of the Federal Open Market Committee for the market place. If we want to find out how the patient is doing, there must be some place where we can take the patient's pulse.

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Now, taking up the real issues in this minor problem. The least controversial issue was dropping from the directive of the Federal Open Market Committee the clause authorizing open market operations to maintain orderly conditions in the market for Government securities, and substituting for it a clause authorizing operations to correct disorderly situations in the market. I voted in favor of this change, and thought it desirable, not just as a question of semantics. But I would stress the avoidance of disorderly situations rather than their correction after they have happened.

One of the virtues of credit control is supposed to be its ability to take prompt action to head off financial disturbances which might otherwise have harmful repercussions throughout the economy. If open-market operations in longer term Government securities can be used to this end, I would use them rather than wait until a disorderly situation or a crisis has developed, and only then depart from operations solely in Treasury bills.

The most controversial issue was the instruction by the Federal Open Market Committee that open-market operations must be confined to the short end of the Government securities market, except in correcting disorderly situations which, in practice, has come to mean confining operations to Treasury bills. I did not get the impression that the action was merely an assertion of the power of the Federal Open Market Committee to determine whether and when the System Open Market Account should engage in transactions outside of the short end of the market. There need not be any question of the power of the full committee to determine the conditions and the general timing of operations in the longer term areas of the market.

I was concerned with the strong emphasis which I thought was given to permanence of the "bills only" doctrine. Suggestions for publishing a set of rules of the game, references to a constitution for open-market operations, and the repeated argument that Government security dealers could not create a broad, continuous market if we did not forego operations in long-term securities—except to correct disorderly conditions—gave me the disturbing impression that we were in danger of placing ourselves in a straitjacket which would not permit us to accomplish what the Congress and the public might expect us to accomplish in terms of monetary management.

I, therefore, welcomed the statement in the answer of the chairman to your question No. 3 that the door is being kept open to a change in the present basic technique of open-market operations, and the recognition in his answer that the present approach to open-market operations is still experimental and that insufficient time has elapsed to draw firm conclusions as to its performance. The publication of these views should help to dispel the idea that present techniques have been adopted for all time, and should help to avoid further hardening of the dangerous opinion that any future operations by the System in the long-term market will be the signal of a critical situation.

I also welcome the repeated references, in the answer of the chairman, to the concern of credit policy with developments in the long-term sector of the market and the assertion of the particular concern of the Federal Open Market Committee that its policies be reflected in the cost and availability of credit in the long-term markets. It has been, and still is, my contention that this concern can find its best

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expression, at times, in open-market operations specifically directed at these longer-term markets.

This is, perhaps, the variant approach to open-market operations briefly commented upon, and summarily dismissed, beginning on page 20 of the answers of the chairman to your question No. 3. As set forth there, it is described as a method of operation in which—

> the Federal Open Market Committee would normally permit the interplay of market forces to register on prices and rates in all of the various security sectors of the market, but would stand ready to intervene with direct purchases, sales, or swaps in any sector where market developments took a trend that the committee considered was adverse to high-level economic stability.

That seems to me to be an eminently reasonable approach to our problem, but it has never really been tried—not even in the period 1951–53 to which the chairman refers. And now it has been dismissed on what I believe is the shaky assumption that it "did not appear to offer real promise of removing obstacles to improvement in the technical behavior of the market."

This probably brings us down to the nub of the differences. The Chairman's answer to your question No. 3 embraces the view, with which I agree, that the "depth, breadth, and resiliency" of the Government securities market, or its "continuity and responsiveness," should be furthered by all means that are consistent with a credit policy of maximum effectiveness, and that, in general, the greater the "depth, breadth, and resiliency" of the market, the greater will be the scope and opportunity for effective credit control through open-market operations. But the proof of that pudding must be found in the actual market, not in a theoretical discussion of a supposedly ideal market.

The answer of the Chairman asserts that the market has become increasingly stronger, broader, and more resilient since the Committee adopted the "bills only" technique. It suggests most persuasively why, theoretically, this should be so. But it does not prove that it has actually happened. In fact, I wonder whether we are talking about the same market, and what are the definitions of "strength" and "breadth" that are being used. It is my information and observation that the market for longer term securities has remained at least as "thin," under existing open-market procedures, as it was before these procedures were adopted.

I think it has lost depth, breadth, and resiliency, whether you view it in terms of dealer willingness to take position risks, volume of trading, or erratic price movements. We must not be misled by the claims of one or two dealers who urge the present techniques and now proclaim that they are helping to create a broader market for Government securities.

I do not think we have helped to create such a market. And, therefore, I do not see how the responsiveness of cost and availability of credit in all sectors of the market since June 1953 can have been the result of a progressive strengthening of the Goverment security market growing out of the actions of the Open Market Committee with respect to the open-market techniques. Much of the success of the System's actions during this period has derived from the promptness of adaptation of overall credit policy to changes in the economic situation, and to a high degree of coordination of Federal fiscal policy and debt management with credit policy. For the rest, it has sometimes

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taken massive releases of reserves, under the techniques adopted or in support of those techniques, to accomplish what might have been accomplished more economically with the help of limited direct entry into the long-term market.

I am hopeful, therefore, that the present period of experimentation will not be too long extended, and that we shall soon have an opportunity to experiment with the middle way—the variant approach—which I mentioned earlier.

One final comment should be made, perhaps, in connection with your question 3 on the discontinuance by the Federal Open Market Committee of direct supporting operations in the Government's security market during periods of Treasury financing.

I would agree that the system open market account should not, as a matter of routine, provide such direct support, but I would also say that we cannot, as a matter of routine, turn our back on such support.

The emphasis in the present approach to Treasury financing is good. The Treasury should meet the test of the market, in relation to other credit needs of the economy, to the fullest possible extent. But too rigid application of this doctrine is questionable as a matter of market procedure and Treasury-Federal Reserve relationships. In periods of credit ease, when policy considerations point to the need of keeping Treasury demands from draining credit away from desirable private use, reliance on bill purchases alone may lead to unwanted consequences. The flooding of funds into the bill market, in order to assure adequate credit in the areas tapped by the Treasury, may produce an undue enlargement of bank reserves, or an extreme distortion in Treasury bill prices and yields, or both.

There will also be times, particularly in periods of credit restraint, as distinguished from the recent period of overall credit ease, when rigid application of the present rule may result in serious collisions of debt management and credit policy, which might have been avoided without jeopardizing the overall public interest.

Now, let me repeat, what I have been discussing are disagreements over techniques of open-market operations, not over general credit policy. It is good to have these differences opened up, and I hope that this hearing will result in more discussions of the problems involved by an informed public. We in the Federal Reserve System cannot consider ourselves to be the sole repositories of knowledge in these matters. What I have been most afraid of is that we might come to think that we can indulge in the luxury of a fixed idea. There is no such easy escape from specific and empirical decisions in central banking. We cannot have a general formula, a kind of economic law, which will serve the ends of credit policy under all sorts of economic conditions.

I apologize if I have taken too much of your time.

Senator FLANDERS. Mr. Sproul, the responsibility of the congressional committee across the table from you lies ultimately in recommendations for legislation. As preparatory to that, it lies in comprehension of the problem concerning which we are to recommend.

You have contributed to that comprehension. It is not quite clear in my mind whether you have the feeling—but I judge you do not have the feeling—that the structure which has been set up by legislation needs changing. At least if you do have the idea that it needs

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changing, I did not note that you brought it out in your discussion.

Mr. SPROUL. I have no such idea.

Senator FLANDERS. So that you were engaged in the necessary and often difficult task of increasing our comprehension.

Mr. SPROUL. I hope so.

Senator FLANDERS. Yes; thank you.

Did I note that the points to which you addressed yourself related largely to the technique of operation?

Mr. SPROUL. Yes, you did, and they related to your question No. 3 which you addressed to the Chairman of the Board of Governors.

Senator FLANDERS. Yes.

Mr. SPROUL. It was an attempt to supplement his answer.

Senator FLANDERS. And the general impression I got from your statement was that you were not personally favorable to too rigid rules, but felt that there should be a good deal of flexibility.

You mentioned that in connection with the question of whether the Board and the Open Market Committee should concern itself solely with the short end of the market. I think you raised the same question of rigidity with regard to another point, as to whether the open market system should intervene in the markets at the time when the Treasury was floating a new issue.

In both of those cases, I take it, you feel that it is not wise to have too rigid rules to go by?

Mr. SPROUL. I think that is right. But I think my fellow members were not abandoning concern with other parts of the market than this short market. They were really confining their operations to that part of the market, but are still concerned, as I am, with the other areas of the market.

Senator FLANDERS. Yes.

Mr. SPROUL. But, in general, I was objecting to too rigid rules of conduct.

Senator FLANDERS. I think we have our minds clearer on that, I think, at the moment.

I would like to ask Chairman Martin to give us his understanding of the way in which the controls applied to the short end of the market affected (1) the whole range of Government securities and (2) affected the longer range purposes of the Federal Reserve Board's sphere of influence.

Mr. MARTIN. I would like to say, Mr. Chairman, that I am glad this statement is available. I hope that the members of the committee will read Mr. Sproul's statement along with the statement that I have made here, because this is a fairly complex subject.

Now, as Mr. Sproul has stated, this discussion is over techniques and procedures, not over policy itself.

Having come out of the Treasury and into the Federal Reserve, and having seen the open-market operation from both sides of the fence, my own view is directly contrary to Mr. Sproul's. I believe that the depth, breadth, and resiliency of the market is being improved: That is, that we are developing a broader, stronger, more vigorous market when the trade, so to speak, knows in a general way that we will deal, for the most part, though not as a fixed rule, nor for all time—as I have been very careful to spell out in my answer—in the closest equivalent to money that there is.

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Now, that does not mean that we are not interested in interest rates or that we are not influencing interest rates. It does mean that we confine ourselves to supplying and absorbing reserves in the shortest area of the market and let the processes of the market channel those reserves throughout all the other areas and maturity sectors of the market. As Mr. Sproul states, and as I state, this is still an experimental technique, but it is my view that we will do better by not applying the slide rule to the market, thus permitting the market to make its own adjustments around the supply of reserves that we put in.

Now, Mr. Sproul would disagree with me as to how effective this technique has been during the period it has been in use.

My own judgment is that it has been very effective and very useful, and has contributed to a better Government securities market; but that is a matter that I think the Open Market Committee will continue to wrestle with for some time to come. Our sole objective is to operate in the most effective way in the public interest.

Senator FLANDERS. Perhaps I wished to ask an earlier question than the one which I just asked you, which related to the way in which, in your judgment, operations on short-term obligations affect interest rates, as a whole and, presumably, affect the market for the long-term operations.

There is, perhaps, a question which should be asked before that one. The primary question might be: What is the Federal Reserve System for? What are your ultimate objectives?

I may interpose there a remark of my own which is to the effect that in my conception, all governmental objectives are ultimately human objectives, they are for the sake of people.

Is there too long a connection, in your mind, from the open-market operation on short-term paper down here to where Mr. X lives so that it is difficult for you to tell us what this has to do with Mr. X?

Mr. MARTIN. Let me say, first, that I think that funds spread faster through the market with minimum intervention than with maximum intervention.

Now, when we talk about a free market, we are not talking about absolving the Federal Reserve of its responsibility to regulate the money supply. That is the problem that you gentlemen have charged us with resolving. We do that by supplying reserves and absorbing reserves. It is my conviction that we do the most service, for the individual that you are talking about, consonant with the concept of private competitive enterprise, by giving the play of the market the maximum influence that it can have without disruptive effects.

Senator FLANDERS. But now without going through all the multiple steps down to Mr. X, you are saying this: that the policies you have in mind lead toward a high degree of freedom in the market for Government securities and other evidences of debt; that, in your judgment, it supports the free competitive system and that, in your judgment, a reasonably free competitive system, as free as is practicable, in consideration of other interests, does lead toward a better living for Mr. X? Is that the chain that you are going to follow?

Mr. MARTIN. That is my contention.

Senator FLANDERS. I just wanted to establish that chain, because otherwise I have comparatively little interest in this hearing, just between you and me.

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Now, that having been established, I shall shortly stop my questions, except for one horse which I want to trot out of the stable in a minute. I would like first to have your idea as to how your operations largely confined to short-term paper affect interest rates all through the structure and affect the long-term paper, as well.

Mr. MARTIN. Well, I think the process of arbitrage, which is the adjustment which Mr. Sproul thinks has more of a lag than I think it has, takes place very quickly in the market for Government securities.

I believe that when we inject funds via the closest equivalent to money that there is—and do not forget that does not always have to be 90-day bills, they might not be available, I am talking about the short end of the market—that the injection of those funds will quite rapidly permeate to the other areas of the market and will be reflected by the forces of the market in changes in interest rates throughout the market.

Now, if we should operate directly in all maturities, we could, perhaps, be wise enough to know just what the relationships between the prices of different securities ought to be at all times. But we would have to use a slide rule to determine these relationships. While I respect Mr. Sproul's judgment, I think that that is a step toward pegging which he deprecates just as much as I do.

Senator FLANDERS. The question then arises as to the timelag; the question is how quickly the one operates or how slowly, and whether it operates too slowly or not.

One other question on this point. When you speak of the nearest thing to money, you are speaking of short-term securities which are taken up by the banks?

Mr. MARTIN. That ght.

Senator FLANDERS. And it is the fact that they are taken up by the commercial banking system which makes them the nearest thing to money; am I right in that? And that long-term instruments which may be bought for semipermanent investment do not have the same effect of injecting money into the market as the short-term ones.

Mr. Sproul points out they can be taken up by others than banks also. Any purchase by the Open Market Committee injects money into the market.

Senator FLANDERS. Yes, that is right.

Mr. MARTIN. Yes.

Senator FLANDERS. Without any excuse whatsoever except that the horse is an old friend of mine, I would like to lead my steed out of the stable. It came to my mind a number of times in the discussion yesterday and this morning. For the life of me, when we speak about the quantity of money, I cannot understand why there is so little interest in the Board or anywhere else that I can find, in the velocity of money. Do you consider that is a constant?

Mr. MARTIN. Oh, I do not think that is correct, Senator. There is a very real interest in the Board in the velocity of money, and also in the individual Reserve banks.

Senator FLANDERS. Do you have information on that in your bulletin and on your charts? It seems to me one knows little about money if one does not join velocity and volume.

Representative PATMAN. Mr. Chairman, is it not in the Federal Reserve Bulletin each month?

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Mr. MARTIN. Yes. We do have information in the monthly Federal Reserve Bulletin on the rate of turnover of demand deposits in New York City and other reporting centers. The data are also shown in our chart book.

Senator FLANDERS. It is a very important factor.

At this point, I will turn over the questioning to other members of the committee, and I would also like to say that I think it will not be out of order from your standpoint, Mr. Chairman and Mr. Vice Chairman, if other members of the Board and other members of the group of presidents, join in the discussion from time to time as you come across something in which they have particular interest or knowledge. That is agreeable to all, I take it.

Mr. Patman?

Representative PATMAN. Thank you, Mr. Chairman. In order to bring out the importance of this great committee, the Open Market Committee, composed of the members of the Board of Governors of the Federal Reserve System and the five presidents who are on the Board at this time, of the Federal Reserve banks, I desire to quote Mr. Eccles, who testified before the Banking and Currency Committee, in which he stated:

> Now, the fact that the interest is where it is, of course, is not just an accident. The rates during the twenties and during the last war, had there been an Open Market Committee, which there was not, in the Federal Reserve System, they could have financed the last war and financed the Government during the twenties, at prevailing rates.

Mr. Monroney, who was then a member of the House and sitting on the Banking and Currency Committee of the House, asked this question:

> Do you mean to say that with your present Open Market Committee and the operation of the Federal Reserve as it now stands, that regardless of what the national income is or other economic factors, that you can guarantee to us that our interest rate will remain around 2.06 percent?
>
> Mr. ECCLES. We certainly can. We can guarantee that the interest rate, so far as the public debt is concerned, is where the Open Market Committee of the Federal Reserve desires to put it.

I bring that out to show the tremendous power of this great committee that has been properly delegated, this power, by the United States Congress.

Certainly, the Congress itself cannot carry out the constitutional requirement relating to the money and credit supply; it must delegate that power. We have done the right thing by delegating the power.

But the point is, this committee has the power to determine whether we have high interest rates or low interest rates, or whether we have good times or bad times.

This committee also has the power to send over to the Bureau of Engraving and Printing and get the printed money of our country, the Federal Reserve notes, and properly distribute those Federal Reserve notes; and I assume in the course of a year that runs into billions of dollars. The power that is lodged in this committee is tremendous.

During the last 40 years, the Federal Reserve System has taken $135 billion worth of Federal Reserve notes from the Bureau of Engraving and Printing. I bring that out to show the importance of this committee.

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Now, Chairman Martin, all these people are not members of the Open Market Committee. Of course, the Board is now composed, I assume, of six members, since you recently had a vacancy.

The other five members of the Open Market Committee representing the presidents of Federal Reserve banks, who are they?

Mr. MARTIN. I might ask them to raise their hands, that will be the simplest way. (Members of the Federal Open Market Committee are listed on pp. 220, 223 of the hearings.)

Representative PATMAN. Mr. Sproul is always a member, is he not?

Mr. SPROUL. That is by statute.

Representative PATMAN. The statute made you a permanent member, that is the New York member.

Now, the other change from time to time, and these other gentlemen who are here, representing Federal Reserve banks, they either have been—they are now or will be members of the Open Market Committee; is that right?

Mr. MARTIN. That is correct.

Representative PATMAN. And that is the reason you brought them along?

Mr. MARTIN. Well, I was requested to bring them.

Representative PATMAN. You work together, do you not, when you have a meeting of the Open Market Committee?

Mr. MARTIN. We usually do.

Representative PATMAN. Don't you have a meeting of all the presidents at the same time?

Mr. MARTIN. We usually do.

Representative PATMAN. And they, in effect, represent the Open Market Committee, whether they are officially on it that year or not?

Mr. MARTIN. Yes.

Representative PATMAN. In other words, the ordinary Federal Reserve bank, like Dallas, would have one-third of a vote at each meeting?

Mr. MARTIN. Oh, no; oh, no.

Representative PATMAN. I mean for all practical purposes. Of course, there is somebody officially on there.

Mr. MARTIN. No, you underestimate the stamina of the members of the Committee.

Representative PATMAN. I should not have named Dallas; I should have named some other city.

But now, then, these 11 members represent the Open Market Committee. The executive committee that carries out the orders and instructions of this committee, how many are they?

Mr. MARTIN. There are five.

Representative PATMAN. They are five. Now, you are always on that Committee, Mr. Sproul is always on that committee; who is on that committee now representing the banks?

Mr. MARTIN. Will the three members that are on the executive committee, please raise their hands.

Senator FLANDERS. Mr. Sproul is a member, I mean at the present time.

Mr. MARTIN. Mr. Williams——

Representative PATMAN. And Mr. Sproul for the banks, and Mr. Martin, and who else for the Board?

Mr. MARTIN. Mr. Robertson and Mr. Szymczak.

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Representative PATMAN. They are the ones on now. Who will be on next year in Mr. Robertson's and Mr. Szymczak's places?

Mr. MARTIN. Well, it will go by rotation.

Representative PATMAN. I am bringing it up to indicate whether or not you have a certain policy or formula to go on, that certain people will come in automatically; is that right?

Mr. MARTIN. Well, we have a system of rotation; yes.

Representative PATMAN. All right.

Now, then, there is a vacancy on this Board. Who is the Vice Chairman of the Board of Governors?

Mr. MARTIN. There is no Vice Chairman at the present time.

Representative PATMAN. Does not the law say there shall be a Vice Chairman?

Mr. MARTIN. The President has the power to appoint a Vice Chairman.

Representative PATMAN. Well, does not the same law that says "shall appoint," does it not say that the President shall designate a Vice Chairman?

Mr. MARTIN. The law says that; you will have to take that up with the President, Mr. Patman.

Representative PATMAN. Well, I have taken it up with him.

How long has it been since you had a Vice Chairman?

Mr. MARTIN. I think it has been a number of years. I would have to look up the exact date.

Representative PATMAN. Is there any particular reason why you do not have a Vice Chairman, except that the President has just failed to designate one?

Mr. MARTIN. Well, we have had your committee and Senator Douglas' committee investigating us, and that has been one of the reasons why we have been studying the problem——

Representative PATMAN. What does that have to do with the Vice Chairman's selection?

Mr. MARTIN. Well, it only has to do with the fact that there might have been some changes in the composition of the Board.

Representative PATMAN. I do not see where that had anything to do with the failure of the President to—I am honestly seeking the correct information about that, Mr. Chairman.

Mr. MARTIN. Well, I am merely——

Representative PATMAN. How does that have anything to do with the failure to designate a Vice Chairman of the Board, when the law says that the Vice Chairman shall be designated?

Mr. MARTIN. I think it depends on whom you are going to designate, and I think that is a matter for the President to decide.

Representative PATMAN. That is what I say. But don't you think that the President should be importuned by the Board or call it to his attention?

I will not place that burden on you and require an answer.

How did it happen that the hard-money policy was pursued in the spring of 1953 right up to a few days after rates on veterans' guaranteed-mortgage loans were raised?

I will finish this and then ask you to comment. Does this not indicate either a failure of liaison among Government agencies or that the change in monetary policy was deliberately delayed until this action,

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unfavorable to veterans and other mortgage borrowers, was put into effect? What is your answer to that, Mr. Martin? In other words, the interest rates on FHA insured and VA guaranty of veterans' loans were raised about 3 days before the Board met and decided to reverse its policy.

If I understand correctly, you testified before another committee that the Board met on May 6, 1953, and decided to reverse policy; am I correct in that or not?

Mr. MARTIN. I think May 6 is the date.

Representative PATMAN. When you decided to reverse your policy that meant that interest rates would decline, did it not?

Mr. MARTIN. No. It takes some time for policy to work, and it might have been changed again. As you pointed out very ably in your statement, this is a fluid operation. We decided to reverse the policy on May 6. We could not be sure then how long the reversal would be or what the degree of the reversal would be. That was something that had to unfold with time.

Now, the rates to which you refer had no connection with our action whatever.

They had been out of line with the market for some time past. So far as I was concerned, and so far as I know, nobody from those agencies consulted with me with respect to this change in direction of monetary policy. There was no way of telling on May 6 or even on June 1 whether our change in policy would continue or how far it would go.

Representative PATMAN. Let us see if we agree on that rate being too low for some time. Is it not a fact, Mr. Martin——

Mr. MARTIN. I did not say too low; I said out of line with the market.

Representative PATMAN. Language like that is very appropriate and discreet; I am not trying to criticize it. The truth is that the mortgage lenders were satisfied with 4 percent as long as the long-term Government bond rate was 2½ percent; is that not right? In other words, they were satisfied with a 1½-percent spread.

Mr. MARTIN. The volume of mortgages that was being placed with investors at that time was not really high. The change in mortgage interest rates was made to bring them in line with the market, so that mortgage credit would be more readily available to veterans and others.

Representative PATMAN. Well, am I correct in stating that the lenders, mortgage lenders, were satisfied with a 1½-percent spread which was considered the traditional spread over a long period of time, and they were satisfied with it; am I right about that or not?

Mr. MARTIN. I really do not know.

Representative PATMAN. All right; that is my contention anyway, whether it is right or wrong. It was the spread they accepted for a long time.

Then when your hard money policy went into effect, commencing in January 1953, Government bonds commenced to slide, and 1 issue went down to 89. That made interest rates go up in proportion and, as Government bonds declined to where the 2½'s sold at a price that yielded 3 percent, the mortgage lenders came in and said: "Now, we are entitled to an increase in the Veterans' rate from 4 to 4½ percent; we are entitled to an increase in the FHA rate from 4¼ to 4½

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percent. The traditional spread is 1½ percent, and since the long-term rate is now 3 percent, we are entitled to 4½." Was it not on that basis that the interest rate on VA- and FHA-backed home mortgages was finally increased?

Mr. MARTIN. I have to go back a little bit, Mr. Patman. The so-called hard money policy that you are talking about was really initiated at the time of the Treasury-Federal Reserve accord, and it was not a case of——

Representative PATMAN. Well, you will cause me to take up these whole 40 minutes, and I did not want to do that, Mr. Chairman.

Mr. MARTIN. Well, in this kind of operation I cannot take a single specific point out of the picture as a whole. We are dealing with a process that goes on, with many ramifications. You cannot at any precise point say, "this is the end result." The forces of the market had been playing in the direction of higher interest rates, in my judgment, for some time.

Representative PATMAN. Well, it commenced in 1946 for the short-term rate?

Mr. MARTIN. I do not remember the precise date.

Representative PATMAN. But here is what I am talking about: The day before the inauguration, the rediscount rate was raised by important banks, most of the others had already raised it, Federal Reserve banks, one-half of 1 percent, was it not, January 1953?

Now, the rediscount——

Mr. SPROUL. One-fourth of 1 percent.

Mr. MARTIN. One-fourth of 1 percent.

Representative PATMAN. One-fourth of 1 percent, excuse me.

You know the rediscount rate is believed to have little practical significance outside of its purely psychological value, am I right on that or not?

Mr. MARTIN. The rediscount rate is a very important rate.

Representative PATMAN. Nobody was borrowing——

Mr. MARTIN. Don't you think $2 billion is a lot of borrowing?

Representative PATMAN. Is it not a fact that you have said it was strictly psychological?

Mr. MARTIN. Oh, no. The borrowings through the discount windows rose to $2 billion.

Representative PATMAN. Well, at any rate, that was my understanding. It was strictly psychological to let the Federal Reserve banks know that we are going to have tighter credit conditions, and "you fellows might just as well get ready for it." This is just kind of an unconversational understanding.

Mr. MARTIN. The adjustment of the discount rate at that time was to bring it closer in line with the market then existing.

Representative PATMAN. But that is when I thought that notice was given to the world that you were starting on a real hard money policy, and I think the bankers of the country recognized that as a signal, that is what I thought.

But, anyway, when the bonds began to decline afterwards more than they had in the past, and much more rapidly, and as the interest rates went up, that is when lenders began to ask for a higher interest rate on housing loans, and the rate was increased just 4 days before you took an about-face on your policy, Mr. Martin.

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It occurs to me that there should be—if there was no liaison between your department and these other lending agencies, there should be. What liaison do you have?

Mr. MARTIN. I think we have pretty good liaison. I want to point out that when the policy was changed on May 6, there was no certainty at that time that we would continue the new policy. It gradually unfolded in response to developments.

Representative PATMAN. As to how long you would do it.

Mr. MARTIN. You have to move very delicately in this operation, and that is the way we started to move.

Representative PATMAN. I see.

This morning I interrogated the Secretary of the Treasury about the debt of the Government, and the question came up about the ability of the Treasury to borrow money from the Federal Reserve banks to take care of their unpaid bills. I think it has been referred to in the past as the Treasury overdraft. You know the bill I am talking about?

Mr. MARTIN. That is right.

Representative PATMAN. For years, commencing about 10 or 12 years ago Congress has passed a law which has been extended each year, sometimes 2 years at a time, that gave the Treasury the privilege, if it wanted to, to call on the Federal Reserve banks to finance any short-term obligations or debts up to $5 billion. Now, that is still the law, is it not?

Mr. MARTIN. That law was passed by the Congress.

Representative PATMAN. And it is up to the Secretary of the Treasury as to whether or not it is used, is it not? It requires no action on the part of the Federal Reserve banks.

Mr. MARTIN. Oh, yes, it requires action. The law gives the Reserve banks the power but does not make it mandatory on them. We discuss every instance with the Secretary of the Treasury.

Representative PATMAN. I know, but you cannot refuse to give the credit, can you?

Mr. MARTIN. We could. Also, if we thought it was being abused we could bring it to your attention.

Representative PATMAN. I know, you would bring it to the attention of Congress, but, as long as there is the law, you feel that you are compelled to finance any expenses of the Government up to $5 billion directly between Federal Reserve banks and the Treasury without going through the open market or the banks or any brokerage office. You are obligated to do that, are you not?

Mr. MARTIN. Not obligated—the Reserve banks have the authority. In practice, it is a very short-term operation.

Representative PATMAN. Well, that is right.

Mr. MARTIN. And I know of no instance when it has been abused.

Representative PATMAN. I am not talking about the abuse of it; I am talking about the use of it; use, not abuse.

Now, the point I am making is why should you have any deposits in banks at all? I will not ask you to answer that, because it is really the Treasury's business when they can call on you any time, and you will finance any of their obligations up to $5 billion; that is the reason I say that they should not keep six or seven billion dollars in the banks all the time; it is unnecessary.

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Now, if the banks need that to compensate them for other things, why, pay them for it. I do not want to deprive the banks of anything, but I do not want to keep idle and unused balances there. I am just trying to show that the Federal Reserve banks may advance to $5 billion to the Treasury at any time, as long as this law is upon the statute books; that is right, is it not?

Mr. MARTIN. Only if they felt it proper. The authority is one that is used in connection with short-term advances.

Representative PATMAN. That is right; yes, sir; that is all. I will not press you on it, Mr. Martin.

Mr. SPROUL. I would question that, Mr. Congressman.

Representative PATMAN. All right, Mr. Sproul, what is your question about it?

Mr. SPROUL. I think the Congress has shown great reluctance to grant that power to the Secretary of the Treasury to borrow directly from the Federal Reserve banks, because it was unwilling to have such a grant of power except for very short-term use under very special conditions, and that the whole legislative history of the power would be one which would justify us in coming immediately to the Congress if the Secretary of the Treasury tried to abuse the power in the way you suggest.

If Congress wants to indicate that is the way it should be used, that would be a different matter, but it has not so far, and there is nothing in the legislative history to suggest it.

Representative PATMAN. I do not agree with you, Mr. Sproul. I have been on the committee that has handled it ever since it first passed.

Senator FLANDERS. Will you yield for a moment?

Representative PATMAN. Yes, Mr. Chairman.

Senator FLANDERS. It is my recollection that in the Finance Committee we have considered that authority primarily as a means for getting past the hump of the income-tax payments. From the standpoint of the Senate, at least, I think we had that purpose primarily in mind.

Representative PATMAN. That is right; that was given as an illustration. In other words, there is a certain time that the Treasury needs money. That was an illustration that has been given. It is given in the House all the time.

But the point is, and the fact remains, that the Treasury has the power to draw upon the 12 Federal Reserve banks up to $5 billion to finance its bills; that is the law of the United States Congress, and signed by the President of the United States; and, for that reason, there is no reason why you should have these idle deposits in the banks.

Now, I will go right ahead. Since the Secretary of the Treasury is legally enjoined from holding Government bonds, and properly so, for the reasons that we know, since their value may be influenced by his official decisions, should the chairman and members of the Federal Reserve Board, and the Open Market Committee, of course, be restricted in a similar manner as to trading in bonds and stocks whose levels can be influenced by monetary decisions? If the public buys stocks because of the easy money decision of the Board, isn't someone, the Board, in a good position to profit by advanced knowledge of these decisions?

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What kind of rules or regulations do you have, Mr. Chairman, about members of the Board dealing in Government bonds or stocks on the market? Do you have any?

Mr. MARTIN. I am glad to tell you that I do not own a single stock, and I do not trade in stocks or bonds.

Representative PATMAN. I am not questioning you personally, Mr. Chairman, but I am just asking, as a matter of policy, for the Government of the United States.

Mr. MARTIN. I understand that, but I would like to put that in the record in connection with this case. I do not have a single stock nor own a bond, outside of series E bonds, personally, because I take my job that seriously.

So far as rules and regulations are concerned, we do not have any statutory rule on the part of the Board of Governors. However, the Board has a rule which is annually called to the attention of every employee that if he uses confidential information for any improper purpose he will be subject to appropriate disciplinary action. I know that the individual Reserve banks have watched this matter very closely and that their staffs are subject to a similar rule.

We take this matter extremely seriously. I do not believe there is any rule which would precisely bind people that would be effective. You are depending upon the integrity of this group. Nobody realizes more clearly than I do from my long association in markets how easy it would be to abuse the position that we have; that is why I am very careful not to make comments on margin requirements or comments on Federal Reserve policy in open meetings or around the country because it could be construed by speculators for their own use. I cannot prevent that sort of discussion from going on, but I have been extremely careful about making any comments of that sort.

Representative PATMAN. I do not bring this up to impugn the motives of yourself, Mr. Chairman, or any other member.

Mr. MARTIN. I understand that, Mr. Patman.

Representative PATMAN. I am just asking that as a matter of information, knowing that the Government has always been very careful about things like that, and I did not know of any rules.

Now, you do not have any rules yourself except just each member is supposed to do what is ethically right and not do anything wrong; but what about the people who conduct the Open Market Committee?

I read in a financial paper not so long ago that about a hundred people had something to do with the operation of the Open Market Committee; is that right or not?

Mr. MARTIN. I do not know the exact number.

Representative PATMAN. Mr. Sproul might tell us about that since he has charge of the Open Market Committee, I mean the executive part of it.

Mr. SPROUL. There are not a hundred people who know what the policy of the committee is and how it is going to be executed.

Representative PATMAN. How many know that, Mr. Sproul?

Mr. SPROUL. Really only the members of the committee and the manager of the system of the open-market account can know that in its entirety, although the staff of the committee itself will know pretty largely what the Open Market Committee has in mind, but the rest of the 100 people that you read about must have been people who are——

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Representative PATMAN. Clerks and stenographers.

Mr. SPROUL (continuing). Clerks and stenographers and secretaries who do not know what the policy is and could not make any use of the information they have if they had any designs or desire to.

Representative PATMAN. Do you have any rules or regulations about the ownership of stocks and bonds, whether it is Government bonds or otherwise?

Mr. SPROUL. We have the rule that no one in our bank is allowed to purchase securities on margin. There is no prohibition against their purchasing securities of any kind outright.

We also have a general rule that no one is to engage in any transactions of any sort, particularly financial transactions, which would in any way bring the bank or the system into disrepute, and that is the kind, the only kind, of rule I think you can make to cover this situation which must place great reliance on the honor and integrity of the individuals you are working with.

Representative PATMAN. Do you not agree, Mr. Sproul, that since the Congress has had a standing rule that the Secretary of the Treasury, for instance, could not even own a Government bond, that that is notice to all other agencies, such as your own, that similar rules should probably be adopted?

Mr. SPROUL. That is a matter for the Congress to decide. Whether you get better results from a hard and fast rule of that sort, as to which there may be legal or technical evasions, or whether you get better results by having the general rule and trying in every way you can by adequate supervision to see that it is enforced, I could not say.

Representative PATMAN. All right.

Now, I will make it short, Mr. Chairman.

To prevent the accumulation of unemployment, and restore employment and production to normal capacity, it is estimated that we should increase the gross national produt rate by about $30 billion above the current rate in the next year. A normal capacity gross national product rate in 1955 should reach $386 billion.

Can we do this, Mr. Martin, and still have a sound money policy?

Mr. MARTIN. I cannot comment on whether it takes $30 billion of increase in the gross national product to provide that number of jobs.

Representative PATMAN. Well, we will change that. It is down $14 billion from last year, isn't it?

Mr. MARTIN. I want to say that it is my absolute conviction that inflation will not create jobs and sustain them. If we maintain a stable price level and a sound dollar, I believe we will create jobs that will be sustained and that will really add something to our economy.

I think that it would be a delusion to believe that we can disregard stability, the stability of the dollar, and create jobs by froth of the sort that occurs often from waste and extravagance and incompetence and imprudence, and all the bad habits that go along as byproducts of inflation. If we were to believe that, we would be doing a disservice to our goal of having as high levels of employment as we can possibly have in this country.

Representative PATMAN. Which do you consider comes first, full employment or a stable price level?

Mr. MARTIN. I do not believe you can separate them. It depends on your——

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Representative PATMAN. Suppose there is an alternative, I mean, you cannot have both right at the present time. Which would you select?

Mr. MARTIN. The definition of the term "full employment" is a difficult one. But if you are talking about full employment in terms of having it for just a couple of months and then having the jobs disappear, that is one thing. If you are talking about employment that is——

Representative PATMAN. Lasting.

Mr. MARTIN (continuing). Permanent, lasting employment, I believe you can——

Representative PATMAN. You think the price level should come first?

Mr. MARTIN. I think it is an important ingredient. I do not know on which you put the most emphasis at a given time because the level of employment has an effect on the price level.

Representative PATMAN. I want to ask Mr. Sproul a question.

Mr. SPROUL. May I make a comment on that question?

Representative PATMAN. Certainly, sir.

Mr. SPROUL. I agree with the findings of the Patman subcommittee of the Joint Committee on the Economic Report that high-level employment and price stability are not necessarily incompatible, and I would like to see that spelled out in the declaration of policy in the Employment Act of 1946.

I think those who would seek to obtain high-level employment by a form of creeping inflation, induced by credit policy, are trying to correct structural maladjustments, inevitable in a highly dynamic economy, by debasing the savings of the people. They should tell the holders of savings bonds, savings deposits, building and loan shares, life-insurance policies and pension rights, and other small savers, that a rise in prices of say 3 percent a year is a small price to pay for removing the swings of unemployment.

If our dynamic, growing economy throws too many people out of work from time to time, we will have to devise further means, resting on the whole economy, to take care of the situation. We cannot debauch credit policy, trying to make it do the job, and we should not steal the savings of the people with one hand, while we promise them a steady job with the other.

Representative PATMAN. I want to ask you a question, Mr. Sproul: What was the nature of the Government bond transactions carried out by the New York Federal Reserve Bank from May 27 to June 10, 1953? What significance, if any, did the $20 million reduction in the New York bank's bond portfolio have for the investors in the Government bond market? Did the inter-bank bond transactions carried out in this period have any connection with the break in bond prices on June 1?

Mr. SPROUL. I cannot speak for every transaction during that period or on that date, but I would say that the actions of the New York banks were only one small part of a whole market situation which developed at that period. Our transactions, as you know, were wholly in Treasury bills during the period you mentioned.

Representative PATMAN. As I understand it, the Open Market Committee has been in operation for 20 years and the Federal Reserve for 41 years. Before the Open Market Committee was officially set up

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by law, each bank carried on its own open market operations; did it not?

Mr. SPROUL. Yes, it did.

Representative PATMAN. One of the first reasons for having any open market operation was to get more earnings; was it not?

Mr. SPROUL. That was the original reason, but that quickly lost its meaning. The ultimate reason, and the continuing reason, for the Open Market Committee is to get coordination of open market operations throughout the system.

Representative PATMAN. Well, naturally, it was easy for a bank to get Federal Reserve notes and trade them for Government bonds and keep the bonds and collect the interest. They had earnings that way, and that is what started the open-market operations, as I understand it from your testimony and Mr. Martin's testimony in the past. But now I thought all the banks had to go along together in their bond selling and buying. I though that your bank, Mr. Sproul, was just a part of the Federal Reserve System—of course, it is a huge part, a major part—but it is a part, and that of the bonds that were bought by the Open Market Committee, you got your share and no more; is that right?

Mr. SPROUL. We get our proportionate share.

Representative PATMAN. That is what I mean.

Mr. SPROUL. It is based on the total assets of the Reserve banks with a formula related to it.

Representative PATMAN. That is what I am trying to say, your proportionate share. Why was it along during that period that your bank lost about $20 million in Government bonds and the banks, say, at Boston and at Atlanta, I believe they were, gained about $20 million? How did that happen?

Mr. SPROUL. Because in the formula which we then used there were allowances for the differences in the expenses and the reserve needs of the individual reserve banks. There is an adjustment made at the end of every quarter, and there may have been an adjustment at that time which transferred some securities from the New York bank to some of the other Federal Reserve banks, but it had nothing to do with the open-market transactions; it was a wholly internal transfer of a small amount of securities between the reserve banks.

Representative PATMAN. Now, the banks engage in no open-market operations themselves, I mean individually as a bank?

Mr. SPROUL. Under the law, the Federal Open Market Committee directs the Federal Reserve——

Representative PATMAN. That is right. They are compelled to carry out whatever the Open Market Committee says in the way of banks?

Mr. SPROUL. That is right.

Representative PATMAN. Suppose wage rates, Mr. Martin, through the process of collective bargaining, are adjusted upward, and threaten a sound money policy. Will monetary policy be permitted to adjust itself to wage developments?

Mr. MARTIN. Money policy will have to take each individual situation as it comes along. Now you are talking about wage rates which, in a country as large as this, cannot be adjusted at least at this time, across the board. You would have to be talking about it in a particular segment of industry.

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Representative PATMAN. Well, suppose we put it another way. Suppose, in order to rid our country of unemployment, it becomes a real problem, that we have a certain degree of inflation or anything else you want to call it, expansion, and the cost of production goes up.

Now, what will you do, will you try to have policies, restrictive policies, that will cause production to go down, or will you increase the flow or volume of money so that the purchasing power will be increased to take care of the added production?

Mr. MARTIN. Monetary and credit policy is just one factor in the economy. It cannot make people borrow money if they do not think they can make a profit on it. Credit by itself is not a source of jobs.

It is just, as I have said a number of times, a stream or a river that courses through business and commerce and from which business and commerce can derive assistance, but it is not in itself a force which will give us the millennium. It never will be.

Representative PATMAN. Thank you, Mr. Chairman. I will stop. I have taken up too much time.

Senator FLANDERS. You have not taken up your full allotment. The thought came to me as I listened to the discussion that there was one question that came up upon which we might hear from the presidents from the different Federal Reserve banks. The question was raised as to the very short timelag which I would think myself was a little bit unfortunate, between that historic bond issue and the raising of the mortgage rate from 4 percent to 4½ percent.

The question is raised whether that increase was justified by a forthcoming increase in rate or whether it stood on its own? I would like to know if there are any of the presidents here who would like to comment on the question as to whether there was, previous to this issue, a satisfactory amount of mortgage money available for financing home building, and whether they would have felt it necessary to raise the rate in any event in order to get sufficient funds flowing for home building.

Do any of you wish to comment on that? What was the condition in your area, Mr. Leach?

Mr. ERICKSON. Mr. Chairman, I might comment that as far as a satisfactory amount is concerned, that is a very difficult thing to answer. There were bankers who would not buy mortgages at 4 percent at the time. They had to have a higher rate if they were going to do that. Both the FHA and VA were pinched in getting their mortgages out.

Senator FLANDERS. And the lending institutions were not interested at that time in a 4-percent rate?

Mr. ERICKSON. That is right.

Senator FLANDERS. Had that existed for some time?

Mr. ERICKSON. It was growing in intensity; yes.

Senator FLANDERS. When the rate was raised to 4½, money flowed more freely into that market, and building increased; was that your experience, Mr. Irons?

Mr. IRONS. Speaking for Dallas, I would say that our experience was the same in that during the latter part of 1952 and the early part of 1953 it was very difficult to get mortgage money at 4 percent. Subsequently, when the rate was raised, there was an increased flow of money into mortgage lending—very definitely.

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Senator FLANDERS. And that resulted in a definite increase in new housing?

Mr. IRONS. Well, there have been very substantial increases, yes; but the big increase has come in more recent times since the relaxation of the credit terms. However, that increase in the rate did serve to bring about a better flow of money into the mortgage market and create a better mortgage market situation.

Senator FLANDERS. Is there any variation of the experience of the presidents on that matter?

Senator SPARKMAN. Mr. Chairman, may I intervene there?

My recollection is not in accord with the statements made. I know that that pressure was before us on the Banking and Currency Committee for a long time with reference to raising the interest rates.

The interest rates were raised on June 6 or June 3, was it—it was somewhere about that time.

I believe, if you will check, you will find that it was several months after that before there was any appreciable easing up of the housing mortgage; the home-mortgage market. I remember we remarked on it frequently during that time, and it is my opinion that the thing that started moving money into the home-mortgage market was not the increase in the interest rate. As a matter of fact, it seemed for 2 or 3 months to have the adverse effect, to dry it up still further.

I believe that the record will show that there was no appreciable effect until sometime probably several months after the reversal of the policy that the chairman referred to was anounced and put into effect.

Now, I think that is something that could very easily be explored, but in my own opinion, that is what we would find to be true.

Senator FLANDERS. From your point of view and from the experience you have just given, that would seem to raise significant questions as to the fundamental importance of the interest rate in expanding business.

Now, is that not a rather serious blow at all the theory of monetary controls and their effects, at least from your story, which I think you, knowing you, I am sure you are prepared to document with suitable statistics—does not your story indicate that the interest rate is not the all-powerful thing we are accustomed to think it?

Senator SPARKMAN. I do not know that you could draw a conclusion such as that. I think there are many factors that must be considered in connection with this.

I think the putting out of the bond issue that was discussed here this morning, produced a shock that resulted in many things that probably were not regular taking place, and I think that probably was true in connection with the home-mortgage market.

I am not saying that under normal conditions the increase in the interest rate would not have poured more money into the home-mortgage market, but I think, first of all, at that particular time, the psychology of the situation was that many people who ordinarily would have made money available, waited expecting a still higher rate, and I think others who might have poured it in were afraid of what was going to happen, they were waiting to see.

Senator FLANDERS. Mr. Fulton?

Mr. FULTON. In the investment of funds by banks, there is one factor that all banks look to, which is liquidity.

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At that time, when the mortgage market became very tight, banks, by and large, had rather full portfolios of mortgage loans. The banks had rather large demand deposits which could not be invested in mortgage loans. Such deposits go largely into short-term securities and business loons. Mortgages had been in supply and had been absorbed in large quantities. Regardless of interest rates, mortgages will not be absorbed by the banking system when it feels that it is impairing its liquidity by taking on more. That, I think, was part of the situation at that time. It was not wholly an interest-rate problem but also a matter of liquidity, so far as the banks were concerned.

Subsequently, funds became available as time deposits grew and business loans fell off. Also banks improved their liquidity by achieving a better distribution of long-term and short-term obligations. But primarily it was the availability of funds from the standpoint of maintenance of liquidity and the ability of banks to meet their obligations that influenced that market at that time.

Senator FLANDERS. Any other comments on this?

Senator GOLDWATER. Mr. Chairman, I would like to comment on this because I recall, with Senator Sparkman, having sat through these hearings. There seems to be, from the figures in the Economic Indicators of November of this year, on page 17, very little change in construction during the particular period we have been talking about.

If we look at the 1953 monthly average we find 2.9, 2.8 billions of dollars; that is 2.9 billions monthly average, and if you go through the year of 1953 by months from September, you find that that change is very, very little, and if you bring it up at the present time, the change is very little; I think that substantiates the remarks of these gentlemen that the law of supply and demand probably influences the building a lot more than interest rates.

Senator FLANDERS. Have you any other questions you would like to ask?

Senator GOLDWATER. I have none; they may come.

Senator FLANDERS. All right.

Senator SPARKMAN. Mr. Chairman, it has just been pointed out to me that in the Economic Indicators on page 18, showing the housing starts, it shows that they continued to go down, and were going down rather steeply right up until December of 1953, so there was no early response to the increase in interest rates.

Senator FLANDERS. Yes.

Representative PATMAN. It was May 3 when it was announced.

Senator SPARKMAN. Yes; I believe that is true.

Well, back in May or June 1, and you can see that the curve is going down rather sharply right on through the end of the year.

Senator GOLDWATER. I am talking about dollars, you are talking about building——

Senator SPARKMAN. I am talking about housing starts which represented, of course, mortgages that went into effect.

Senator GOLDWATER. I disagree. Mortgages are reflected by money, I do not think by starts, but there again I feel that the facts that were brought out during our hearings were that the market had become rather saturated, had a greater effect on starts than the fact that

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the interest was 4 or 4½ or any rate we might have put it at or agreed to put it at.

Senator SPARKMAN. Well, I don't agree that the market—that we had enough houses, if that is what you mean by the market having become saturated. They very fact that during the present year we are building 1,300,000 houses, that many, indicates there was no saturation, and still is none.

Senator GOLDWATER. There was a saturation at that point or they would have been sold. There has been an adjustment period as there has been in automobiles, as there has been in everything.

The point I wanted to bring out was in dollars to our economy there hasn't been any appreciable fall-off or increase anytime during the period we are talking about.

Senator SPARKMAN. I don't follow you, in view of the number of starts. That is what counts in the housing market.

Senator GOLDWATER. We are talking about mortgages, and that relates to the dollar market.

Senator SPARKMAN. The two certainly go together.

Senator FLANDERS. Senator Douglas, have you any questions?

Senator DOUGLAS. Yes, sir; I would like to have the gentlemen discuss what seems to have been a change in Federal Reserve policy beginning in December of 1952 and January 1953 from that which had prevailed during the period of the so-called accord.

I not only approved of that accord, but possibly had something to do with its conclusion, and I think it was a very great step forward.

I would like now to point out what I have been trying to point out at previous meetings, that in the ensuing 21 months, namely, March 1951–December 1952, we did not have what Mr. Martin has referred to as a "hard money" policy.

We moved instead from an easy money policy into, say, that we had a flexible money policy, because during that period of 21 months the index of fiscal production rose by 6 percent on an unadjusted basis to 9 percent on a seasonal or adjusted basis, somewhere between 6 and 9 percent.

During that period, too, member bank reserves in the system rose by 5 percent, approximately, that is. The Reserve was buying Government securities at approximately the same rate as the index of fiscal production advanced.

It is true that loanable funds by banks were increased somewhat more than that, but the net result was a stable price level and maintenance of full employment.

I congratulate the Federal Reserve System and the Open Market Committee for the work which they did during these 21 months.

The question I raise is whether it was wise to change this policy, as I think it was changed in December of 1952 or January 1953.

Now I would like to point out that during the ensuing months according to the Reserve's own statement in its tabular form here, that the Open Market Committee sold or redeemed $800 million net of United States Government securities or certain other adjustments so that member bank reserves at least did not increase. Loans by banks and demand deposits declined.

I think that the open market operations had some effect on this. Loans by member banks decreased by about 6 percent, but the index of fiscal production during this time, from December to April, actually

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rose, rose on an unadjusted basis by 4 percent, on a seasonal basis by approximately 3 percent.

This is the question I would like to raise: Whether the Reserve did not take fright at something which was nonexistent, namely, inflation, in fact there was no inflation, that the price level had been stabilized. But the Reserve adopted a restrictive policy at a time when a restrictive policy was not needed, and failed, at the very least to increase the money supply at a time when it should have been increased, and possibly actually diminished the money supply, with the result that it had some adverse effect upon the level of business activity, and contributed to the decline of business which set in during the summer of 1953.

Now this is a question I should like to have answered.

Mr. MARTIN. I will accept your amendment of the word "hard" to "flexible," if you would like, Senator, to start off the discussion. I will accept your amendment of the word "flexible" for "hard."

Senator DOUGLAS. I did not think you adopted a hard money policy in March 1951, and I may say I am oposed to both a hard and an easy money policy as evils in themselves.

What I want is a supply of money which, taking into account velocity, moves with the volume of trade and production, to maintain two purposes: namely, substantially full employment and substantial stability in the price level, and I want to suggest that for 21 months both of those conditions were satisfied.

Mr. MARTIN. I wouldn't agree that they were completely satisfied. I hope that all the members here will discuss this.

In the early months of 1953 there was forming what my colleague, Mr. Sproul, has called a bubble on top of a boom. We were endeavoring to stem it, and perhaps were slow. There was in the economy at that time, as I see it, a great deal of what I have described before as waste, extravagance, incompetence, inefficiency, and imprudence. All that was a part of the hysteria that went on in the post-Korea days. We finally reached a point where we permitted the credit mechanism to function once again as one of the governors in the economy.

Senator DOUGLAS. What were you afraid of? Production increasing, prices were stabilized, and there was substantially full employment?

Mr. MARTIN. Look at what was happening to inventories, for example. Do you think you can just build up inventories more and more and let production go up higher and higher, and that there will never be any adjustment, particularly when shortly thereafter there was going to be an end to the constant increase in defense expenditures?

Now, all of those were factors that had to be taken into account in our policies. As we approached the spring of 1953 we had the expectations of the market revolving around all of these developments. Some of them were misconstrued by the market. It seems to me that you can't eliminate the fact that inventories were rising rapidly at the same time that production was continuing very high.

Senator DOUGLAS. Well, high production is not evil.

Mr. MARTIN. I didn't say it was evil. I am just talking about it in relationship to inventories and the fact that we were heading towards a precipice.

Perhaps we jammed on the brakes at one point a little bit too tight. I have admitted this. We are certainly not infallible in our judg-

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ments. Within a few areas we are bound to make some misjudgments. But by and large it seems to me that the situation was kept well in hand. I believe we would have had much more unemployment and further distress if we had not pursued those policies.

Senator DOUGLAS. I think you make a mistake, myself. There is a further inconsistency which I find.

You say that you wanted to reduce latent inflationary tendencies back doors which did not manifest themselves in the price index, but at approximately the same time, namely February of 1953, you diminished the margin requirements for the purchase of securities from 75 percent to 50 percent.

Now, that is, of course, a directly inflationary move so far as the prices of stocks are concerned, namely, that it permits a much greater purchase of stock with a small amount of individual cash, and I fail to see why you should be wanting to deflate one section of the market and inflate another at the same time. I think this shows gross inconsistency. I would be interested in your answer to that.

Mr. MARTIN. I can take a long time, not on that question, but on the inconsistencies that were bound to develop after the Korean hysteria. Before the "accord," we invoked almost every possible control short of the one control which would have been effective, that is, general control, to try to restrain the inflation that followed the Korean outburst. Now, in the early stages of that——

Senator DOUGLAS. Well, my objection is that when Korea started you did not do that; that instead, you became the handmaiden—I don't think you were on the Board then, but that the Reserve became the handmaiden—of the Treasury and permitted a greater increase in prices than was needed.

My criticism of the Reserve was that during that period they contributed to inflationary forces, so I think the record of the Reserve up to 1951, March 1951, was a bad record, largely because the Treasury turned on the heat and the Reserve didn't have the courage to restrain itself. But I think from March 1951, to December of 1952 it was a good record.

Now you moved in the other direction. Having given in one period excessive doses of castor oil and then getting the organism on a healthy basis for 21 month, you proceeded to dose the organism up with excessive does of bismuth.

Isn't there a happy medium which can be maintained? Having reached virtue for 21 months, isn't it possible for the Federal Reserve to maintain it for a further period?

Mr. MARTIN. Senator, we are struggling for the happy medium all the time.

Senator DOUGLAS. I don't think you have succeeded.

Mr. SZYMCZAK. Mr. Chairman, I think the Senator recalls certain facts, because the Senator was very closely identified with some of them at the time. If we made a mistake in pegging the Government security market, it was made at a time when the war began with Pearl Harbor. We pegged the Government security market at that time to help the Treasury through the financing of the war, and that was all to the good. Nobody could complain about winning the war. We needed money to win the war. That pegging was done on our own initiative.

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Now, the difficulties that arose were subsequent to the end of the war. We did try to unpeg, and we did unpeg the short-term Government security market. The short-term rates were up as a result.

We continued to move in that direction together with the Treasury, and, of course, it was very difficult to unpeg once we had pegged and continued the pegs too long after the war, as you know. Many people who had securities and valued them at the pegged price, banks, individuals, insurance companies, and many others, in addition to the Treasury, did not want to see a drop in the price of the securities they held. That would make the refunding by the Treasury more difficult.

And, therefore, when we finally did get to Korea, we announced in August—Korea was in June 1950—we announced a higher discount rate, and also not only announced the higher discount rate but announced a tight money policy throughout.

It was from that point on until March that we had the discussions with the Treasury, and while we kept on pegging the long-term securities, you will recall, we kept dropping that long-term support price to par. Our attempt was to unpeg the long-term market.

We finally did unpeg in March 1951, and by the end of that year we completely unpegged the Government security market. You, Senator, will recall that because you were very helpful, particularly at that time.

Now, as we got into the latter part of 1952 and early 1953 we did have a capital situation, we did have abnormal inventory increases, and the demand for credit kept increasing—it was partly psychological—for in a cyclical, dynamic, competitive economy such as ours the greater the rise in demand for credit to build up inventories the greater the urge for more credit. True, the price level was not rising and production and employment were at high levels.

But what we were trying to do was not to take away credit for growth, but not to supply the amount of credit that was being asked for by the market to build up inventories to unsound and unstable heights. We stood on the side line, not giving the reserves that building up of inventories required in order to expand credit further and thus expand the inventory and allied elements further.

Subsequent events proved that course to be right, because it was the inventory condition of industry and others throughout the country, plus the reduction in defense expenditures that came in the second half of 1953, that brought on the downturn. It would have been much worse had we allowed the inventories to increase to even greater heights through an additional supply of credit.

Senator DOUGLAS. But in your tabular statement, exhibit A, you say from January to April you sold or redeemed $800 million net.

Mr. SZYMCZAK. We were buying as well as selling, but that was net; yes.

Senator DOUGLAS. You thus diminished member bank reserves, and therefore diminished their lending capacity.

Mr. SZYMCZAK. The essence of that situation was that business was seeking much more credit because of the great demand to build up inventories—which demand was feeding on itself in a competitive economy.

They were just building up inventories hand over fist, and the demand was so great that to the extent we didn't satisfy the demand by adding the reserves required, of course the rate went up because

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of the demand and supply relations—and not because we pushed up the rate.

Senator DOUGLAS. Well, are you happy—may I ask you this—at having made such a large increase in funds available for the purchase of stocks?

Mr. SZYMCZAK. Well, that is a different question because the total amount of credit involved there was not large. It was about 1 to 2 billion, so we wished to make an equitable adjustment in February 1953, and therefore we placed margin requirements on a basis where we could increase or decrease margin requirements as required rather than move by 25 percent once in a while and thus dramatize our action beyond its actual worth.

It was merely an adjustment that gave us a better base from which to operate. It wasn't at all related to the credit or economic situation because the amount of credit in that sector of our economy was relatively small.

And, of course, it doesn't necessarily relate itself to price. It does relate itself to volume.

Senator DOUGLAS. The more you stimulate purchases, the greater is the effect on the general level of stock prices. The low margin requirements in the twenties certainly contributed in part to the stock market boom in the late twenties.

Mr. SZYMCZAK. Of course, as you know, when the SEC and margin requirements were considered by Congress there was a question whether margin requirements shouldn't because of other considerations be placed in the SEC, and somebody suggested that since it was credit no matter what the other considerations that it should be placed in the Federal Reserve, and that is how Congress placed it in the Federal Reserve. But, so far as the actual amount of credit is concerned, it is and was relatively small—especially as related to other credit sectors of the economy.

Senator FLANDERS. Mr. Talle, have you any questions you would like to ask?

Representative TALLE. No, thank you, Mr. Chairman.

Senator FLANDERS. I might say that at times we get confused with some of these complicated subjects.

I have a very simple one which I would like to present. I would like to have a poll of the members of the Federal Reserve Board and then have the presidents of the Federal Reserve banks polled on a simple question, but I will first ask you if you are willing to be polled. We tried it on the economists yesterday, and they were all willing.

This is the question taken from the report, the Patman report, of the 2d session of the 82d Congress:

> We believe that to restore the free domestic convertibility of money into gold coin or gold bullion would militate against rather than promote the purposes of the Employment Act, and we recommend against such restoration.

First, I would like to ask the members of the Board whether they are willing to be polled on that subject, convertibility of gold.

All appear to be willing to be polled, so will those who favor the free domestic convertibility of money into gold coin or gold bullion raise their hands?

Mr. VARDAMAN. Mr. Chairman, may I ask if you refer only to the immediate foreseeable future?

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Senator FLANDERS. Yes; foreseeable future; let's call it that.

All in favor of convertibility in the light of the foreseeable future, raise your hand.

(There was no showing of hands.)

Senator FLANDERS. All against.

(There was a showing of hands by a majority of the group.)

Mr. SZYMCZAK. I don't think you can answer it "yes" or "no." I think the question is whether we wish to return to the institutional method once adopted, or whether we think we can use the powers we have without going back to gold convertibility.

Senator FLANDERS. You think we can do what we want to, without going back to convertibility?

Mr. SZYMCZAK. I don't think we need it. We can get along without it, but I have no very strong objection to it.

Senator FLANDERS. We have, I think, a clouded but not too direct a poll on that. Perhaps I will put it for the presidents in this form:

I will again read the paragraph and ask if you agree with it. Are you willing to be polled?

Mr. SPROUL. I would prefer not to be polled on such a question, under such conditions, although my views are very well known.

Senator FLANDERS. You are excused.

Mr. SPROUL. Thank you.

Senator DOUGLAS. I think the record should be very clear on this point, that Mr. Sproul is not pleading the fifth amendment.

Mr. ERICKSON. Mr. Chairman, is there a time limit there?

Senator FLANDERS. No, there is no time limit in this statement.

Are you ready, however, to express approval or disapproval with the statement? All who approve, raise the right hand.

Representative PATMAN. Why don't you read it off, Mr. Chairman. We have had so much discussion, I think it has been lost sight of.

Senator FLANDERS. This is the proposition:

We believe that to restore the free domestic convertibility of money into gold coin or bullion would militate against rather than promote the purposes of the Employment Act, and we recommend against such restoration.

All who feel they can accept that statement raise their hand.

(There was a showing of 10 hands.)

Senator FLANDERS. All opposed?

All who wish to amend the statement by inserting the words "in the foreseeable future," raise their hands.

(There was a showing of hands.)

Mr. BRYAN. Mr. Chairman, I would have liked to have voted for it because it would have made central banking so easy.

Senator FLANDERS. You might just explain yourself on that.

Mr. BRYAN. Well, last year it would have been very simple when the Atlanta district was losing reserves, I would have raised the rediscount rate to attract them back, and so forth and so on. I would have had no qualms, no problems of intellect or conscience.

Senator FLANDERS. Do you want it that way?

Mr. BRYAN. No.

Senator FLANDERS. I think we got a vote on that. I hope there will be no recount.

I just received word that I must leave a little bit earlier than I had intended to.

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Is there anyone who wishes to proceed with further questioning? We have quite a record already.

Senator DOUGLAS. Mr. Chairman, I don't wish to proceed with any further questioning, but I am told that there is a report of an ad hoc subcommittee of the Open Market Committee dealing with some of the questions discussed this afternoon, and I request that it be made part of the hearings.

Senator FLANDERS. I am not quite sure what documents wou are referring to, Senator Douglas.

Senator DOUGLAS. I believe it refers to a point which you raised earlier, at the very beginning of your questioning this afternoon.

The documents, since they are documents either of the Open Market Committee or of the Executive Committee, are naturally not known to Members of Congress. I naturally am not certain of the exact content, but I think they will be known to the Open Market Committee and to the subcommittee itself.

Senator FLANDERS. You are not suggesting the minutes?

Senator DOUGLAS. No, no; the report.

Senator FLANDERS. The report of the Open Market Committee?

Senator DOUGLAS. The report of an ad hoc subcommittee.

Representative PATMAN. You mean, it made a report today?

Senator DOUGLAS. No; it was made earlier.

Senator FLANDERS. Mr. Martin, I would like to have you comment on that. I am not just clear what the document is.

Mr. MARTIN. I think the reference is to an ad hoc subcommittee report which was made on the subject, referred to at the start of this hearing, on which Mr. Sproul and I are in disagreement.

Senator FLANDERS. It would seem to me that the disagreement was quite clearly expressed. I wonder what more there is in the ad hoc report? Does it censure either of you?

Mr. MARTIN. It doesn't censure either of us. It contains analytical and descriptive material, as well as recommendations.

Representative PATMAN. Does it condemn you?

Senator FLANDERS. Yes, or commend you?

You feel that it was descriptive material; did you say?

Mr. MARTIN. Well, as far as I am concerned, I am perfectly willing to make it available to the committee for publication, if they wish it.

Senator FLANDERS. It would seem to me offhand, Senator Douglas, that we had a fairly clear expression of the difference of opinion between the two men.

Senator DOUGLAS. Mr. Chairman, I was the one who 2 years ago moved that the very spicy exchange of correspondence between the Treasury and the Federal Reserve Board in 1950 and 1951 be made part of the official records.

Mr. Martin at that time was very reluctant to have those documents brought forward, but they were published, and I think they contributed greatly to an understanding of the monetary history during the period 1950–51. Now, since those documents were published, I think they did, in general, help everybody.

I think the publication of this document would be of some assistance. In short, I believe that the Federal Reserve, the Open Market Committee, should not conduct their operations with the secrecy which has previously attended them, that the more we have an airing of differences on these matters, the better educated Congress and the

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public will be, that sunlight is not to be feared, that honest differences are not to be feared, and that there is nothing quite like facts and knowledge.

Senator FLANDERS. We will ask the Open Market Committee, then, to make that available for inclusion in the record.

Mr. SPROUL. I would like to say something on that, Mr. Chairman.

I have been, and continue to be, of the view that this was a working paper, prepared by an ad hoc committee of three members of the Federal Open Market Committee for the consideration of the full committee, not as a public document.

I believe it would be a bad precedent if we began publishing working papers of the committee, inhibiting and corroding free discussion within the committee.

In this case, to complete the record would require the publication of all letters and documents commenting on the ad hoc report prepared by the majority and minority members of the Open Market Committee. The ad hoc committee report did not have unanimous acceptance.

There would inevitably be a lot of deadwood in this material. There were 14 items of action culled out of the ad hoc committee report, but only 3 of these were of significance so far as present policy is concerned, and only 2 of these 3 recommendations—confining open market operations to short-term securities and support of Treasury financing operations—have been the subject of continuing debate.

If there is a real public interest in these two matters, the way to feed that interest is by public discussion of these issues, such as we have today, uncluttered with a lot of extraneous material such as is included in the ad hoc committee report. The answer of the Chairman of the Board of Governors to question No. 3 of this subcommittee's questionnaire is an example of the kind of discussion of these issues which I would say is constructive. I have tried to present my opposing views.

I regret to say that the public interest in these matters does not seem to be great nor intense. The minor clamor for publication of the ad hoc committee report, with few exceptions—and this does not include Senator Douglas—has come mostly from the curious, or those who think they see a chance of stirring up trouble within the System, or between the System and the Congress. I would not pander to that curiosity, or to the decisive urge.

This does not mean that there is anything that needs to be hidden or covered up in the ad hoc committee report or that we want to shut out the sunlight. There isn't anything to be hidden in the report. It merely means that publication of this internal working document is not necessary if we want to discuss soberly and constructively the issues of current policy, which, I believe, would benefit by more informed discussion, both within and outside the System.

Mr. VARDAMAN. Mr. Chairman, may I, as one member of the Board, gladly follow the lead in this instance of Chairman Martin, who states that he sees no objection to the publication of the ad hoc report.

I regard the ad hoc report as far more than a working paper. If, when publication of the ad hoc report takes place, it becomes advisable to reveal documentary evidence filed with the Board in the form of letters and other forms connected with it, then we should give those papers, if you please, to this committee for editing before publication,

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but I would like very much to see the ad hoc report published for the information of this committee.

Mr. BRYAN. Mr. Chairman, I would like to say that I also support the publication of that report.

I had the honor to be a member, and I think the committee would be in error if it believes that it was a mere working paper. We have had here a most fundamental attack upon the policy of the System. I believe that this committee deserves the whole history out of which that policy was evolved.

Senator FLANDERS. I would suggest to the committee that this material be placed in its hands, and that then the committee itself, the subcommittee itself, determine on the use of the material, if that is satisfactory. (See statement by Chairman Flanders on action taken on ad hoc subcommittee report, p. 257 and following.)

Mr. WILLIAMS. Mr. Chairman, may I suggest also that the subcommittee may wish to call someone into consultation to get the implications of full disclosure here.

Senator FLANDERS. I will be glad to have comments from all those concerned as to significances which don't appear in the material.

Representative PATMAN. Mr. Chairman, I ask unanimous consent that when it is received that it be left up to the chairman and Senator Douglas as to whether or not it goes in.

Senator DOUGLAS. Oh, no; I am not a member of the subcommittee, so I should not serve on it. I think you should serve, Congressman Patman.

Senator FLANDERS. I regret that I must go.

Representative PATMAN. I want to bring up one question. These people are so cooperative, I want to ask them what is going to happen in the next few months.

Senator FLANDERS. We will have a lot of hearings in January and February when the full committee will consider these matters.

Representative PATMAN. I bow to your judgment, Mr. Chairman.

Senator FLANDERS. Additional statements to clarify the presentation can be offered for insertion in the record.

(By direction of the chairman, the following is made a part of the record:)

(The following comments on the Treasury and Federal Reserve statements of December 6, 1954, to the Joint Committee on the Economic Report have been submitted by Edward C. Simmons, professor of economics, Duke University, Durham, N. C., in response to an invitation by the subcommittee to present material for inclusion in the record:)

The statements of the Treasury and the Federal Reserve reveal that monetary and debt-management policy is formulated on only vague and indefinite criteria. Such things as stability and growth of the economy are frequently mentioned as having a bearing on policy matters, but these concepts are not reduced to objective criteria. One cannot tell whether or not the desired goals have been reached. Both agencies express satisfaction with their achievements, yet both seem to reveal uncertainty as to events preceding and following the downturn in the spring of 1953. In view of the admitted inability to forecast the faith expressed in ability to apply discretionary judgment is quite remarkable.

The Treasury's expressed view is that floating debt can be excessive and also that long-term financing may not be undertaken when long-term funds are needed to finance private investment outlays. This may explain why the Treasury does not bother to argue the case for funding. Much is made in the Treasury statement of the quite modest achievements in the direction of lengthening maturities.

The Federal Reserve statement is very long and very technical. It provides an abundance of information on recent central bank operations, particularly as to sales and purchases of Government securities, although the attempt to expound

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what is meant by "preventing disorderly conditions" is hardly successful. On monetary policy proper, the outcome is only slightly better. Year-to-year changes in bank reserves are commented upon, but one cannot be sure that what happened was the result of design or of conjecture. Similar changes in the economy's stock of demand deposits are discussed, but one never learns what should happen to this most important economic quantum, nor can one tell whether the Federal Reserve has been successful in bringing about the result it desired. The discussion of monetary policy is conducted along with the discussion of a great many other matters, and one cannot always tell whether these matters are means or are ends of the same order of importance as monetary policy.

At various places in the Federal Reserve statement one encounters language such as policy is "* * * to influence the level of bank reserves and the money supply in accordance with seasonal requirements, the capacity of the economy to produce goods and services, and suitable growth in the economy." Obviously, a target so poorly defined can never be said to have been missed.

Question No. 4 is allocated only 1½ pages of text, although other answers extend over much more space. Reference is made to a Federal Reserve statement to the Patman subcommittee and to an appended 16-page reprint from the Federal Reserve Bulletin. Both of these, as the reply indicates, are concerned with describing the complexities of the monetary mechanism and only incidentally if at all with answering the question, "How much money does an economy need?" Some may doubt if question No. 4 is answered by saying that monetary policy is a complex matter upon which the Federal Reserve brings to bear its best judgment Specifically the lengthy statement cast little light on the causes of the marked seasonal and other short-run fluctuations in member bank reserves and the stock of money, although these would seem to be subjects for comment in a discussion of monetary policy.

Neither the Federal Reserve nor the Treasury may be said to have failed to answer the questions. Much of the difficulty lies in the questions themselves. They do not call for incisive replies.

(The following memorandum was submitted December 8, 1954, in response to the invitation by the subcommittee to present material for inclusion in the record:)

MEMORANDUM TO SENATOR FLANDERS, CHAIRMAN, SUBCOMMITTEE ON ECONOMIC STABILIZATION, JOINT COMMITTEE ON THE ECONOMIC REPORT

(By Arthur R. Upgren, Dean, the Amos Tuck School of Business Administration, Dartmouth College, Hanover, N. H.)

I—*LIQUIDITY*

The two ideas I would like to forward as being the major responsibilities of our banking system are assistance in avoiding deep economic declines and acceptance of the responsibility to maintain liquidity. I think the void in liquidity all through the latter 1920's and up to 1933 is simply the negative of too much credit inflation which we so commonly think of as coming with wars. When we have such credit inflation we have rising prices. Similarly wthen the banking system in short of liquidity, we have our busts and sharp falling prices. Each is rather inexcusable but of the two, the existence of illiquidity is by far the most needless and most damaging.

This can be illustrated by the record of the banking system. Up to the end of the 1920's our banks in the Midwest were very illiquid. Country banks probably had about 10 or 12 cents on each dollar of deposit in liquid assets. Out in that section of the country when the break came, something of the order of 15 to 22 percent of all deposits were withdrawn. The net result was that in the United States 15,000 banks failed from 1921 forward. Some readjustment immediately following the First World War was inescapable but the loss of the banks, the absence of liquidity, and the colossal damage inflicted on the American people following the year 1930 was mostly needless and could probably have been avoided if we had discovered some way to create the needed liquidity.

Today all the banks are extraordinarily liquid and the western banks are more liquid than the banks of Wall Street. In Denver this summer bank statements released at that time revealed a liquidity ratio ranging from 60 to 75 percent. Comptroller of the Currency, Ray Gidney, recently reported that all the member banks were 62 percent liquid.

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Thus we have solved the problem of liquidity and in fact, we probably have an oversurplus of liquidity in the banks at this time.

But this liquidity is surely "going to run out" sooner or later.

One recent estimate suggested that total commercial bank credit outstanding in 2000 will be at least $2,000 billion. If it is, that will be about the slowest rate of increase we have ever known for such a period.

If we should have bank obligations of that size, we would need a banking system which would be at least 20 percent liquid, or better, 25 percent. This will call for a liquidity in absolute amount of about 400 to 500 billion dollars. You will readily appreciate that is far short of the liquidity which is likely to be had by the banking system on a basis of scanning of all the liquid assets which might come to the banks. I think our national debt is not going to be appreciably increased; I think Europe is going to retain most of the world's newly mined gold; and I am not inclined to think that short-dated liquid paper of the business system will be developed in any large amount.

Thus we could say that we might, by 1973, be lulled into such a state of complacency by the liquidity we then shall have enjoyed for 28 years, that we could have a repetition of 1873. The banking system already is using a fair share of its liquid assets and certainly will be expanding its deposits as soon as we have further economic growth and expansion which is probably proceeding at the very present time. This is indeed a long-run problem. It will be a problem for the next 15 to 25 years. But its delineation and the experience we have had with it in the past, reveals how completely we have ignored it.

If memory is correct in this matter, in 1857 and in 1893 the British Parliament indemnified the Bank of England for any damage or loss that might be caused by its overissue of bank notes. That overissue of bank notes broke the extreme tightness in the money markets on both of those occasions. Yet in 1933, 40 years after one experience and 85 years after the other, we got into the same kind of a jam and it was the central bank which did not perform the function. It accepted failure. Banks were needlessly sacrificed because the central bank and the Treasury did not provide liquidity.

If a crop is to be grown in the arid West, water must be sprinkled upon the fields. Out in Minnesota and Wisconsin farmers are now instructed by the State universities in the techniques to be followed to grow more than 100 bushels of corn per acre. To do so fertilizer must be spread upon the fields in very large amount.

This analogy may be used for an economy. If it is to survive the shocks and moderate recessions, then that economy must be sprinkled generously with liquidity. I think the struggles of the American people for 12 years reveal this very fact. In 1837 we so lacked liquidity that the State of Wisconsin passed a law making banking illegal for approximately the same length of time that prohibition made liquor illegal about 80 years later. The people were disgusted with a banking system that could break so completely. We only need remind ourselves of later dates of other illiquidity. These were, as I remember, the outstanding ones when financial crashes made the most noise, 1857, 1873, 1884, 1893, 1907, 1921, and 1933.

Today we have the Employment Act of 1946 which has been considered the economic capstone of all economic and financial policies of the Federal Government. I am sure that to promote that high level productive employment for the people, we shall find ways and means to increase debts, "the promises men live by" as Harry Scherman once defined debt.

II—FUTURE DESIRABLE FISCAL AND MONETARY POLICY

I now turn very briefly to the side of monetary policy for the future. It seems to me that this can be simply stated. The American people are very literate, fiscally speaking, as has been evidenced by their willingness to bear taxes. In the First World War we produced about one-third of Government expenditures by taxation and prices fell only a little short of reciprocally short of tripling. The wholesale price index went to 247. In World War II we taxed for 46 percent of total expenditures—and there was no improvement in this ratio when there could have been the most improvement in this ratio, namely in 1944. In consequence, prices almost doubled, the index rising to 190. After Korea, at least except for one larger deficit in fiscal June 30, 1953, we taxed for 95 percent of total Federal expenditures. The net result has been that the inflation in wholesale prices has been only 10 percent and in consumer prices only about 15 percent. In addition, we have had remarkable stability of the price level for 3½ years. The rise in that period, which has been slight in the con-

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sumer price index, has been wholly an adjustment to the needs of the earlier, 1950–51, sharp rise in wages. It has not been the result of any recent inflationary pressure.

Moreover, as a result of this high rate of taxation we have the happy consequence of now being able to reduce taxes as rapidly as defense expenditures are being reduced. That has been very stimulating to the economy in the past year. In 1946, and the years following, defense expenditures had to come down by $54 billion, or from $100 billion of spending to $46 billion of spending before we could have any tax reduction on the basis of the $46 billion tax revenues we then had. Happily defense expenditures declined by almost $68 billion so that we did have tax reductions which I have estimated were worth the difference of about $14 billion. But those tax reductions were only $1 for each $5 of expenditure reduction.

In the last year we have been able to have almost $1 of tax reduction for $1 of defense expenditure reduction and still retain a balanced budget. This tax reduction has been sufficient to sustain personal disposable income without any diminution at all despite a decline in personal incomes (before taxes) which decline has been caused by somewhat shorter hours and somewhat increased unemployment, slightly offset by some increases in hourly wage rates. In addition, this tax reduction has been able to convert the declining earnings of corporations due to an approximate 7 percent decline in sales, into an absolute increase in profits for most companies. The importance of this increase in profits is that a good record of profits is the most important single requirement for a good record of continued high capital investment by industry. That continued high investment is expected now for 1955, now seems likely, according to recent reports.

What is needed is education to the fact that monetary policy should be flexible and liberal at any time when there is unemployment above, say a 3-percent figure, or about 2 million unemployed. Moreover, that liberality and easiness in monetary policy should continue until the reduction in unemployment comes at a very much slower rate and there is a tendency toward wage rates and toward price levels to rise. That is the only guide I would give for monetary policy. It is the guide that when we have unemployment, policy should be liberal and generous and there should be tax reductions. As unemployment subsides and does not seem to be able to drop any more, nor employment rise, and as prices tend to rise somewhat and especially wage rates rise, then monetary policy should be restrictive.

This leads to the fact that the simulation of an economy must, however, come primarily out of fiscal policy. Then when restraint is needed, since taxes are said not to be something the American people will vote quickly, monetary policy can be used to restrain that growth of credit at "too fast" a rate. "Too fast" means, of course, that the rise of prices is beginning and the rise in wage rates at an increasing rate becomes apparent and total employment is not appreciably lifting—barring, of course, a rise in the labor force.

Such a policy even if somewhat slowly applied at times, here I refer to the restraining monetary policy, will provide the liquidity which the country needs.

I would like to think that we would be imaginative enough, and abstract enough in our thinking as was Gustave Cassell, to create liquidity in a very abstract way. But we know we do not wish to create liquidity by emissions of excessive amounts of currency. Thus we must fall back on the orthodox and accepted form of creating liquidity which is an enlargement of the Federal debt. If there are other ways and they can be widely accepted, they certainly should be offered and adopted.

In summary, I see our economic history as showing that our society has for about 200 years in this country struggled to provide needed liquidity. The struggle became so tense and arduous at times that we placed great premium upon gold and silver mining and we could not meet demand so that we had complete collapses. The struggle was also attended with extremely high interest rates such as the 9 percent call money rate of 1929 and the 8 percent borrowing rate of some good industrial companies in 1921. We have eased on that but that only means there will be debt expansion of the banking system, the central banks, and therefore we need to face up to the creation of liquidity so that we may retain for ourselves the fruits of these new modern, more orderly scheduling of debt repayment which contributes so very greatly to the high prosperity of the American people and which provide places in which they can so satisfactorily lodge their savings.

This is the time for a discussion of these issues because the issues are not "hot" at the present time. Thus, we should be able to place it in perspective

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so that we would be certain to take action to provide needed liquidity when that time comes. In my own view that time will not come immediately ahead but could come by perhaps the year 1965 or the fateful 100th anniversary of 1873, in 1973.

It seems to me, therefore, that the maintenance and creation of liquidity is one function of the banking system. The second function is the sharp restraint by monetary policy in the event of any inflation and excessive boom. The monetary authorities can act. June 1953 showed us that their action need not endanger the banking system as so many had falsely predicted in connection with their arguments for 100 percent support prices for all Government securities.

Fiscal policy then can be via tax reduction, the powerful lever to move an economy upward in the event an adequate full level of employment is not maintained and in the event output of the economy is not expanding as we know it can at rates of at least 3 percent per year.

STATEMENT BY CHAIRMAN FLANDERS ON ACTION ON AD HOC SUBCOMMITTEE REPORT, DECEMBER 9, 1954

The subcommittee has decided to release and make part of this record the report of the ad hoc Subcommittee on the Government Security Market of the Open Market Committee dated November 12, 1952. At the hearing on December 7 the Subcommittee received arguments both pro and con, with respect to publication of the document from officials of the Federal Reserve System. Our decision to publish the document is based upon the following statement by Chairman William McChesney Martin, contained in the record above: "Well, as far as I am concerned, I am perfectly willing to make it available to the committee for publication, if they wish it."

The subcommittee believes that proper procedure has been followed in this matter since the head of the agency involved has assented to its publication. This view is concurred in by Senator Barry Goldwater and Congressman Wright Patman, members of the subcommittee. Senator J. W. Fulbright and Congressman Richard Simpson were unavailable for the hearings and did not participate in this decision.

We have advised both Mr. Martin and President Allan Sproul that the document will be published, and have invited them to append any additional papers that they believe should be published simultaneously with the ad hoc report. They are appended.

FEDERAL OPEN MARKET COMMITTEE REPORT OF AD HOC SUBCOMMITTEE ON THE GOVERNMENT SECURITIES MARKET, NOVEMBER 12, 1952

PREFACE

Securities of the Federal Government have come to play a unique role in the flexibility and sensitiveness of the American money market. Our financial institutions now hold the bulk of their secondary or operating reserves invested in these issues, particularly in the shorter term securities. This is true especially of commercial banks but also of insurance companies and savings banks, as well as savings and loan associations. It is also increasingly true of many of our larger industrial corporations. As a result, any change in the demand for funds or their supply is felt promptly in the open market for Government securities. When our financial institutions gain funds, they usually invest immediately in Government securities, and, conversely, when they have net payments to make, they liquidate Government securities. When their customers borrow or opportunities for profitable investment arise, financial institutions switch out of Government securities, and when loans are paid or investments are sold the proceeds are usually invested, at least temporarily, in Government securities. The resulting daily turnover of securities in the market is enormous. It reflects the transactions by which thousands of individual financial institutions and business organizations keep their funds fully employed at interest, without sacrifice of their ability to meet the changing financial requirements of their more basic business operations.

Arbitrage transactions add to this daily turnover in the market. There is no credit risk in a portfolio of Government securities, i. e., no possibility that the holder will not be able to obtain cash at par at maturity. The relative

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prices at which different issues trade, therefore, reflect predominantly changes in the demand for and the supply of loanable funds in the money market as a whole and also as between the various short-term, intermediate, and long-term sectors of the market. Since trading is done at commissions or spreads as small as one sixty-fourth ($156.25 per million) and even smaller in very short issues, there are constant opportunities for arbitrage of small differentials in prices when the impact of buying or selling is especially heavy in some particular sector of the market. The secondary reserve portfolios of practically all the large financial institutions are managed by skilled professionals to take advantage of such opportunities.

The Federal Open Market Committee is a major factor in this market. At present its portfolio consists wholly of United States Government securities. It is the largest existing portfolio under one control. When the Federal Open Market Committee adopts a policy directive, it is executed in the market for Government securities. It takes the form of a series of specific transactions in Government securities. Total transactions for the account—purchases and sales—mount up to billions of dollars in the course of a year.

The impact of these operations is not measured by the volume of transactions alone. It is much greater, for example, than the impact of a similar volume of purchases and sales by a private investor. The Federal Open Market Committee releases or absorbs reserve funds when it operates in the Government securities market. When the Committee buys, it augments not only its own holdings of Government securities but also the ability of other investors to enter the market on the bid side Conversely, when the Committee sells Government securities, it does much more than add to the market supply of such securities. The reserves that it absorbs subtract also from the capacity of the banking system to carry Government securities.

It is necessary to keep these basic features of the money market in mind in considering the subcommittee's report. They help to explain why relatively small operations, sometimes even rumors of operations, by the Federal Open Market Committee may give rise to such quick and pervasive response not only throughout the money market and the investment markets generally but also in business psychology. Any purchase or sale of Government securities by the Committee adds to or subtracts from the reserves of the member banks and is promptly reflected in the tone of the money market. A relatively small injection of funds through the purchase of bills will ordinarily find a response in the market for long-term securities. Large purchases of bills could scarcely fail to elicit such a response.

These transactions condition the tone of the money market and the general availability of credit because they immediately affect the value of securities in the operating portfolios of leading financial and business institutions. They cause changes in the prices of the specific issues bought or sold, and affect opportunities for arbitrage as between various issues and sectors of the market. As a result, a new pattern of yields emerges as between all different issues and sectors of the market. When the readjustments have worked themselves out, both the prices of Government securities and the pattern of their yields will have been affected. Both the absolute and the relative market values of the securities that constitute the liquid operating reserves of all our major financial institutions will have changed. In other words, there will have occurred a shift in the financial liquidity of the money market and of the economy.

Experience has demonstrated that the climate or tone of the money markets tends to respond directly to the volume of member bank borrowing at the Federal Reserve banks. Changes in the volume of borrowing represent the first response of member banks to losses or accessions of reserve funds from any source, including open-market operations of the Federal Open Market Committee. It constitutes, in fact, an essential link in the mechanism by which these operations exert a magnified effect on the money markets. When such borrowing is low, the tone of the money market is easy, that is, funds tend to be easily available at going interest rates for all borrowers who are acceptable as credit risks. When member banks themselves are heavily in debt to the Federal Reserve banks, the tone of the money market is tight, that is, marginal loans are deferred and even better credit risks may have to shop around for accommodation.

These responses seem to be independent, to some extent, of the level of interest rates, or of the discount rate. For example, the tone of the money market might be easy even though the discount rate were 4 percent. This would happen mainly in a situation where the volume of member-bank borrowing was low. Conversely, the tone of the money market might be on the tight side when the

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discount rate was 1¾ percent. This would occur when member banks were heavily in debt.

The fact that the tone of the money market is responsive to the level of member bank borrowing at the Reserve banks gives a unique character to the role of open-market operations in the effectuation of credit and monetary policy. They can be used flexibly to offset the net impact on bank reserves of other sources of demand and supply of reserve funds in such a way as to result in an increase or decrease of member-bank borrowing, or, if desired, to maintain a level of such borrowing that is fairly constant from week to week, or month to month. This means that when the Federal Open Market Committee decides that a tone of tightness, or ease, or moderation, in the money markets would promote financial equilibrium and economic stability, it has the means at hand to make the decision effective.

Changes in the discount rate cannot be used in this way. They can exert powerful effects upon the general level of interest rates, but cannot be counted on to insure that the relative availability or unavailability of credit at those rates will be appropriate to the requirements of financial equilibrium and economic stability.

Neither can changes in reserve requirements be used with this precision. There are many administrative and technical problems which militate against the continuous or frequent use of this instrument of policy. Even if these did not exist, however, the instrument is much too blunt to be used to maintain member-bank borrowing from week to week or month to month at an appropriate level.

In short, open-market operations are not simply another instrument of Federal Reserve policy, equivalent or alternative to changes in discount rates or in reserve requirements. They provide a continuously available and flexible instrument of monetary policy for which there is no substitute, an instrument which affects the liquidity of the whole economy. They permit the Federal Reserve System to maintain continuously a tone of restraint in the market when financial and economic conditions call for restraint, or a tone of ease when that is appropriate. They constitute the only effective means by which the elasticity that was built into our monetary and credit structure by the Federal Reserve Act can be made to serve constructively the needs of the economy. Without them, that elasticity would often operate capriciously and even perversely to the detriment of the economy.

They require an efficiently functioning Government securities market characterized by depth, breadth, and resiliency. It is with these characteristics of the market that this report is mainly concerned. The subcommittee was authorized shortly after the Federal Open Market Committee decided that the continued maintenance of a relatively fixed pattern of prices and yields in the market for Government securities was inconsistent with its primary monetary and credit responsibilities. The Federal Open Market Committee felt that a freer market for Government securities would lessen inflationary pressures and better promote the proper accommodation of commerce, industry, and agriculture. It came to the conclusion, in fact, that a securities market, in which market forces of supply and demand and of savings and investment were permitted to express themselves in market prices and market yields, was indispensable to the effective execution of monetary policies directed toward financial equilibrium and economic stability at a high level of activity without detriment to the long-run purchasing power of the dollar.

Accordingly, the subcommittee was authorized to examine and report on the relevance and adequacy of the Federal Open Market Committee's own procedures and operations in the new context. Transactions for the Committee's account exert a powerful impact on that market. It is important that they be so executed as to avoid disruptive technical repercussions. In particular, it is important that technical operating procedures and practices, conceived in the atmosphere of war finance and developed to maintain a fixed pattern of prices and yields in the Government securities market, be reviewed to ascertain whether or not they tend to inhibit or paralyze the development of real depth, breadth, and resiliency in today's market that operates without continuous support.

This is the problem with which the subcommittee has been most concerned. The absorption and release of reserve funds which results from Federal Open Market Committee transactions should constitute a constructive factor in the Government securities market, as well as in the economy generally. Without open market operations, appropriately conceived and executed when there is need to absorb or release reserve funds, it would sometimes be impossible for the market to evaluate correctly fundamental trends in the economy as they affect the supply of money relative to its demand.

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It is evident, therefore, for the well-being of the Government securities market itself, that the possibility be minimized of disruptive technical market repercussions from Committee transactions. It is also evident that the Federal Open Market Committee should be in a position to operate promptly and in appropriate volume at all times, without fear of such adverse technical market repercussions, when the need for operations exists. This requires a Government securities market characterized by great depth, breadth, and resiliency. Without a market possessing these characteristics, the Committee might, on occasion, find itself unable to discharge its responsibilities.

INTRODUCTION

(1) The Federal Open Market Committee, at its meeting on May 17, 1951, authorized an ad hoc subcommittee to study and report on the operations and functioning of the Open Market Committee in relation to the Government securities market. The subcommittee was organized in April and May 1952, as follows: Wm. McC. Martin, Jr., chairman; Abbot L. Mills, Jr., Malcolm Bryan, Robert H. Craft, vice president and treasurer of the Guaranty Trust Co., of New York, was appointed technical consultant to the subcommittee, and was given leave of absence by the Guaranty Trust Co. to devote his full time to its work.

(2) Efforts have been made to keep the executive committee of the Federal Open Market Committee, all the Governors of the Board, and all of the presidents of the Federal Reserve banks informed of the activities of the subcommittee. The interval, amounting to nearly a year, between the authorization of the subcommittee and its actual establishment reflected the desirability of deferring the study until the conclusion of the hearings of the Patman subcommittee of the Joint Committee on the Economic Report, as well as the desirability of permitting some experience to accumulate on operations of the Committee under the more flexible conditions that followed the Treasury-Federal Reserve accord of March 5, 1951.

Procedures of the subcommittee

(3) As its first step, the subcommittee, with the help of suggestions from the executive committee, prepared an outline of study which was sent to a list of the individuals and institutions active in the market for Government securities, either for information or response. So that there would be no misconceptions, the outline and letters were made available to the press.

(4) Beginning June 9, 1952, the subcommittee held 10 sessions with recognized dealers, 11 meetings with unrecognized dealers, and 8 meetings with nondealers intimately familiar with the operations of the Government securities market, discussing the material covered in the outline of study. The subcommittee also received letters from other individuals to whom the outline was sent. Stenographic notes of the discussions were taken for the convenience of the subcommittee but are not part of the record, since they were not subsequently cleared with the discussants.

(5) The outline of study, together with the list of individuals and institutions to which it was sent, and the covering letters by Chairman Martin, are attached to this report as appendix A. Mr. Craft has prepared a technical analysis of the correspondence and discussions focused on the outline of study which is attached as appendix B. Mr. Craft has also prepared a memorandum, entitled "Ground Rules," with respect to certain problems before the subcommittee which is attached as appendix C. A memorandum from the staff, discussing the possibilities of reopening an open market call money post to finance dealers' portfolios, is attached as appendix D.

THE GOVERNMENT SECURITIES MARKET

Size, participation, and composition

(6) Of the total gross Federal debt of $265 billion, about $145 billion are outstanding in marketable form. Ownership of the marketable debt is about as follows: Commercial banks have about $60 billion; corporations about $15 billion; mutual savings banks, life insurance companies, and State and local governments about $7 billion each; casualty insurance companies about $5 billion; Federal agencies and trust funds about $3 billion; and savings and loan associations and foreign governments about $2 billion each. All other investors, including individuals, trust funds, private pension funds, endowments, etc., own around $13 billion in the aggregate. The Federal Reserve banks, which have nearly $24 billion, or about one-sixth of the marketable securities, have by far

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the largest single holding in the market, about 10 times larger than the next largest portfolio under one control.

(7) The marketable debt is comprised of $20 billion of Treasury bills, $17 billion of certificates, $30 billion of notes, $36 billion of bonds due or callable in 5 years, $17 billion of longer term bonds not restricted as to bank ownership, and $27 billion of restricted bonds. Commercial banks hold about one-third of the bills and certificates, half of the notes, and two-thirds of the bank-eligible bonds. It is roughly estimated that business corporations hold about half of the bills, one-fourth of the certificates, and much lesser proportions of the notes and bonds. Savings institutions, including life insurance companies, pension funds, etc., own the bulk of the long-term bonds. Federal Reserve holdings are heavily concentrated at the present time in certificates, notes, and short-term bonds.

Market structure and activity

(8) The Government securities market provides the mechanism through which marketable Government securities have their secondary distribution. It is an over-the-counter market; it is really a group of markets made by the various dealers and knit together into a unit by an extensive communications system. About 20 dealers, including some banks with trading departments, comprise the basic structure of this market. The focus of the market is in New York, and most dealers have a network involving branch offices, representatives, correspondents, local investment houses, or the like through which they maintain contact with major Government security holders throughout the country. There are a number of secondary dealers who also trade in Government securities, frequently as a part of the broader over-the-counter business.

(9) The volume of transactions in marketable Government securities runs to a very large figure—on an average several hundred million dollars a day. These transactions are typically made by dealers without commission on a very narrow spread between the price at which they will buy and the price at which they will sell. So-called inside markets are typically made on spreads ranging from $\frac{1}{32}$ ($312.50 per million dollars) for long-term bonds down to an 0.01 in yield ($25 per million dollars) on 90-day bills. As a usual thing, transactions of good size—as much as $1 million or more for long-term bonds and up to $5 million or more for short-term issues—are executed on-the-wire with customers. Trading is thus on a split-second basis, in large amounts in relation to dealer capital, and on close margins. Alert arbitraging is also constantly going on among the various issues of securities, both by dealers and by other active elements in the market. Success or failure in professional trading in such a market turns importantly on ability to appraise changing market factors quickly and accurately.

(10) The Federal Reserve stands in a key position with respect to the entire money and capital market in this country and particularly with respect to the Government securities market. System contacts with the market for United States Government securities take four main forms—transactions in Government securities made for the account of the system, extension of credit by a Federal Reserve bank to the nonbank recognized dealers through purchases of short-term securities under repurchase agreement, transactions made as agent for Treasury and foreign accounts or for member banks, and the gathering and dissemination of information on developments in the Government securities market. Aside from some transactions executed by the other Reserve banks for the account of member banks, these points of system contact with the market are focused at the trading desk at the Federal Reserve Bank of New York.

Trading desk facilities and activities

(11) The trading room at the Federal Reserve Bank of New York is equipped with some 10 or 12 key-type telephone stations with direct lines to each of 8 dealers in New York City, plus several trunklines for outside calls. These phones are manned continuously by 4 or 5 people regularly assigned to direct contact work with the dealers. Instantaneous contact can be made either by the personnel at the trading desk or by any 1 of the 8 dealers simply by pushing the proper key. At least one officer of the Bank is always on call at the desk during trading hours.

(12) Other personnel assigned to the trading desk handle special tasks of various kinds such as transactions for Treasury agencies, foreign accounts, or for member banks in the New York district. Clerks maintain current price quotations on all Government securities on a large quote board, which can easily be seen by any of the personnel on the trading desk. The quotation board itself lists quotations on all Government securities as received hourly from

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several dealers. From these quotations a composite or average quotation for each issue is computed. Routine reports on developments in the stock market and corporate and municipal bond markets are received and transmitted to the operating personnel on the trading desk.

Transactions

(13) Purchases and sales of securities for the System open market account are supervised by the manager of the account and are made in accordance with instructions issued by the Federal Open Market Committee. Such transactions, both on a repurchase and on an outright basis, (as well as all transactions in Government securities made by the New York bank for foreign accounts, member banks, or the Treasury) are now confined to 10 recognized dealers. This strict limitation of the dealer group with which the account now trades was formalized by the committee in 1944. Previously, the Federal Reserve Bank of New York had followed a less formal arrangement with a larger group of dealers.

(14) The policy of confining open market account business to a small group was adopted by the Federal Open Market Committee in 1944 in an attempt to deal only with that portion of the market where the final effort at matching private purchases and sales takes place. This approach was based on the hope that by operating closely with a small group of key dealers responsive to its discipline, the Federal Open Market Committee could peg a pattern of low interest yields in a period of heavy war financing with minimum monetization of the debt.

(15) In accordance with the instructions of the Federal Open Market Committee, open market transactions are practically always made on an agency basis, that is, not with dealers as principals but with other holders, using dealers as brokers. This has meant that dealers could not ordinarily sell to the account from position. The Commitee has specified that the commission allowed shall not exceed $156.25 per million dollars on notes and bonds, and $100 per million dollars on certificates and bills. In practice it generally has been smaller on maturities of less than one year. Repurchase agreements are by their nature made with the nonbank recognized dealers as principals.

(16) Transactions executed by the trading desk are never made for cash, i. e., for delivery the same day, but rather for regular delivery the following day (occasionally for delayed delivery). For short-term issues, however, a large part of transactions made by others in the market is on a cash basis. The account will not knowingly buy securities handled by dealers on a cash basis.

(17) In addition to transactions for the System's open market account, a large volume of purchases and sales is made by the New York bank for domestic and foreign accounts. Acting as fiscal agent for the Treasury, the New York bank transacts business for various Government agencies and trust funds. These transactions may be of a routine nature or may involve special operations designed to support the market. Foreign central banks and other foreign agencies also employ the New York Federal Reserve Bank as agent and channel purchase or sale orders on Treasury issues through it. Member banks in the New York Federal Reserve District—usually smaller banks in outlying areas—also use the New York bank for what are typically odd-lot transactions. All of these transactions by the bank as agent are handled through the trading desk.

(18) Transactions for the open market account are normally handled by any 1 of 4 or 5 persons who maintain constant direct contact between dealers and the account. Transactions for the Treasury, foreign agencies, or member banks are usually handled by an individual on the trading desk who is not one of the persons regularly contacting dealers for information or normally trading for open market account. Thus, the dealers can generally distinguish between agency transactions and those for the open market account on the basis of the origin of the call from the trading desk. There are also other clues in the trading operation which dealers can use in appraising the source of a transaction. At times, however, the regular procedures of the desk may be changed in order to conceal the operations of the open market account. Orders for the account may be channeled through the individual who ordinarily handles foreign agency and member bank business, or those who usually trade for the open market account may take over business to be done for agency or foreign accounts. Pending the weekly report of condition of the Federal Reserve banks, the actual operations of the account may thus be screened from the market or the market may be led to believe that the Federal Open Market Committee was active at a time when it was not.

(19) The volume of transactions in Government securities carried out by the New York bank's trading desk for foreign, Treasury, and member bank accounts

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is very substantial. In the 12 months ending June 30, 1952, such business amounted to about $2.4 billion, of which $1.5 billion was in bills, $600 million in certificates and notes, and $300 million in bonds. These transactions amounted to about one-third the volume of total trades for open market account; they were almost as large as open market transactions other than in periods of Treasury refunding.

(20) Federal Reserve banks outside New York also transact business in Government securities as a service for some of their member banks. In the 12 months ending June 30, 1952, $1.9 billion of such business was handled. While some Reserve banks confine such dealings to those dealers qualified to transact business with the open market account, others do business with a wide group of investment houses.

Information arrangements

(21) The 4 or 5 individuals assigned to contacting dealers at the New York trading desk are constantly receiving oral reports from dealers, maintaining current records of reported transactions in the market, and checking and relating the information thus received with various written reports also submitted by the dealers. In addition, 1 or 2 of these contact men report to various interested officials in and out of the System on current trends in the market.

(22) Before the market opens each day, several meetings are held with representatives of recognized dealers. These meetings, which are limited to approximately 10 minutes each, are scheduled on a rotating basis, with 2 or 3 dealer organizations participating each day. At the meetings, the dealer representatives report on the major transactions handled in the market during the previous trading session. They also pass on other information about the Government securities market or other aspects of the money and capital market. The meetings are largely devoted to reporting by dealers rather than to an exchange of information, as the comments of the Committee's representatives in attendance are very guarded.

(23) During trading hours in the market, contact is maintained regularly between the trading desk and each recognized dealer in New York City. Any transactions involving a million dollars or more are currently reported to the trading desk. A worksheet is maintained on the transactions for the day, divided into various categories of securities, with a general description of the type of customer involved in each trade. This transaction sheet provides a quick general picture of the demand or supply of various types of securities in the market. Important discrepancies between the information on this transaction sheet and the written reports submitted by dealers on their volume and positions or the oral reports made during the morning session are usually clarified by checking further with the dealer.

(24) On days when auctions for Treasury bill issues are being held, one of the contact persons on the trading desk makes several special calls to all dealers to get their appraisals of developments in the auction. At about 11:30 a. m., each one of the dealers gives his estimate of the level at which customer bids (i. e., bids of nonbank investors who usually submit them as customers of banks) will be submitted and also as to the lowest price level at which awards will be made. Again, at about 1 p. m., dealers will be contacted to see if there has been any change in sentiment. Based on the information received, bids are submitted for the amount of maturing bills held in the portfolio. The manager of the foreign department is also informed as to the market estimate of the bill auction and he then determines at what price bids for foreign agencies will be submitted.

(25) Supplementing the information received verbally by the trading desk, various written reports of a statistical nature are also made by dealers. Daily reports are received from each of the recognized dealers, as well as many of the nonrecognized dealers, on their current positions broken down into various categories. Reports are also made on the total transactions handled each day in each of those categories. Thus, shortly after the opening of the market on any day, the trading desk personnel has available to it data on the current long and short positions of each dealer, the aggregate positions of nearly all dealers in the market, and the volume of transactions in various classes of securities made by each dealer and the aggregate of such transactions.

(26) The trading desk also received from other departments of the New York bank a daily report on the reserve position of each of the central reserve city banks in New York City and reports on the money market factors affecting the

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New York market, including a prediction of the effect of these factors for the ensuing day. The most recent figures on factors affecting reserves of all member banks are also supplied to the desk, as well as frequent projections of major factors affecting bank reserve positions over the next 2 weeks. Estimates supplied on Treasury receipts and expenditures are compared each Monday and Thursday with the operating personnel at the Treasury in a discussion of the amount of calls on tax and loan accounts to be made and the timing of such calls; this contact is handled at the trading desk by an officer of the securities department.

(27) At regular intervals during the day, information on market prices is given by the trading desk personnel to representatives of the Treasury and of the Federal Reserve Board. In addition to the routine price reports, a summary of market developments during the day is given shortly after the market closes to the Treasury and the Board. Flash reports are sent to each Federal Reserve bank president twice daily—at about 11 a. m. and after the close.

(28) Two regular reports on developments in all securities markets are issued by the New York bank, and trading desk personnel contribute a summary of developments in the Government securities market to each of these reports. One of these is a daily report to the Board of Governors which is distributed to various System representatives and to the Treasury. A somewhat more complete report is made weekly to the Federal Open Market Committee, and circulation of this report is limited to a list approved by that Committee.

FINDINGS AND RECOMMENDATIONS

Structure of the market

(29) It is the conviction of the subcommittee, based on its intimate discussions with a very large segment of key participants in the United States Government securities market, that that market at the present time possesses, with one exception noted below, the organizational elements essential to successful performance of its functions. It is competently staffed, and its operations cover the relevant sections of the community.

(30) The only serious qualification that the subcommittee makes to these generalizations relates to certain deficiencies in the credit facilities available to dealers. During recent months, the rates paid by dealers to carry their portfolios of United States Government securities have averaged above the yield on these portfolios. This amounts to a negative "carry" and obviously affects seriously the ability of the dealer organization to maintain broad markets. This problem has become more serious since the discussions with the dealers. At the time of those discussions, the dealers dealt at length with the problem of negative carry but they were referring, for the most part, to periods of stringency of very limited duration, not to the kind of continuing stringency that prevailed in most of the third quarter of 1952. The subcommittee advances suggestions to correct this deficiency later in the report.

(31) It is likewise the conviction of the subcommittee that the market for United States Government securities is already sufficiently broad, experienced, competitive, and arbitrage minded as to minimize the success of attempts of private operators to "rig" the market.

(32) The market has developed a considerable degree of resiliency and ability to handle itself since the accord. After years of pegging, it took a few months for the establishment of market equilibrium, but this was achieved without the development of disorderly conditions and with none of the drastic changes in prices and yields that had been feared by so many. In the long-term area, this equilibrium has now been maintained for more than 1 year without material Federal Reserve intervention. Subsequent to mid-year 1951, total dealings of the open-market account in securities of longer than 14 months' maturity have amounted to $32 million, excluding securities acquired in exchange for maturing issues. Most of these transactions occurred in late November and late December of last year.

(33) The actual record of transactions by the Federal Open Market Committee since mid-1951 is shown in the following table:

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Open market account transactions in U. S. Government securities [1]—July 1, 1951–Sept. 30, 1952

[In millions of dollars]

Class of security	Total		During periods of refunding [2]		Other than periods of refunding	
	Purchases	Sales	Purchases	Sales	Purchases	Sales
Maturing issues (rights)	3,059		3,059			
Other securities maturing:						
Within 91 days	1,568	2,206	541	372	1,027	1,834
91 days to 14 months	594	2,277	341	1,154	253	1,123
14 months to 5 years	1				1	
5 years to 10 years	3				3	
Over 10 years	23	5	6	3	17	2
Total	5,248	4,488	3,947	1,529	1,301	2,959

[1] Excludes repurchase agreements with dealers and brokers and purchases and sales of special certificates from and to Treasury.
[2] Commitments from date of announcement to closing of books, plus all transactions in new securities on a when-issued basis.

(34) The table indicates that the Federal Open Market Committee has concentrated its transactions very heavily in short maturities since mid-1951. Purchases of issues of over 14 months were negligible, despite the fact that this record covers a period during which the price of Victory's moved between $95½ and $99⅛, and that both the market and the Committee were feeling their way out from the conditions that prevailed under the pegs. The $32 million of transactions in the intermediate and long-term sector are the only ones that could properly be described as undertaken by the Committee to "maintain an orderly market."

(35) It would be inaccurate, however, to describe the present market for United States Government securities as possessing depth, breadth, and resiliency to the full degree that would be desirable for the efficient conduct of effective and responsive open-market operations. It is important that there be no misunderstanding of the intent of the subcommittee in making this qualification. The subcommittee is not referring to the degree of fluctuation that has characterized prices in the market for Government securities since the accord. Considering the pressure on the economy and on the supply of savings, the range of price fluctuation in the market for Government securities has been moderate. The subcommittee refers rather to the psychology that still pervades the market, to the confusion among professional operators in the market with respect to the elements they should take into consideration in the evaluation of future market trends, and to their apprehension over the attitude toward prices in the market on the part of the Federal Open Market Committee and of its representatives on the trading desk. This psychology would not characterize a market that possessed real depth, breadth, and resiliency.

(36) In strictly market terms, the inside market, i. e., the market that is reflected on the order books of specialists and dealers, possesses depth when there are orders, either actual orders or orders that can be readily uncovered, both above and below the market. The market has breadth when these orders are in volume and come from widely divergent investor groups. It is resilient when new orders pour promptly into the market to take advantage of sharp and unexpected fluctuations in prices.

(37) These conditions do not now prevail completely in any sector of the market. They are most nearly characteristic of the market for Treasury bills, but even in that market reactions have been sluggish on more than one occasion since the accord. They are least characteristic of the market for restricted

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bonds. In these issues, there has prevailed persistently since the accord a wide gap between the prices at which the least firm holders are willing to sell and potential buyers are willing to purchase. Within this gap, quotations have fluctuated widely, either in response to relatively small buy or sell orders, or, more frequently, as a result of professional efforts to stimulate interest by marking quotations up or down.

(38) In the view of the subcommittee, the persistence of this condition operates to weaken the effectiveness of open-market operations and emphasizes the importance of steps to improve the depth, breadth, and resiliency of the market. Since the Committee's transactions are among the most important factors that condition the market, the Federal Open Market Committee has an obligation to scrutinize its own organization and its own operations to see in what respects, if any, they can safely be modified, if the effect of such modification would contribute to the depth, breadth, and resiliency of the market.

Role of the System in the market

(39) It is the unanimous view of the subcommittee that the Federal Open Market Committee should keep its intervention in the market to such an absolute minimum as may be consistent with its credit policy. This position rests not only on the fact that the System's primary role has to do with credit policy in the broad sense, but also because of important technical considerations related to the highly desirable development of strength in the private market for United States Government obligations. The normal functioning of the market is inevitably weakened by the constant threat of intervention by the Committee. In any market, the development of special institutions and arrangements that serve to provide the market with natural strength and resilience and to give it breadth and depth tend to be greatly inhibited by official "mothering." Private market institutions of this kind are repressed particularly by the constant possibility of official actions which, by the market's standards, will frequently seem—and be—capricious. Such actions constitute a risk that cannot reasonably be evaluated in advance and anticipated in the formulation of individual, private judgments of market prospects.

(40) The subcommittee has come to the conclusion—fully supported by the testimony before it—that the Federal Open Market Committee bears a real measure of responsibilyity for part of the lack of depth, breadth, and resiliency in the Government securities market. There is not only the history of many years of closely controlled markets, but also the fact that the Committee has not yet been specific with respect to what it means by a free market for United States Government securities. In replies to the Patman questionnaire, in official publications, and in public speeches by its personnel, the Committee has indicated that it contemplates operating in a free market from here on out, but at the same time the policy record of the Federal Open Market Committee, published in the 1951 annual report, shows that it is still committed to the "maintenance of orderly markets," which clearly implies intervention.

(41) This inconsistency has not added to dealer or customer confidence. To take positions in volume and make markets, dealers must be confident that a really free market exists in fact, i. e., that the Federal Open Market Committee wil permit prices to equal demand and supply without direct intervention other than such as would normally be made to release or absorb reserve funds. They have no such assurance. To the dealers, and to professional buyers and sellers of Government securities, the pronouncements of the Federal Open Market Committee mean (1) that it has dropped the pegs, (2) that it is willing to see fluctuations in the market, but (3) that it is watching these fluctuations closely and is prepared to intervene on occasion whenever it considers intervention necessary. From the dealer's point of view, this means that the Federal Open Market Committee desires a fluctuating market but will not necessarily permit one to develop that is free. Their conclusion is that they are operating in a fluctuating market subject to unpredictable, however reluctant, intervention by the Federal Open Market Committee.

(42) The distinction has a vital bearing on the ability of the market mechanism to function with depth, breadth, and resiliency. It is in the nature of a dealer's business that he is constantly exposed to market risk from both sides of the market. One test of his professional skill and, indeed, of his fitness to be in the market at all is the ability to judge the factors in a free market with sufficient foresight and prudence to preserve or even augment his relatively thin margin of capital, whichever way the market turns. He does this by reversing or covering his positions at times or by alert arbitrage of markets for particular issues that are out of line. Thus he is able to function continu-

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ously and to make markets. He cannot do this, however, with anything like the same degree of skill in a market that is subject to unpredictable and overpowering intervention by the Federal Open Market Committee. The Committee, with practically unlimited resources to back up its intervention, is not guided in its operations by considerations of profit, and unlike other investors, is not forced to cover its operations to minimize loss. Such intervention can impose drastic risks on a dealer or other holders, particularly if the intervention is in intermediate or long securities where the dollar impact on the capital position of modest changes in yields is large.

(43) It is easy to understand why dealers, with their lack of confidence in the Committee's intentions to restore a free market, would be reluctant to go very far in taking positions. To do so would not only involve the risk of being wrong in their evaluation of economic and market trends, but also of being wrong in guessing at what point the Federal Open Market Committee might feel it necessary to intervene. A difference of a few thirty-seconds in the level of prices of such intervention would not necessarily be of great moment to the Federal Open Market Committee, but it might be of real importance to a dealer's operations.

(44) It is the judgment of the subcommittee that the lack of professional dealer confidence in the intentions of the Federal Open Market Committee is justified, and that it is not enough for the development of an adequate market that the Committee's intervention be held to a strict minimum. It is important that the dealers be assured, if it is at all possible to give such assurance, that the Committee is prepared to permit a really free market in United States Government securities to develop without direct intervention for the purpose of establishing particular prices, yields, or patterns of yields.

(45) When intervention by the Federal Open Market Committee is necessary to carry out the System's monetary policies, the market is least likely to be seriously disturbed if the intervention takes the form of purchases or sales of very short-term Government securities. The dealers now have no confidence that transactions will, in fact, be so limited. In the judgment of the subcommittee, an assurance to that effect, if it could be made, would be reflected in greater depth, breadth, and resiliency in all sectors of the market.

(46) Such assurance would not impede open market operations by the Committee designed either to put reserve funds into the market or to withdraw them to promote economic stability. It would simply guarantee that the first impact of such purchases and sales would fall on the prices of very short-term issues, where dollar prices react least in response to a change in yield, and where the asset value of a portfolio is least affected. A dealer organization, even though it operates on thin margins of capital, can live with impacts such as these and consider them a part of its normal market risks.

(47) Nor would such an assurance prevent the effects of open market operations, initiated in the short-term sector, from spreading to other sectors of the market in the form of changes in prices, yields, and the pattern of yields. These changes would come about as a result of market arbitrage, i. e., of the exercise of market skill by the professionals who make up the market, the dealers who specialize in matching bids and offers and the professional managers of portfolios who are constantly balancing their investments to take advantage of shifts in prices and yields between the different sectors of the market. A dealer can survive, even if the capital value of long-term issues reacts sharply, when these reactions are brought about as a result of market trading and arbitrage. His risk exposure, on positions in intermediate and long-term issues, is much greater when these changes are induced by direct intervention at arbitrary prices by the Federal Open Market Committee.

(48) The subcommittee realizes the difficulties involved for an operating body, such as the Federal Open Market Committee, in giving any assurance that would limit its own future freedom of action. An assurance, of course, that the Committee would limit its intervention to the very short-term market would fall within, not without, the boundaries of the best central banking traditions. It was long held axiomatic that central bank portfolios should properly be confined to very short-term bills of the highest liquidity and quality. In fact, most effective central banks have operated within this restriction, imposed either by tradition or by law. Traditional principles of central banking made no provision for operations in the intermediate or long maturities of any borrower.

(49) There are only two types of situation where the freedom of action of the Federal Open Market Committee would be seriously limited by such an assurance. In the one case, potential System intervention revolves in general around its commitments with respect to "orderly markets." In the other, it is

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associated mainly with the purchases and exchanges in periods of Treasury financing.

(50) So far as the first type of intervention is concerned, the form and wording of the directive issued by the Federal Open Market Committee with respect to "orderly markets" assumes a particularly crucial importance. The subcommittee was much impressed with the wide differences in opinion among dealers and nondealers as to what constitutes an "orderly market." From the discussion, it is thoroughly apparent that the term "orderly markets" does not have a clearly defined meaning which is generally understood and accepted.

(51) In view of these differences in concept, and particularly in view of the narrow definition of this term held by some market elements, it seems to the subcommittee that the apprehensions of the dealers have substance. The present wording of the directive of the Federal Open Market Committee on "maintenance of orderly conditions" carries with it an unduly, and even dangerously strong, implication of continuing intervention in all sectors of the market. This prospect of intervention seriously impairs the ability of the market to stand on its own feet or to evaluate correctly the real forces of demand and supply in the economy. It is clearly evident that a directive to "maintain orderly markets" can mean all things to all men, and in effect constitutes a blanket delegation of discretionary authority which can be interpreted to cover almost any action by the Committee in the market.

(52) In the subcommittee's view, a directive which is subject to such an interpretation by either the market, the executive committee, or the management of the account is entirely inconsistent with the minimum role in the market which the Federal Open Market Committee must assume if the Committee and the market are each to perform their respective functions most effectively.

(53) The subcommittee recommends, consequently, that the wording of the directive of the Federal Open Market Committee to the Executive Committee be changed to provide for the "correction of disorderly conditions" rather than the "maintenance of orderly conditions" in the market for Government securities. The directive by the Executive Committee to the management of the account in this regard should involve an instruction to notify the Executive Committee whenever conditions become sufficiently disorderly to warrant the consideration of corrective action by the Federal Open Market Committee.

(54) In making this recommendation, the subcommittee takes the position that fluctuations resulting from temporary or technical developments are self-correcting in a really free money market without the necessity for intervention of any kind. This is particularly true of a functioning market characterized by depth, breadth, and resiliency. Of the movements that are not self-correcting, most reflect basic changes in the credit outlook and should not be the occasion for intervention. Of the remainder that do not fall in either of these two categories, the great preponderance, throughout all sectors of the market, will respond readily to arbitrage induced by positive intervention on the part of the Committee in the very short sector of the market. In other words, it is only rarely that selling creates a sufficiently disorderly situation to require intervention in other than the very short market. A disorderly condition created by buying is very unlikely to occur if the Committee is in a position to absorb reserves by selling in the short-term market.

(55) The subcommittee considers a declining market really disorderly in the sense that it requires intervention to meet it when selling feeds on itself so rapidly and so menacingly that it discourages both short covering and the placement of offsetting new orders by investors who ordinarily would seek to profit from purchases made in weak markets. There are occasions when such really disorderly reactions occur in the market. They may lead, if left unchecked, to the development of panic conditions. These must be corrected. In the judgment of the subcommittee, it is in these circumstances, and these circumstances only, that the Federal Open Market Committee would be impelled, by its basic responsibilities for the maintenance of sound monetary conditions, to intervene, and intervene decisively, in other than the very short-term sector of the Government securities market.

(56) The reserve funds put into the market in such operations would complicate the smooth execution of monetary policy, but the occasions for intervention would be infrequent. Once properly explained, consequently, this specific exception to a general public assurance that the Committee henceforth would confine its operations to the very short maturities, preferably bills, should not impede the development of a market with greater depth, breadth, and resiliency.

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The problem of Treasury financing

(57) The Federal Open Market Committee now follows the practice of intervening in the market to support rights values on maturing Treasury securities. So long as this practice continues, it will be impossible to give the type of assurance discussed above. These interventions are recurrent. When sales to the Federal Reserve are appreciable, they result in the injection of reserve funds into the market in amounts that are embarrassingly large. They impose a pattern of yields on the market, and, consequently, are disturbing to its depth, breadth, and resiliency.

(58) The practice of supporting Treasury financings developed during the period of war finance, when the Treasury and the Federal Open Market Committee undertook jointly to see that lack of funds would not impede effective prosecution of the war. In the judgment of the subcommittee, it would be appropriate to sit down with the Treasury and review the practice in the light of current experience. If any change is to be made, there would be need for extensive consultation with the Treasury, since the Treasury's present debt management policies and its current practices in managing its cash balance would be directly affected.

(59) The subcommittee's views on this point have been considerably influenced by the judgment of its technical consultant, Mr. Craft, and it urges that the Federal Open Market Committee give most serious consideration to the views expressed in the memorandum, entitled "Ground Rules," attached as appendix C. The conclusion presented in this document is that for the open market operation to be successful there must be new ground rules, i. e., new methods of operation by the Committee, known in advance, that will permit the Committee to pursue vigorous credit and monetary policies without incurring the danger of disruption in the market for Government securities. The principal recommendations with respect to the most appropriate ground rules are three: (1) that the Committee (except in the case when it is dealing with a disorderly market) confine its operations to bills, (2) that, in the rare case of the emergence of a disorderly market, corrective actions be deferred until the need for them is clearly indicated and then be taken only after a poll of the executive committee rather than at the discretion of the management of the account, and (3) that the practice of supporting directly either new or refunding issues of Treasury securities be abandoned. The memorandum outlines in detail the considerations that have led to these conclusions, and the specific technical operations that would best carry them into effect.

(60) The memorandum outlines the serious operating problems that the Federal Open Market Committee will face, necessarily, if it continues to acquire Treasury issues of new or refunding securities. The subcommittee is particularly impressed by the conclusion that the portfolio of the open market account may become, in fact if not in theoretical composition, frozen or semifrozen. As is pointed out, the securities which the open market account has acquired as rights in underwriting a refunding have subsequently been exchanged for the new issue and the Federal Open Market Committee has been hesitant to dispose of these new issues under normal conditions in the market—a justifiable hesitation because sale of the securities in the market before they have been held quite near to their maturity might be disruptive.

(61) It is also pointed out that when these securities or, in fact any securities other than bills, however acquired, were sold into the market as they approached maturity, they have been purchased largely by corporations or other investors who had a specific need for cash at the maturity date. They have tended, consequently, to increase the natural and inevitable attrition connected with any maturing Treasury issue. Consequently, the securities have tended to be reacquired by the Committee in supporting the refunding.

(62) The persistent growth in the open market account of securities acquired directly or indirectly in support of Treasury refundings is disquieting.

(63) The present semifrozen position of the portfolio brings out in new form the desirability of a larger proportion of bills in the System's portfolio, and underscores the cogency of the recommendation that henceforth the Committee operate exclusively in bills except when it is intervening in the market to correct conditions of very serious disorder. Bills, in addition to their ready market ability and other qualities that make them preferred components of the portfolio, have the unique advantage, from the point of view of the Committee's operations, that they are marketed at auction for cash and are redeemed in cash at maturity. Neither at issue, nor at redemption, do they raise problems of support for the Committee, nor of attrition for the Treasury.

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(64) It is clear that the Federal Open Market Committee cannot consider the type of assurance that would contribute most to the development of depth, breadth, and resiliency in the market until it has come to a decision on the question of whether or not the Committee should continue to buy rights or any other securities other than bills during periods of Treasury financing. There are two opposing viewpoints on this basic and difficult problem.

(65) If it is believed that the System's responsibilities are strictly limited to the formulation and execution of credit and monetary policy, logic would preclude the Federal Open Market Committee from purchasing rights or other issues to support Treasury financing. Under this view, the Treasury, being responsible for debt management, would be responsible also for naming such terms and coupons on new securities that a natural-rights value in the market would be established automatically. There would be no occasion, therefore, for intervention or support by the Federal Open Market Committee. The Committee might, of course, engage simultaneously in open-market operations to relieve an unexpected stringency in the money market, but it would not be expected to do so, and if it did it would operate only because of its responsibility for the general credit situation.

(66) This view rests on the doctrine that the governmental structure must provide that responsibility for public decision be clearly fixed and that public officials be held strictly accountable for their decisions. It, therefore, leaves little scope for purchases to support a new issue by the Federal Open Market Committee during the period of subscription. In this view, the Federal Open Market Committee would buy no rights on a maturing issue, with the result that all attrition would fall on the Treasury if the issue were not attractively priced.

(67) This would be expected under the logic of the doctrine of responsibility. Since decisions with regard to debt management are unquestionably a prerogative of the Treasury, the Treasury, under that doctrine, would expect to accept the consequences of an erroneous decision. If attrition were large, the Treasury would be expected to replenish its cash balance with a second offering on terms more in tune with the market.

(68) In contrast to this view is the position which holds that debt-management and reserve-banking decisions cannot be separated. While the Treasury is primarily responsible for debt-management decisions, that responsibility under this second view is shared in part by the Federal Reserve System, and while the Federal Reserve is primarily responsible for credit and monetary policy, that responsibility must also be shared by the Treasury. According to this position, the problems of debt management and monetary management are inextricably intermingled, partly in concept but inescapably so in execution. The two responsible agencies are thus considered to be like Siamese twins, each completely independent in arriving at its decisions, and each independent to a considerable degree in its actions, yet each at some point subject to a veto by the other if its actions depart too far from a goal that must be sought as a team. This view was perhaps unconsciously expressed by the two agencies in their announcement of the accord in March 1951. In that announcement they agreed mutually to try to cooperate in seeing that Treasury requirements were met and that monetization of debt was held to a minimum.

(69) In the view of the subcommittee, it would be wise to avoid pushing either of these positions to the full logical extreme. Neither position exactly fits the immediate situation facing the money market, the Treasury, or the Federal Open Market Committee.

(70) The Federal Open Market Committee has only recently abandoned its previous policy of continuous control of prices and yields throughout the list of Government securities. During periods of refunding, it is still purchasing rights, and on occasion interfering with market arbitrage by supporting issues whose maturity approximates the maturity of new Treasury issues. The object of these transactions is to shield the cash balance of the Treasury from the attrition that might otherwise occur when maturing issues are not presented for exchange.

(71) The Treasury, faced with enormous financing problems both for new money and refundings, has modified to a considerable degree the debt-management techniques developed during the war. Maturing certificates, however, are usually rolled over into a similar issue and when projections are made of needs for new money it is assumed that only moderate attrition will fall on the Treasury in connection with these refunding operations.

(72) The market, too, is in a period of transition. It is confused with respect to the occasions when it should expect intervention from the Federal Open Market Committee, and it is uncertain with respect to the sectors in which this intervention might occur. It is hesitant, therefore, and lacks the depth, breadth,

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and resiliency that would be desirable. It is in the interest of the Treasury as well as of the Federal Open Market Committee that every effort be made to improve these characteristics of the market.

(73) It is in the context of this situation that the subcommittee is formulating its recommendations. It has found (1) that the Federal Open Market Committee can promote the well-being of the market for Government securities by an assurance that henceforth it will avoid unnecessary intervention in the market, and will confine that intervention as much as possible to the very short maturities, preferably bills, (2) that the ability of the Federal Open Market Committee to give such an assurance is blocked by the present practice of purchasing rights and certain issues during periods of Treasury financing, and (3) that, in addition the portfolio of the open market account is becoming unduly weighted with the securities that have been acquired in these support operations.

(74) The subcommittee recommends, therefore (1) that the Federal Open Market Committee ask the Treasury to work out promptly new procedures for financing, and (2) that, as soon as practicable, the Federal Open Market Committee abstain, during periods of Treasury financing, from purchasing (*a*) any maturing issues for which an exchange is being offered, (*b*) any when-issued securities, and (*c*) any outstanding issues of comparable maturity being offered for exchange.

(75) Should the Federal Open Market Committee adopt the recommendations of the subcommittee with respect (*a*) to the type of situation justifying intervention to correct disorderly market conditions, and (*b*) to the kinds of transactions appropriate during a period of Treasury financing, it would be in a position to give a public assurance to the market that henceforth, with two exceptions, the Committee will intervene in the market only to absorb or release reserve funds to effectuate its monetary policies, and that it will confine its intervention to the shortest sectors of the market, preferably bills.

(76) The two exceptions should be carefully explained to the market. They would occur (1) in a situation where genuine disorderly conditions had developed to a point where the executive committee felt selling was feeding on itself and might produce panic, and (2) during periods of Treasury financing. In the first case, the Federal Open Market Committee would be expected to enter more decisively in the long-term or intermediate sectors of the market. In the second case, intervention, if any, would be confined to the very short maturities, principally bills. The subcommittee recommends most strongly that the Federal Open Market Committee adopt the necessary measures and give this assurance.

Judgments of System market techniques

(77) The whole Federal Reserve System can take pride in the prestige enjoyed by the Federal Reserve Bank of New York, and by the management of the open market account in their relations with the Government-securities market. The subcommittee in its discussion made every effort to provide an atmosphere where the market participants would feel encouraged to talk freely with the understanding that their comments would be considered impersonally and objectively. In most cases, the participants in the discussions responded to this atmosphere and discussed their problems objectively, including problems that have arisen in dealing with the Federal Open Market Committee. Without, in any sense, diminishing the importance of these problems and the urgent necessity of taking actions recommended below to eliminate their recurrence, the subcommittee found that by and large the market personnel which participated in the discussions had confidence in the integrity of the personnel of the Federal Reserve Bank of New York, and respect for the competence of its management.

(78) At the same time, the subcommittee was surprised to find extensive criticism of many of the technical operations of the Committee, especially in its relations with the dealer organization. As was anticipated, it found that the drawing of a rigid line between "recognized" and "nonrecognized" dealers was resented by the latter. In addition to this, however, there were evidences, even among the recognized dealers, of irritation with the dealer-Federal Open Market Committee relationship, and some doubt and confusion as to exactly what function the relationship now serves under conditions of unpegged markets.

(79) It is the view of the subcommittee that these two sources of dissatisfaction and irritation cannot be brushed off lightly or viewed complacently as inevitable accompaniments of the difficult and broad operations that are performed by the Committee in the market for the huge outstanding Government debt. The complaints are specific and relate to specific techniques of operation. Unless corrected, they will continue to fester and rankle.

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(80) In all too many cases, the criticisms are interrelated; that is, the technical operations of the Federal Open Market Committee most broadly criticized in the market are the very types of operations which require for their effectuation a sharp differentiation between dealers who are recognized and others who are not. If these technical operations of the Committee were abandoned in accordance with the suggestions of the bulk of the participants in the discussions, there would seem to be less need or justification for the present rigid system of dealer recognition. The subcommittee proposes, therefore, (1) to examine the technical operations to which objection has been raised in its discussions, (2) to come to a judgment as to whether or not the objections are valid, (3) to recommend alternative procedures if they are considered valid, and (4) to consider what form of relationship between the Federal Open Market Committee and the dealers would be most appropriate to a situation of unpegged markets.

(81) *"Reluctant buying."*—The "reluctant buying" technique employed on frequent occasions by the Federal Open Market Committee during the period of pegging, and apparently still used in more limited extent and in modified form during certain refunding operations since March 1951, furnished the most prevalent and active target for criticism on the part of dealers, both recognized and unrecognized, as well as of nondealers. This criticism was practically unanimous on the part of all who referred to the subject in their discussion.

(82) Reluctant buying is the term used to refer to the practice followed by the Committee of limiting its purchases of securities to only a portion of the amounts offered while at the same time requiring that dealers not lower their quotations. This practice involves the exercise of judgment as to whose securities will be taken. The technique is premised on the theory that failure to secure prompt execution will discourage offerings and give time to the dealers to shop around and find market lodgment for securities pressed for sale. It requires a tight Committee control over the major trading elements in the market—maintained through the recognized dealer mechanism—in order to enable the Committee to prevent changes from being made in quoted dealer prices without having to use reserve funds to clear the market of securities being offered for sale at those prices.

(83) Criticisms of the technique (and these were more or less tied together with all the arrangements under which the System took control of the market under the pegs) relate in part to the effects it has on market institutions. It precludes proper functioning of the dealer mechanism, both recognized and unrecognized. It makes brokers of recognized dealers and prevents their taking positions and making markets. Unwillingness to deal with unrecognized dealers, or even to permit recognized dealers to split commissions, makes unrecognized dealers refuse business and turn their customers away since they cannot cover costs. When first applied, it automatically eliminated the auction market for Government securities on the stock exchange, since the specialist, unlike the recognized dealers, could not cover his bids through the Federal Open Market Committee.

(84) However, the most striking criticism, in the opinion of the subcommittee, was that the technique failed in its basic purpose of pegging prices with a minimum of Federal Open Market Committee purchases. It was the general conclusion of most discussants that the theory underlying the entire "reluctant buying" technique rests on an incorrect judgment of market reactions. It was the consensus that the response of investors to this technique is perverse in that holders are induced to attempt to force a greater volume of securities on the market than they otherwise would. Failure to secure prompt execution of sales at quoted markets, instead of reducing sales, heightens uncertainty, encourages further offerings, and in the case of the restricted bonds seems to have stimulated attempts to dispose of bonds to the Federal Open Market Committee through resorting to various types of "blinds." For example, the Committee was believed to have been less reluctant to buy restricted bonds from recognized dealer banks (because of the $500,000 limit on their portfolios) than from nonbank dealers.

(85) It was the almost universal recommendation that, should an occasion ever arise again that justified support operations, a policy of aggressive rather than reluctant buying on the part of the Committee would reduce uncertainty among investors as to their ability to sell and to that extent diminish the volume of offerings. The subcommittee finds this technical judgment persuasive. Certainly the technique of "reluctant buying" should be avoided. In the execution of an aggressive technique, moreover, purchases should not be confined to recognized dealers. If the objective is to engender confidence and remove uncertainty from the market by a show of bids, the desired effect will be achieved

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more readily and with less monetization of debt by spreading the bids among all dealers with whom the public is accustomed to trade rather than by raising questions in the minds of investors as to whether or not they can secure execution through accustomed channels.

(86) The "reluctant buying" technique is perhaps merely the ultimate development in a series of arrangements for controlling the market that had their genesis during the war period. These were further strengthened in the postwar period. The principles and theory underlying these arrangements were that control over the market could be achieved with a *minimum* outlay in reserve funds if the final effort at matching off private transactions were narrowed to a small group of dealers, provided that the Committee could control these dealers by various devices and could confine its buying to the residual transactions. It is the view of the subcommittee that with the passing of the pegging operation the need for such arrangements, if it ever existed, has also passed. Fortunately the circumstances which give rise to most of the serious criticisms directed against the operations of the Committee revolve about the arrangements made to control the market under pegs. By dispensing with these arrangements, no longer needed, these sources of criticism can be corrected.

(87) *Trading on an agency basis.*—Dissatisfaction was general throughout the group of recognized dealers with respect to agency transactions on behalf of the Federal Open Market Committee. This dissatisfaction was expressed most openly and acutely with respect to the commissions allowed by the Committee. These were claimed to be too small in many cases to cover costs. It was also alleged by some, but not all, that the commissions allowed by the Committee have been a factor in the narrowing of spreads in the market to the point where it has weakened the dealer organization.

(88) Dissatisfaction was expressed with the rule that prohibits a recognized dealer from selling from his position when engaged in an agency transaction for the Federal Open Market Committee. Whenever the Committee is the major buyer of a particular issue, the rule has the effect of freezing the recognized dealer's position in that issue, precluding him from making a market in that issue, and turning him, in effect, into a broker for the Federal Open Market Committee. It constitutes a strong inducement not to make markets and thus acquire positions if the dealer thinks the account may enter the market; it raises the specter of losses on positions previously acquired; and in some circumstances it creates a situation where the Committee is subsequently under moral compulsion to absorb dealer positions to protect them against loss.

(89) Nonrecognized dealers resent the fact that they have to absorb all handling costs themselves or refuse customer business when the Committee is the sole buyer in the market, since recognized dealers are not allowed to split commissions on agency transactions. The unrecognized dealers also suspect or are aware that recognized dealers have been "bailed out" on occasion.

(90) These are problems that arose most acutely during the pegging operations, but they did not end with the accord. They still arise during periods of Treasury refundings and, in fact, whenever the Federal Open Market Committee operates, as it customarily does, on an agency basis. One recognized dealer was troubled by the fact that in many instances he is put in a morally indefensible position of acting as agent for both buyer and seller, i. e., for the Committee as well as for his customer.

(91) In the judgment of the subcommittee, this bundle of problems and irritations all stem from a common source, i. e., the emphasis on agency transactions in operations of the Federal Open Market Committee, and would be corrected by willingness to transact business at the market with dealers as principals. This would eliminate the problem of inadequacy of commissions and allow competition in the market to establish spreads adequate to support an efficient and functioning dealer organization. It would remove the problem of frozen positions and permit dealers to make markets by building up and reducing positions in accordance with market considerations. It would end the problem of "bail outs."

(92) From the point of view of operations to effectuate Federal Reserve credit policy, reserve funds are put into or absorbed from the market just as effectively when securities are bought from dealers as principals as when dealers are used as agents. From the point of view of promoting a strong self-reliant Government securities market characterized by intelligent pricing, alert arbitrage, depth, breadth, and resiliency, the Committee's purposes are better served by techniques of operation which avoid the freezing of positions, always at the hazard of loss, on the part of those whose professional attitudes toward the mar-

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ket are probably most influential in hour-to-hour and day-to-day shifts in market situations.

(93) It is the subcommittee's conclusion, therefore, that agency transactions should be abandoned and that the Federal Open Market Committee should enter into transactions with dealers as principals on a net basis. Such transactions should, of course, be made at the best market available. It is very doubtful whether they should be confined as a matter of procedure to the presently recognized dealers. A case may perhaps be constructed for rigid rules of dealer qualification where agency relationships with the Federal Open Market Committee are involved, but there is little basis in public policy for such discrimination among dealers in transactions where dealers are principals.

(94) *Use of the repurchase facility.*—The role occupied by repurchase agreements and the terms of settlement in the technical operations of the Federal Open Market Committee is a subject of considerable controversy within the dealer organization, and many conflicting points of view are present. Recognized nonbank dealers are quick to point out that their bank-dealer competitors have direct access to the Federal Reserve banks and therefore are in a position to borrow at the Reserve banks at the discount rate in order to carry portfolios when money is tight. Nonbank dealers, on the other hand, borrow at the money market banks at rates that frequently rise above the bill rate. A negative "carry" thus develops which makes it expensive and at times prohibitively costly to maintain adequate portfolios. This problem is particularly acute when money is tight over a period of weeks or months, and also when a holiday falls on Friday or Monday, necessitating a 4-day carry. In these circumstances the nonbank dealers are at a serious competitive disadvantage in their ability to make markets. In the endeavor to mitigate this situation, they try to borrow from out-of-town banks and also use credit accommodation from corporations on repurchase agreements.

(95) Bank dealers, in part because of their access to Federal Reserve credit, are readily able to service customers on a cash, rather than the usual regular delivery basis. There has been an increasing use of cash transactions which has constituted an increasingly serious competitive disadvantage to nonbank dealers. Except when the repurchase facility at the Federal Reserve bank is available, the only way they can meet the competition is by buying Federal funds, which is costly when money is tight.

(96) All of the recognized nonbank dealers felt strongly that the Federal Open Market Committee should alleviate these difficulties by a more liberal policy with respect to the extension of Federal Reserve credit on repurchase agreements. Their proposals ranged from the suggestion that each nonbank dealer be given what would be in effect a line of credit for repurchase contracts by the Federal Open Market Committee to be used at his own discretion, to the more modest suggestion that repurchase facilities be extended freely over weekends, particularly over weekends lengthened by a holiday. They complained that frequently they are not informed until the last moment whether or not repurchase facilities would be available. They also desired a change in the policy of the Committee under which it now refuses to buy bills, either outright or on a repurchase basis, which dealers have bought for cash delivery. Some even suggested a change in policy by which the Committee would be willing to buy bills outright with payment in immediate funds.

(97) Most bank representatives, but not all, opposed the availability of repurchase agreements to nonbank recognized dealers. They maintained that the advantage enjoyed by a member bank of direct access to Federal funds at the rediscount rate was an inherent advantage of membership. The equivalent extension of facilities to dealers on repurchase contracts would constitute, in effect, the opening up of membership privileges to nonmembers. They also maintained that the competitive advantage they enjoyed over the nonbank dealer in their access to Federal funds merely offset the competitive advantages enjoyed by the nonbank dealer in being able (1) to take positions in excess of $500,000 in restricted bonds, and (2) in being permitted to enter large subscriptions for attractive Treasury issues, such as the 2⅜s of 1958. They further claimed that free extension of repurchase facilities to nonbank dealers would have the effect of pegging the bill rate.

(98) Nonbank unrecognized dealers complained that they worked under a double competitive disadvantage. They enjoyed neither the full access to Federal funds of the bank dealers nor the occasioned access to repurchase facilities of the recognized nonbank dealers. Nonbank dealers, both recognized and unrecognized, stated that they were forced to bid to miss in the weekly bill auction when the impact of these competitive cost disadvantages was too severe.

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(99) The subcommittee feels that this testimony reveals unsatisfactory aspects of the bill market. In some degree these basic frictions are inevitable in a market structure that is shared by bank and nonbank dealers. No problem would exist, for example, if all dealers were also member banks. Then the dealer organization would price securities and develop competitive patterns in an environment in which access to immediate funds to carry portfolios and to buy for immediate cash were available at the discount rate to all dealers alike. There would be no call for repurchase contracts since the member bank discount window would meet the need.

(100) Similarly, there would be a less difficult problem if there were no bank dealers. Then all dealers alike would have to pay the market money rate to carry portfolios and likewise would have to buy Federal funds in the Federal funds market if they bought securities for cash delivery. In that case, the Federal Open Market Committee could confine its consideration of whether or not to make repurchase facilities available to the effect of such facilities on the rate structure and to the desirability of mitigating the sudden development of very tight conditions in the money market over periods of temporary strain.

(101) The problems created by the presence of both bank and nonbank dealers as indispensable components of the market structure must be recognized by the Federal Open Market Committee. Little comfort can be derived from the fact that the competitive disadvantage of nonbank dealers with respect to direct access to Federal funds is alleged to be compensated by a competitive disadvantage that prevents bank dealers from freely competing in the market for restricted securities. Both disadvantages react adversely on the structure of the Government securities market. Both impair the market's ability to perform efficiently under all conditions. Certainly a serious situation is revealed when the nonbank dealer component in the weekly auction for bills bids to miss at times of stringency, not because the bills acquired could not be marketed but because the necessary risks and costs of carrying the bills prior to resale is higher for nonbank dealers than for their bank competitors.

(102) The subcommittee feels that these fissures in the structure of the market can be alleviated somewhat by changes in the technical operations of the Federal Open Market Committee. They should not be accentuated by the Committee's operations. The subcommittee sees no purpose served by a procedure under which the Committee first divides the bills bought by a dealer into two categories, according to whether or not they were acquired for immediate cash, and then confines its purchases to those which have been acquired on a regular delivery basis. It may be that the original consideration back of this discrimination was to discourage deals for immediate cash and encourage market transactions on the basis of regular delivery in order to achieve a more effective control over the New York money market. If so, the maneuver has lost utility and should be dropped. Sales for cash are increasing and will probably continue to do so as long as banks use this medium for adjusting reserve positions and dealer banks with ready access to immediate cash are in a position to service them.

(103) The subcommittee likewise sees no consideration sufficiently relevant to justify overlong delay in letting dealers know whether or not repurchase agreement facilities will be extended. If the facilities are to be made available, the dealers should be informed in sufficient time to perform their market functions efficiently.

(104) The subcommittee doubts whether our experience with operations in a free market has yet developed to the point where it is possible to lay down definitively all the situations in which the availability of repurchase facilities would or would not be advisable. The testimony, however, has presented a clear case for the more ready availability of repurchase facilities to nonbank dealers over weekends as well as in periods of acute credit stringency. It recommends that they be made available regularly to nonbank dealers over weekends. Any tendency to abuse the privilege should be subject to control by variations in the rates on these facilities.

(105) These moves should go some distance toward alleviating structural impediments which have acted to prevent the nonbank dealers from carrying their full load in the bill market. They should make it more possible for all nonbank dealer participants in the weekly bill auction to gage their bids at each auction on their evaluation of the demand for bills rather than on their lack of access to credit facilities enjoyed by competitors.

(106) In addition, the subcommittee feels it would be worth while to see whether or not a call-money post could be reactivated where nonbank dealers could borrow for portfolio purposes. It is anomalous to find money-market banks

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maintaining over a considerable period of time a portfolio of bills that yields them a lower return than the rates at which they are willing to lend on call an equivalent collateral. Normally one would expect the opposite relationship to prevail; provided the market were truly impersonal the loan with less risk exposure should carry the lower rate. It is disturbing to find a money market so unorganized that dealers, to counteract this situation, cultivate both out-of-town banks and corporations individually on a customer basis as sources from which to borrow money. Revival of an effective call-money post for dealer loans such as existed in the 1920's would go far to correct this condition. A more detailed discussion of this problem is given in appendix D of this report.

(107) The restrictions against bank ownership on most of the remaining restricted issues will expire by 1954 and this will go far to restore equal competitive relationships between bank and nonbank dealers in that sector of the market. These restrictions may be removed at any time by the Treasury.

(108) The subcommittee sees no public purpose served by limiting repurchase facilities to the present restricted list of recognized nonbank dealers. The market structure would be better served by equal extension of the privilege to all nonbank dealers of integrity who participate effectively in the bill market. It recommends that in the future when repurchase contracts are made available by the Federal Open Market Committee, they be offered fairly and impartially to all nonbank dealers who participate regularly in the weekly bill auction, and in amounts related to that participation, say, in some relationship to the average of the dealer's bill awards over the preceding 3 months.

(109) *Operations during Treasury financing.*—The techniques applied by the Federal Open Market Committee during Treasury refunding operations were subject to some criticism, but the more important conclusion that emerged from the discussion of this phase of the Committee's operations was the fact that neither the committee nor the dealer organization has yet come to well-defined and consistent positions on this difficult technical problem. Because the subject dealt with the placement of new Treasury issues, the discussion inevitably touched on problems that fall also in the area of debt management. For example, the view was unanimous that the dealers cannot function effectively as secondary underwriters unless the coupon and terms placed on new issues are sufficiently attractive to establish a natural rights value in the market. There were other suggestions that may minimize the problem of attrition, as, for example, that refundings be conducted through new issues for both cash and exchange rather than solely on the basis of exchange. The subcommittee has not considered problems of debt management and the following comments and recommendations deal solely with technical procedures which the Federal Open Market Committee has followed during periods of Treasury financing.

(110) All of the criticisms of the dealers that relate to the technical practices of the Federal Open Market Committee during periods of refunding stemmed basically from the agency relationship of the Committee with the recognized dealers. Nonrecognized dealers complained that they were forced out of the market during periods of refunding. They had no outlet that would cover costs for issues they might take from their customers since the Federal Reserve refused either to deal with them directly or to permit recognized dealers to split commissions with them.

(111) Recognized dealers for their part complained that the commissions allowed by the Federal Open Market Committee on agency transactions barely covered clearing, telephone, and other current costs and made little or no contribution to carrying overhead costs. They also complained that because of the agency relationship their own holdings of the maturing issues were frozen so long as the books were open or the Committee was operating since under this relationship dealers are not allowed to sell to the Federal Reserve from their own position. The practical result is that in the case of any offering that requires Committee support dealers are frozen into any maturing securities they had in position at the time the Committee started supporting operations. In their capacity as dealers they feel obligated to tender such securities in exchange. Under these circumstances they avoid making markets in order not to add to their positions. They become, temporarily, merely brokers for the Federal Open Market Committee. They resent losses they sustain when the rights value established by the Committee is high in relationship to the market, and they feel that the Committee should feel morally obligated to bail them out.

(112) Recognized dealers also complained (1) that the Committee has been slow on occasions in deciding what rights value to pay when the books are opened on refinancings, and (2) that at times it has operated for short periods

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with different rights values to different dealers, thus giving the dealers' customer the idea that some dealers can secure better execution than others.

(113) Most of these problems will disappear if the Federal Open Market Committee decides to abandon agency transactions as recommended by the subcommittee. All, of course, would disappear if the Committee should decide to refrain from purchases of rights. Presumably the emphasis on the agency relationship stems from the period of general pegs when it was feared that dealers, if permitted to operate as principals, would canvass investors to stimulate market activity and persuade them to sell rather than exchange maturing issues. This apprehension may have been justified when the Committee was operating with more or less continuous pegs, but has no substance in a free competitive market. In a free market, any dealer who solicited customer business merely to create activity would soon find himself with fewer customers.

(114) It is the subcommittee's recommendation, therefore, that if the Federal Open Market Committee decides to purchase rights during a period of Treasury refinancing, it purchase them from dealers as principals without regard to whether or not the securities come from a dealer's own position. This will eliminate the problems of frozen positions, of the bailing-out of losses on those positions, and too narrow commissions. It will also free the dealers to perform their function of making markets at all times.

(115) The subcommittee also recommends that these transactions be conducted without regard to whether or not a dealer is on the recognized list. It is hard to see how a refunding operation, accompanied as it must be by a very general turnover of securities in the market, is aided by a technique that either eliminates some dealers from the market or forces them to trade exclusively off other dealers' markets.

The problem of dealer recognition

(116) There is no room for complacency on the part of the Federal Open Market Committee over the problem of dealer recognition. That fact emerged more and more vividly as each of the unrecognized dealers discussed his problems before the subcommittee. The unrecognized dealers showed up well as individuals both in terms of personality and integrity, and in terms of professional grasp of the business and ability to evaluate the impact of credit and monetary problems on the money markets. It would be hard for anyone sitting through all the hearings to reach the conclusion that this group of unrecognized dealers differed significantly, on the average, from those who represented the recognized dealers with respect to training, integrity, professional capacity, or ability to analyze problems. The fact is that they made a very good impression as a group.

(117) These were the dealers who fell outside the line when the Federal Open Market Committee, at the same time that it was pegging the prices of Treasury securities and was frequently the only source of demand, established formal criteria to distinguish the dealers with whom it would deal from those with whom it would not. That line seriously impaired the ability of unrecognized dealers to function and survive in the Government securities business. Of that fact there can be little question. The impairment came, not only through loss of prestige, which was bitterly resented, but also through loss of customer contacts because of inability to function in rough markets, i. e., when the Committee was operating in the market. This impairment is not so serious now that the Committee has stopped pegging but it still persists to some degree. Curiously, it has not seemed to impair the credit standing of the unrecognized dealers at the banks. All stated they had no difficulty in securing the financing necessary for their business.

(118) There was practically unanimous agreement on the part of dealers, recognized and unrecognized alike, that character, integrity, and professional grasp of the business are the essential prerequisites to effective operation as a Government securities dealer. All seemed to feel that capital, though important, is secondary. Even some of the recognized dealers who defended the practice of formally designating the dealers with whom the Federal Open Market Committee would do business, indicated that capital is not the first essential for successful dealer operation. Since additional capital can apparently be attracted when justified by the scope and profitability of the business, a determining factor in success and growth of a securities dealer is the ability to gain customers, to hold them, and to service them at a profit.

(119) The lines drawn by the Federal Open Market Committee, therefore, struck the unrecognized dealers in a most vulnerable spot, namely, in their ability to service their customers. It cut down the range of their customer potentialities

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and thus reduced their ability to attract or earn capital to meet the minimum capital requirements of the Federal Open Market Committee. It acted in the same way to impair the ability of a nonrecognized dealer to earn recognition by developing customer relations that were nationwide in scope and that extended to all sectors of the list. In short, once the lines were drawn and recognition was accorded to some dealers and not others, a hurdle of some magnitude was imposed on the unrecognized dealers which impaired their ability to develop their business to the point where it would be able to meet the standards imposed by the committee.

(120) The subcommittee probed both recognized and nonrecognized dealers alike to ascertain whether there were not also special responsibilities imposed upon the recognized dealers that might be considered to offset in some degree the privilege of direct contact with the Federal Open Market Committee, but this line of inquiry enlisted only feeble response. The unrecognized dealers professed a willingness to submit reports to the Federal Open Market Committee. In fact, many do report now even though they are unrecognized. In general, the dealers, both recognized and unrecognized, did not seem to feel that the responsibilities to the Federal Open Market Committee imposed on the recognized group operated seriously to their disadvantage in competition with the nonrecognized group. It is clear that the unrecognized dealers would be only too willing to accept such burdens in return for recognition.

(121) The Federal Open Market Committee cannot afford to be complacent about this situation. It has explosive potentialities. Privilege as such is repugnant to the spirit of American institutions. The privilege of dealer recognition, if it is to be continued, must be justified on grounds of high public policy as essential and necessary to the effective conduct of open market operations. It is not sufficient to aver that dealer recognition was once useful or that it should be maintained because it is already in existence, in the absence of a positive reason for change. The fact that privilege exists by virtue of actions of the Federal Open Market Committee is in itself a positive reason for its eradication unless there are necessary and compelling considerations to require its perpetuation.

(122) The present system of official dealer recognition instituted by the Federal Open Market Committee in 1944 was an element in a technique of open market operations designed to peg the yield curve on Government securities and at the same time minimize the monetization of public debt. This technique was based on the hope that the yields on Government securities could be pegged with only a few securities monetized by the Federal Open Market Committee if all offers to the committee had to pass first through a very limited number of dealers with whom the committee would maintain intimate and confidential relations, and who would be required by the committee to make strenuous efforts to find other buyers for securities in the market place before they looked to the committee for residual relief.

(123) The inexorable march of events on which that hope foundered is now a matter of history. The facts are that debt was monetized in volume and that the country suffered a serious inflation until the Federal Open Market Committee abandoned the pegs. The basic reason, therefore, that seemed to justify a small privileged dealer group no longer exists. The technique of which it was an integral part did not work out according to expectations and failed of its purpose.

(124) The subcommittee has already recommended that the Federal Open Market Committee discontinue the technique of reluctant buying and abandon agency relations in its transactions with dealers. It has recommended that the Committee enter into transactions with dealers outside the recognized list if it is operating to support markets, e. g., to peg rights during periods of Treasury refunding. It has also recommended that in its dealings in the bill market both on an outright and on a repurchase basis, it enter into transactions with all dealers who perform a responsible and continuous role in the weekly bill auction. If these recommendations are adopted by the Federal Open Market Committee the competitive importance of recognition in the market place would diminish greatly. It would become a matter of less importance, therefore, whether the fiction of a recognized list of dealers was maintained or dropped. For its own part, the subcommittee feels it advisable to drop the relationship completely and so recommends.

(125) If the Federal Open Market Committee decides to maintain the recognized dealer relationship, on the other hand, the subcommittee recommends most earnestly that it proceed promptly to revise the present list of dealers who enjoy

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the privilege of recognition. It is difficult to justify exclusions that have been made from the select group when comparison is made with some that are within. There are bank dealers within the recognized group that do not take positions or make markets, that do not attempt a nationwide coverage, that do not operate in volume in all segments of the list, and that are clearly motivated in their conduct of operations by a desire to attract and hold correspondent banks for their institutions rather than by a desire to earn a competitive return on the capital at their disposal as dealers. If the relationship is continued, it is urgent that the Federal Open Market Committee draw the lines for recognition on bases that can be justified as impartial and objective.

Reports and information

(126) The Federal Open Market Committee faces no problem of lack of access to market information available to dealers. The Committee has been too powerful a market factor for its requests for information to be easily challenged. It has frequently been the determining factor in hour-to-hour and day-to-day trading in the market for Government securities, i. e., the market in which dealers risk their capital on a relatively thin margin of equity in continuous, almost split-second, trading operations. Despite the dropping of the pegs and smaller intervention in the current market, the potential power of the Federal Open Market Committee, backed by the power to create bank reserves, remains. Under these circumstances, dealers will continue to cultivate contacts with the Committee since no single quality is more important to their ability to survive than their ability to forecast correctly (1) the probabilities of intervention in the market by the Federal Open Market Committee, (2) the direction of that intervention, either on the bid or the offered side, if it occurs, and (3) the sectors in the market to which it may be directed.

(127) Under these circumstances, also, dealers tend to seek orders from the Committee, not because of the profit potentialities of business involved but because they may indicate the direction of the Federal Open Market Committee's thinking. Receipt of an order from the trading desk, in fact, acquires a significance out of all proportion to the actual commission involved. In addition, the dealer endeavors to cultivate access to the Committee and to its staff representatives. He readily accepts the obligation to give information on his activities and to make reports. He welcomes hour-to-hour contact with the trading desk, both to submit quotations and to tender market reports. The responses, however guarded, may provide clues to the state of the market. Even when the Committee is pursuing a neutral policy and is out of the market, the trading desk has business to do, orders to execute for agency and foreign accounts. As noted earlier, this amounted to $2.4 billion in the year ending June 1952. The dealer does not necessarily know whether or not these represent market intervention on the part of the Federal Open Market Committee, but he is likely to feel that continuous and close contact with the trading desk helps him to come to a judgment on whether they do or not. Under the present arrangements the trading desk has probably more knowledge of the sources of demand and supply in the market as well as the money position than any other element.

(128) This situation places a heavy responsibility upon the Federal Open Market Committee. It cannot, in this instance, rely on the customary reluctance of respondents to furnish information to act as a check on its own curiosity. It must decide for itself not only what information should properly be supplied to the market so that it can function effectively but also the limits of what the Committee can, with propriety, ask from the dealers in the way of informaion.

(129) The fundamental rule is that no general information should be furnished a dealer that is not equally available to others. It is unavoidable that dealers executing orders for the Federal Open Market Committee gain special knowledge with respect to that particular transaction, but every effort should be made, as in fact the subcommittee believes it is, to be close-mouthed with respect to these transactions. It goes without saying, of course, that no member or representative of the Federal Open Market Committee should indicate an attitude toward the prices which dealers quote and at which they do business in the market.

(130) So far as additional information to be supplied to the market in the weekly condition statement is concerned, the subcommittee recommends (1) that securities held under repurchase agreement by the Federal Open Market Committee be segregated from the balance of the System portfolios; (2) that the amount of special certificates of indebtedness outstanding be regularly indicated, either in the text or on the stub of the statement; (3) that weekly averages of member bank borrowing be shown in addition to the actual volume of member

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bank borrowing at the close of business on statement days, as is now done for excess reserves.

(131) The extent of the limitations which the Committee should impose on itself and its representatives in seeking information from the dealers poses a more serious problem. In the discussions with the dealers, expressions of irritation, dissatisfaction, and resentment were confined to three quite specific points: One, they did not like the tone or content of the morning meeting when different dealers report individually to the manager of the open market account before market opening. They stated they got little out of the contact and some suggested that it would be better to drop the meeting and substitute a more general type of meeting from time to time between the manager of the account and all the principal dealers together as a group. They felt that they might be given a chance to ask questions at such a meeting and to receive helpful enlightenment on the attitude of the Federal Open Market Committee toward the market. Two, the dealers did not like it when they were questioned so closely by the trading desk on the geographical source of current customer orders as to reveal indirectly the identity of their customer. While the great bulk of the dealers did not object to disclosing the general source of their customer orders, they did feel that it was morally wrong to be asked a series of indirect questions so pointed as to permit identification of the source of their business. Some felt that incorrect use of this information may have been made by the Committee, either by direct approach to sellers, thus revealing that the dealer had not maintained secrecy on a confidential relationship, or by discrimination between offerings, buying some securities pressed for sale by a particular customer but not all. Three, they were apprehensive lest the disclosure of their individual positions to the personnel of the trading desk might tend to affect the decisions of that personnel in subsequent dealings with them.

(132) With respect to these three specific points, the subcommittee recommends: (1) That the individual morning dealer conference be abandoned. It recognizes that there may be merit in the more general type of conference suggested by some of the dealers as a substitute for these meetings but feels that any information furnished by the Federal Open Market Committee at such a meeting should be such as might properly be given to any other segment of the public, (2) that disclosure of the source of customer orders be so limited that there will be no possibility of identification, direct or by inference, of the individual source of customers to the trading desk, and (3) that the Federal Open Market Committee discontinue its present practice of collecting statistics on dealer positions and activity, and substitute for this practice the regular collection of dealer position and activity reports by an officer of the System not connected with the Federal Open Market Committee. This officer would furnish aggregate summaries to the trading desk that did not reveal the position or activity of any individual dealer.

(133) The subcommittee feels that the furthest its representatives can go with propriety in soliciting or accepting information from individual dealers with respect to the source of their orders, is to receive only information as to the general type of customer, the volume of the business, and the sector of the market involved. It questions seriously the propriety of the present practice in which its representatives on the trading desk are free to press dealers for quite specific information on customer transactions and on the basis of this information proceed to compute transaction sheets currently during the trading day, such sheets being subject to later verification against the dealers' statistical reports. It recommends that this practice be dropped.

Housekeeping

(134) In many respects, the Federal Open Market Committee is unique both in the form and the substance of its organization. In form, it is a completely independent organization, specifically set up by statute, with exclusive power of decision with respect to the matters delegated to it. Its composition is designed to insure, to the full extent that legislation can insure, that its members will not only be fully competent, but will also be immune to outside pressure. It is neither an appendage of the Federal Reserve Board nor a creature of the Federal Reserve banks, but a completely independent body, each member of which, as an individual, whether he be a Governor from the Board or a president from a Federal Reserve bank, reports to no one. His actions are a matter of public record but each member sits as an individual, bound only by his oath to execute the law. The responsibilities delegated to the Committee are of almost incomparable import.

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(135) The statutory individuality of the Federal Open Market Committee and its separation both from the Federal Reserve Board and the Federal Reserve banks is expressed in its chart of organization. It has its own staff, and when it gathers it meets as a separately organized and staffed body. Its sessions are not joint sessions of the Federal Reserve Board and the Federal Reserve banks, but statutory meetings of the Federal Open Market Committee.

(136) In a very general sense, the Federal Open Market Committee stands in the relation of a fiduciary to the Federal Reserve banks. It, and it alone, has the decision with respect to the amount, as well as the issues, of their open market portfolios. They hold, at the moment, nearly $24 billion of securities, the greatest investment portfolio by far in the history of the world. It is wholly in the discretion of the Federal Open Market Committee to direct the investment of large additional amounts.

(137) In an even more general sense, the Federal Open Market Committee stands in a fiduciary relationship to the whole American economy. It could be called special trustee for the integrity of the dollar, for the preservation of its purchasing power, so far as that integrity can be preserved by its operations. It is especially charged, also, to use its powers to provide an elastic currency for the accommodation of agriculture, commerce, and business, i. e., to promote financial equilibrium and economic stability at high levels of activity.

(138) This unique structure of the Federal Open Market Committee was hammered out after long experience and intense political debate. Like other components of the Federal Reserve System, it exemplifies the unceasing search of the American democracy for forms of organization that combine centralized direction with decentralized control, that provide ample opportunity for hearing to the private interest but that function in the public interest, that are government and yet are screened from certain governmental and political pressures since even these may be against the long-run public interest.

(139) When the substance, rather than the form, of the Federal Open Market Committee is analyzed against this background, certain possible anomalies arise. It has no individual budget, nor does the act provide for one. There is no single person on its operating staff who is responsible to the Committee alone. Each of its officials is paid either by the Federal Reserve Board or by a Federal Reserve bank. Each would automatically cease to have any relationship with the Federal Open Market Committee the moment that connection was severed. No member of the Committee, nor of its staff, is charged to give exclusive attention to its concerns. Everyone connected with it wears also another hat. Even the manager of the open market account, who comes nearest to devoting his full time to its functions, has heavy independent responsibilities in connection with the fiscal agency and other operations of the Federal Reserve Bank of New York.

(140) The Federal open market account is not managed by the Federal Open Market Committee. This function has been delegated to the Federal Reserve Bank of New York, subject to policy directives that provide discretionary leeway within which the management operates. The manager of the account is selected by the directors of the Federal Reserve Bank of New York and approved by the full Federal Open Market Committee each year. In his day-to-day operations, he is subject to the authority of the Federal Reserve Bank of New York, and not to that of the Federal Open Market Committee.

(141) The subcommittee urges that the Committee take the initiative in reexamining and reviewing this structure of organization. There has been much experience since the arrangements were first established. In the light of that experience, is the structure well designed to carry out the Committee's important functions? For example, should the Federal Open Market Committee operate under a budget of its own? This might require legislation, but if a separate budget would improve its operations, the Committee is morally obligated to suggest such legislation to the Congress.

(142) Should all or part of the staff of the Federal Open Market Committee be separate and distinct from the staffs of the Federal Reserve Board and the Federal Reserve banks? However paid, should they wear one hat, and one hat only, devoting all their time exclusively to the operations of the Federal Open Market Committee? There are both advantages and dangers in this suggestion which must be weighed. The Federal Reserve System is a family, and the Federal Open Market Committee urgently needs the knowledge, the judgment, and the skill of all the members of that family. It would be extremely difficult to build up a new and independent staff as qualified as the personnel which it now enlists to work on its problems. It would be equally unfortunate to

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lose the contributions of that staff to System problems that fall outside the limited area of responsibility of the Federal Open Market Committee. Yet there are equal dangers in a situation where the time of no one person on the whole staff of the Committee is wholly devoted to its responsibilities, where everyone wears two hats, and where each must fulfill duties separate and distinct from those imposed by the Federal Open Market Committee.

(143) Should the present situation, which delegates the management of the open-market account to the Federal Reserve Bank of New York, be retained, or should the manager of the open-market account be made directly responsible to the Federal Open Market Committee? The present arrangement has the advantage that the mechanical operations of the account, the keeping of its books and records and the handling of its funds, are under the immediate supervision of the Federal Reserve Bank of New York with its superb facilities. More important, it has the advantage that the president of the Federal Reserve Bank of New York, situated as he is in the center of the Nation's money market, with his personal insight into problems of monetary policy and his immediate access to financial information not so readily available to anyone else, can supervise on the spot the execution of the general policy directives of the Federal Open Market Committee and the executive committee and thus determine that that policy is made effective in operations.

(144) It has the disadvantage that the president of the Federal Reserve Bank of New York sits at meetings of the Federal Open Market Committee and of the executive committee necessarily in a somewhat different role from that of his colleagues. He comes not only as a contributor to the discussion on policy formation, but, also necessarily, as a protagonist for the actual day-to-day operations of the account. These operations are his responsibility. He cannot criticize them without criticizing his own staff. The committee, therefore, in some part loses contact with the critical insight of its best informed member. It has the disadvantage also that other members of the Federal Open Market Committee, reluctant to seem critical of a colleague, may hesitate to scrutinize adequately the technical operations of the account. This is a serious deficiency because the other bank president members of the Committee are usually scattered and out of intimate touch with one another as well as with the market. They must depend on give and take discussion at Committee meetings and at the meetings of the executive committee to sharpen their appreciation of the Committee's operating problems.

(145) The present arrangement makes one major contribution of paramount concern to effective operations. There must be confidence throughout the market and throughout the financial community generally that open-market operations are immune from political pressures. This confidence is undeniably strengthened by the fact that the Federal Reserve Bank of New York actually conducts open market operations for the Committee. Under the present management arrangement, the actual contacts of the market are contacts with personnel of the Federal Reserve Bank of New York, subject to the discipline of its directors.

(146) There is, of course, the equal necessity of maintaining the confidence of the public generally that the Committee's operations are immune from banker domination. This consideration is reflected in the general structure of the Federal Reserve System with the Board of Governors and the regionally decentralized Federal Reserve banks. It is also reflected in the actual statutory composition of the Federal Open Market Committee. From this point of view, the present arrangement by which the management of the open-market account is delegated to the Federal Reserve Bank of New York requires that the individual members of the Federal Open Market Committee maintain close contact with all important aspects of its operations.

(147) Throughout its consideration of the recommendations it is making in this report, the subcommittee has had this problem in mind. These recommendations do not stop with the evaluation of technical practices of the Committee, originated during the period of the pegs, that now handicap the development of a free market. The subcommittee has been aware also of the urgent necessity of simplifying as much as possible, the operating procedures of the committee and the points of impact which its operations have on the market mechanism. The problem has been to work out procedures (1) that will provide more effectively for the execution of the Committee's monetary policies in the open market, (2) that will do this in a way that will minimize confusion in the market with respect to the committee's purposes, and (3) that will enable individual members of the Federal Open Market Committee to maintain more intimate contact with its technical operations. The subcommittee feels that operations under its recommendations will not only make for greater depth,

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breadth, and resiliency in the market, with less misunderstanding, but will also enable each member of the Federal Open Market Committee to carry out more effectively his individual statutory responsibility as a committee member.

(148) The subcommittee desires to raise one aspect of the problem for special consideration. It urges that the full Federal Open Market Committee take a definite position with respect to the suggestion advanced above that the manager of the open-market account be employed by the Federal Open Market Committee as a whole, rather than by the Federal Reserve Bank of New York.

(149) The subcommittee is not proposing this shift. It is recommending, however, that the change be most seriously considered. The operations of the account would continue to be located in the Federal Reserve Bank of New York, as at present, and the Federal Open Market Committee would continue to avail itself of the personnel, wisdom, and experience of the whole Federal Reserve System, as at present. The only change would be that the manager of the open-market account would be employed by the Federal Open Market Committee as a whole, that he would be solely responsible to the Federal Open Market Committee, and that he would have no responsibilities other than those imposed on him by the Federal Open Market Committee.

(150) Should the Committee decide to make such a move, certain details of organization would have to be solved. They are not of concern at this point. The immediate concern is whether such a move would be in the public interest, whether it would improve the functioning of the Federal Open Market Committee. Certain features of the proposed arrangement stand out as crucial. Since the manager of the open-market account would be directly responsible to the whole Federal Open Market Committee, the individual members of the Committee might feel less reluctant to make direct contact with him and thereby familiarize themselves with details of the Committee's operations. The manager of the account also would no longer occupy the dual role of manager of the account and also of vice president of the Federal Reserve Bank of New York. He would be relieved of responsibility to its directors with respect to any of his activities. Finally, he would no longer participate in transactions originating in the fiscal agency or foreign correspondent relationships of the Federal Reserve Bank of New York.

(151) Some duplication of facilities would result from this change but there would be offsetting advantages. For example, the money market might be less confused with respect to the significance of orders transmitted through the trading desk. The execution of an order for the Treasury, or for a foreign correspondent, could not then give rise to rumors that the Federal Open Market Committee had entered the market.

(152) The chief change, of course, and the one which requires the most serious consideration would be the change in the relationship of the president of the Federal Reserve Bank of New York to the account. As Vice Chairman of the Federal Open Market Committee, he would have, as he now has, full access to all the operations of the account and continuing responsibility for maintaining a vigilant scrutiny over them. He would continue to be in the same building with the manager of the open-market account, and would be as continuously available for consultation as at present. The line of responsibility between the whole Committee and the manager of its account, however, would be direct and undivided. It would not impose upon the president of the Federal Reserve Bank of New York the added individual responsibility which he now bears for operational and discretionary decisions within the directives laid down by the whole Committee or its executive committee.

Relations with the Treasury

(153) There is one final recommendation the subcommittee would like to make. It falls in the difficult and delicate area that deals with problems of debt management and Treasury relationships. Specifically, the subcommittee recommends that the Federal Open Market Committee inform the Treasury that in the future it will keep the Secretary continuously informed as to its credit and monetary policies but that it will refrain as an official body from regularly initiating specific proposals with respect to details of individual Treasury offerings. That is, it will no longer on its own initiative regularly write formal letters or seek official interviews to lay before the Secretary of the Treasury its suggestions as to issues, coupons, etc., that in its judgment would be appropriate for particular debt management operations. The Federal Open Market Committee would, on the other hand, be prepared to respond to a request of the Secretary for the committee's judgment as to whether the terms he had in mind for a new issue were appropriate in the light of market conditions, i. e., whether the

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committee would expect them to develop a sufficient rights value, and also whether they would create complications for monetary management or would conflict with or run into difficulties because of credit operations in contemplation by the Federal Open Market Committee.

(154) The subcommittee urges this change in procedure in order to establish formal official communications with the Treasury on a more correct basis than prevails at present. The Secretary of the Treasury is primarily responsible for decisions in the area of debt management. In coming to those decisions, he should feel free to consult and talk over his problems with anyone he wishes, commercial bankers, investment bankers, security dealers, etc., and also with anyone he chooses within the Federal Reserve System, either in or out of the Federal Open Market Committee. So far as system personnel is concerned, however, it should be wholly understood that he consulted them as individuals. The decision he arrives at should be a decision for which he, as the responsible official, takes full responsibility. Neither the Federal Open Market Committee nor the executive committee should take responsibility, as it now does, for initiating a recommendation as to coupon and terms in the area of debt management.

(155) In the judgment of the subcommittee, the present practice under which the Federal Open Market Committee convenes itself and, after consideration and vote, writes a letter outlining its official recommendation with respect to debt management policies is improper and unwise, in view of the clear location of responsibility for debt-management decisions in the Treasury. It is just as unwise and improper as the converse would be, namely, that the Secretary of the Treasury should regularly and officially, as a member of the President's Cabinet, write the Board of Governors and the Federal Open Market Committee his considered views with respect to future credit policies and open-market operations.

(156) Such formalized action by either, however well intended, trespasses upon the statutory responsibility of the other. It tends to complicate rather than to facilitate that adjustment of views and of official decisions which is essential to the achievement of their common objectives in the public interest.

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS [1]

A. Relations with the market

The subcommittee finds that a disconcerting degree of uncertainty exists among professional dealers and investors in Government securities with respect both to the occasions which the Federal Open Market Committee might consider appropriate for intervention and to the sector of the market in which such intervention might occur, an uncertainty that is detrimental to the development of depth, breadth, and resiliency of the market. (35–43) In the judgment of the subcommittee, this uncertainty can be eliminated by an assurance from the Federal Open Market Committee that henceforth it will intervene in the market, not to impose on the market any particular pattern of prices and yields but solely to effectuate the objectives of monetary and credit policy, and that it will confine such intervention to transactions in very short-term securities, preferably bills. (44–48) The subcommittee feels most strongly that it would be wise to give such an assurance.

The subcommittee finds two outstanding commitments that may require intervention by the Federal Open Market Committee in other than the very short-term sectors of the market, and that may add to or subtract from reserve funds available to the market for purposes other than the pursuit of monetary policies directed toward financial equilibrium and economic stability. (49) These commitments are, first, the directive to the management of the open-market account to "maintain orderly conditions" in the market for United States Government securities, and, second, those arising from the practice of purchasing rights on maturing issues during periods of Treasury financing, and also on some of these occasions of purchasing when-issued securities and outstanding securities of comparable maturity to those being offered for cash or refunding.

With respect to the first of these commitments, the subcommittee recommends that the Federal Open Market Committee amend its present directive to the executive committee by eliminating the phrase "to maintain orderly conditions

[1] For the convenience of readers, the numbers of the paragraphs in the report specifically dealing with each recommendation have been inserted opposite to the same recommendation as it appears in this summary.

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in the Government securities market" and by substituting therefor an authorization to intervene when necessary "to correct a disorderly situation in the Government securities market." It has indicated in its report the conditions it would consider sufficiently disorderly to require correction. (50–56) The subcommittee recommends also that such intervention be initiated by the executive committee only on an affirmative vote after notification by the manager of account of the existence of a situation requiring correction.

With respect to the second, the subcommittee recommends that the Federal Open Market Committee ask the Treasury to work out new procedures for financing, and that as soon as practicable the Committee refrain, during a period of Treasury financing, from purchasing (1) any maturing issues for which an exchange is being offered, (2) when-issued securities, and (3) any outstanding issues of comparable maturity to those being offered for exchange. (57–74)

The subcommittee feels that such qualifications as are implicit in these two recommendations would not seriously impair the constructive effect of a general assurance from the Committee that its intervention henceforth will be limited to the effectuation of monetary policies and will be executed in the very short sector of the market. It recommends most strongly that such assurance be given as soon as its existing commitments have been appropriately modified. (75–76)

B. Relations with dealers

The subcommittee finds no present or prospective justification for continuing the present system of rigid qualification for dealers with whom the account will transact business, and recommends that the system be dropped. (116–124)

In the event the Federal Open Market Committee, contrary to the subcommittee's basic recommendation, decides to maintain the system of recognized dealers the subcommittee recommends:

(*a*) that the present list of recognized dealers be revised, both by eliminations from and additions to the list. (125)

(*b*) that repurchase agreements be extended impartially to all dealers who participate regularly in the weekly bill auction, irrespective of whether or not they are on the recognized list. (108)

(*c*) that if rights are acquired in support of Treasury refundings they be purchased as freely from nonrecognized as from recognized dealers. (115)

(*d*) that transactions to correct disorderly conditions in the Government securities market be made with unrecognized as well as recognized dealers. (85)

C. Operating techniques

The subcommittee finds that many of the present operating techniques of the account are upsetting to the smooth functioning of the market. In general, these techniques were prescribed by the Federal Open Market Committee at a time when it was attempting to peg market prices and yields of United States Government securities. With respect to market techniques, the subcommittee recommends specifically:

(*a*) that "reluctant buying" be completely abandoned, and that supporting operations in the market, if undertaken at all, be executed through a technique of aggressive rather than reluctant purchasing. (81–86)

(*b*) that agency transactions be abandoned and that the account conduct its transactions with dealers as principals on a net basis. (87–93, 110–113)

(*c*) that if rights are acquired during refundings they be purchased from dealers without regard to whether or not they come from the dealers' positions. (114)

(*d*) that refusal to buy bills acquired by dealers on a cash basis be discontinued. (102)

(*e*) that nonbank dealers be informed adequately in advance when repurchase facilities will be made available. (103)

(*f*) that repurchase facilities at an appropriate rate and with appropriate limitation as to volume be made regularly available to nonbank dealers over weekends. (94–104)

The subcommittee finds that relations between the open market account and the dealers are not as impersonal as is desirable now that the Committee is no longer trying to peg prices and yields on Government securities by maintaining a tight rein on the activities of dealers. It recommends:

(*a*) that the Open Market Committee make known to the dealers the "ground rules" which henceforth will govern the occasions for its transactions with dealers. (59, 75–76)

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(*b*) that the individual morning dealer conference be abandoned. (131–132)

(*c*) that the information obtained by the trading desk from dealers be so restricted as to eliminate the possibility of identification, directly or by inference, of individual customers. (131–132)

(*d*) that reports on individual dealer positions and activity be collected by an officer of the System other than the manager of the account, that the individual reports be kept confidential, and that only aggregates compiled from the individual dealer reports be disclosed to the manager of the account. (131–132)

(*e*) that the present practice of asking dealers to report transactions currently during the trading day in sufficient detail to permit the computation of current individual dealer transactions sheets be discontinued. (131, 133)

The subcommittee finds that there is a serious gap in the structure of the money market as it affects the functioning of the market for Government securities. Continuously in recent months, funds available to dealers to carry portfolios have been inadequate in volume and available only at rates higher than the yield of their portfolios. This deficiency could not exist so continuously in a central money market equipped (1) to attract temporarily idle funds from over the country to New York, and (2) to make these funds available on call to dealers in the money market. The subcommittee recommends that the feasibility of re-establishing a central call-money post for dealers be explored. (106)

D. Federal Reserve reports

The subcommittee finds that the Federal Reserve System can improve the data which it makes available to inform the market on its operations. It recommends that the following information be shown henceforth on the weekly condition statement of the Federal Reserve banks:

(a) securities held on repurchase agreement;
(b) special certificates of indebtedness held by the system;
(c) weekly averages of member bank borrowing. (130)

E. Organization of the Open Market Committee

The subcommittee finds many anomalies in the structure and organization of the Federal Open Market Committee, particularly (*a*) the absence of a separate budget covering its operations, (*b*) the absence of a separate staff responsible only to the Committee, and (*c*) the delegation of the management function to an individual Federal Reserve bank. It recommends that the Committee re-examine and review its present organization, and in particular that it consider the advantages and disadvantages that would ensue, were the manager of the open market account made directly responsible to the Federal Open Market Committee as a whole, and not, as at present, responsible through the Federal Reserve Bank of New York. (139–152)

F. Relations with the Treasury

The subcommittee finds that the Federal Open Market Committee is frequently placed in an inconsistent position by its present practice of initiating advice to the Secretary of the Treasury with respect to decisions in the area of debt management. It recommends that the Committee inform the Secretary of the Treasury that henceforth it will refrain, as an official body, from initiating regularly proposals with respect to details of specific Treasury offerings, and will confine itself officially to providing information currently on its monetary policies and to counseling on the credit and monetary implications of debt-management suggestions advanced for its consideration by the Treasury. (153–156)

OUTLINE OF STUDY

(1) Outline of Study prepared by ad hoc subcommittee on the Government securities market
(2) Letter dated May 28, 1952, from Chairman Martin to individuals and organizations receiving the Outline of Study for informational purposes
(3) List of recipients of Outline of Study for informational purposes
(4) Letter dated May 28, 1952, from Chairman Martin to individuals who received, as addressees, the explanatory letter and Outline of Study
(5) List of recipients of Outline of Study as addressees

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I. FUNCTION OF DEALERS IN TREASURY OBLIGATIONS

A. What are the essential functions performed by dealers in Treasury obligations? Discuss their functions in relation to the operations of banks and financial institutions, of the Treasury, and of the Federal Reserve banks, particularly the open-market account. How were these functions affected by the maintenance of pegs by the Federal Open Market Committee?

B. What are the essential attributes which a dealer must possess to perform these functions efficiently (capital, borrowing facilities, moral and technical qualifications, etc.)? Were these affected by the maintenance of pegs? How are these attributes affected by specialization: (*a*) geographical (with respect to location of customers; (*b*) structural (with respect to types of securities); (*c*) types of customers (e. g., banks as against insurance companies, etc.)?

II. EFFECT ON DEALERS OF OPERATIONS OF FEDERAL OPEN-MARKET ACCOUNT

A. How have the operations of the open-market account affected the ability of dealers to perform their essential functions? Discuss with relation to amount of capital required, credit availability, adequacy of commissions, effect on spreads, willingness and ability of dealers to take positions, etc. Distinguish between open-market-account operations during maintenance of pegs and the effects since the discontinuance of pegging operations.

B. From the point of view of successful dealer functioning, what are the advantages and disadvantages of qualification? Distinguish between conditions prior to and following the discontinuance of pegs.

C. Either as a qualified or nonqualified dealer, have you any suggestions or criticisms of the effect of the operations of the open-market account on your own operations? Do you feel that the standards for qualification are appropriate and are applied objectively?

D. Is disclosure to the Federal Reserve by qualified dealers of the general sources of customer orders a justifiable aid to the orderly functioning of the market?

E. Do you feel that the operations of the account are, or have been, discriminatory and, if so, that the discrimination was not justified by overriding considerations? Distinguish between operations of the account when it was working under the overriding directive to maintain a relatively fixed pattern of yields and operations since the discontinuance of the pegs.

F. To what extent have you been directly or indirectly influenced in the quotation and positioning of selected issues of Government securities by the open-market management?

III

What should be the general relation of the open-market account to the dealers and the market in view of the discontinuance of pegging operations? Are any broad changes in the organization of the open-market account indicated? How frequently and under what conditions should the account intervene in the market, either through outright purchases and sales of securities or through resort to repurchase or resale contracts? Is it desirable to effect a closer liaison between the open-market management and dealers? If so, what suggestions do you have for achieving a closer liaison? Discuss separately under each of the following headings:

A. Operations to temper seasonal, emergency, and week-to-week or day-to-day fluctuations in the money market resulting from changes in currency demand, float, Treasury calls and payments, etc.

1. Should the account operate from day to day to offset such fluctuations in the availability of funds or can the necessary adjustments be left to the market mechanism with necessary access to and absorption of Reserve bank funds provided by member bank borrowing? Under which circumstance would the market develop greater breadth, resilience, and strength?

2. If you feel that direct operations of the account are needed in addition to member bank borrowing, should these be provided mainly through outright purchases and sales of securities or should more use be made of repurchase and resale agreements?

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3. If outright purchases and sales are used, should they be made in that sector of the market best able at the moment to absorb such operations in the judgment of the management of the account, or should they be concentrated, as a matter of routine, in the very short maturities?

4. Are the present repurchase facilities adequate to enable dealers to take positions and make markets? Do you have any suggestions for the improvement of the present type of repurchase contract?

5. Would it be worth while to explore the use of 1-day resale agreements to absorb reserves when they are temporarily redundant? For example, the open market account might make bills or certificates available to the market on a 1-day resale agreement for sale to banks with redundant excess reserves.

6. To what extent does the increasing use of Federal funds transactions between banks in different Federal Reserve districts affect the short-term market for Government securities?

B. Operations affecting dealers as underwriters of the weekly bill offering. In view of the importance of bills as a medium for Treasury financing, it is desirable that dealers be in a position to enter bids sufficient to assure adequate coverage of each auction.

1. Are the dealers now in a position to perform this function effectively or is greater assurance needed that, in the event of an unexpected stringency, Federal funds will be available on repurchase agreement?

2. Assuming repurchase facilities are provided, what limitation should be placed on their use?

3. When the Open Market Committee purchases bills to relieve congestion in the money market, should such purchases be made at a penalty rate, as in London, and should these operations be confined to short-dated bills?

C. Operations during periods of Treasury refundings.

1. Should the open market account maintain a rights value on maturing issues during refunding?

2. Have you any criticism of the technical operations of the account during refundings; or any suggestions for improvement in the technique?

D. Operations to maintain orderly markets in Treasury securities.

1. What, in your judgment, constitutes an "orderly" market?

2. What criteria should the open market account apply to determine whether intervention is necessary for the maintenance of order in the market?

3. Except for extreme emergencies, do you foresee the frequent occasion for System intervention to maintain "orderly" conditions?

E. Operations to carry out basic changes in credit policies of the Reserve authorities for the mitigation of economic instability, i. e., major changes in the open-market portfolios of considerable duration designed to reduce the availability of credit during periods of boom or to make credit much more freely available during periods of recession.

1. Have you any recommendation as to the types of securities to be sold or purchased in operations of this type?

2. Should the operation normally be in the long-term or the short-term sector of the market? Why?

3. What would be the effect of large-scale operations in the long-term sector on the market mechanism and on the ability and willingness of dealers to hold adequate portfolios?

IV. ADEQUACY OF DEALER ORGANIZATION

A. What has been the effect of greater market flexibility since the accord on willingness of dealers to take positions, participate in the bill auction and make markets, both in long-term and short-term Treasury issues?

B. Are more dealers needed and is more dealer capital desirable? If so, how could it best be attracted?

C. Has the lack of personnel trained to operate under flexible market conditions hampered operations and smooth market functioning since the discontinuance of the pegs?

D. Have you any suggestions or comments concerning the basic organization of the market for Treasury obligations? Does the present over-the-counter market adequately fill the need or would a continuous auction market enlarge participation and give greater depth and breadth to the market? If so, should an existing securities exchange be used? How would this be effected?

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V. APPROPRIATENESS OF PRESENT ORGANIZATION OF OPEN MARKET ACCOUNT

A. Would the employment of a special broker to execute Federal Reserve System transactions (in substitution for the operations of the present trading desk) be adequate for the performance of System operations? Would it be preferable? Have you any other suggestions as to an appropriate organization for System operations in Treasury obligations? Please discuss this problem with specific reference to System operations under each of the five major headings in question III above.

B. Assuming the continuance of operations as presently organized, i. e., over-the-counter markets with a trading desk in the Federal Reserve Bank of New York, have you any suggestions as to the basis of distinction for the qualification of dealers? Please discuss this problem as it would be affected under each of the five major headings in question III above.

1. Are formally qualified dealers needed?

2. If so, what should be the essential requirements for qualification?

3. Should qualified dealers be required to report positions to the open market manager? If so, in what form do you suggest that reports be made?

4. Can distinctions be drawn between the role of bank and nonbank qualified dealers? In what respects should they be differentiated?

C. Would it be desirable to make additional data regarding System operations available through the regularly published weekly figures of the Federal Reserve banks? For example, should repurchase figures be segregated from total System holdings of United States Government securities? Should daily average member bank borrowings be included in the published figures? Do you have any other suggestions?

VI. MARKET COVERAGE

Have you any suggestions for broadening and deepening the customer market for Treasury obligations?

A. Institutional.

Is there adequate coverage of institutional investors, such as small insurance companies, commercial and savings banks, etc.?

B. Noninstitutional.

What suggestions have you to encourage greater participation by corporations, particularly smaller corporations and businessmen, and by individual investors?

C. Is there any manner in which Federal Reserve banks and branches outside New York City could be more helpful in aiding smaller investors in the purchase and sale of Government securities? Is it an economical operation for the dealer organization to attempt this type of coverage?

VII. TECHNIQUES OF OPEN-MARKET OPERATION

A. Assuming for policy reasons the Open Market Committee desires to effect changes in total holdings or in the composition of the portfolio, what methods aside from letting maturing securities run off should be employed to effectuate these changes with a minimum of disturbance to prices? Would it be desirable to employ the mechanism of secondary offerings by inviting bids or offerings up to a certain time limit on specific blocks of Government securities?

B. Should the open-market management buy and sell on dealers' quotations and should dealers be required to make firm markets up to some minimum amount? If so, what minimum would you suggest?

BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM,
Washington, May 28, 1952.

Enclosed is an outline of a technical study, together with explanatory letter, which is being sent to dealers and other specialists in the United States Government securities market. We are sending you copies herewith for your information.

Sincerely yours,

WM. MCC. MARTIN, JR.,
Chairman, Federal Open Market Committee.

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Washington, May 28, 1952.

The Federal Open Market Committee is undertaking a study of the technical and operational phases of the market for United States Government securities. As has been previously announced, the committee has appointed Mr. Robert H. Craft as technical consultant.

The study is occasioned by the fact that in effectuating general credit policy the main reliance is now placed upon discounts and open market operations. The study is in the nature of a fact-finding inquiry as to the breadth and most efficient functioning of the market and is not concerned with questions of national credit, monetary, or debt management policy.

The Federal Open Market Committee would like to have the benefit of the views of those most closely associated with this general subject. Enclosed is an outline of the scope of the study, which is designed primarily for your guidance. It is directed specifically to dealers in Government securities. We appreciate that there may be many phases of the study in which all of the recipients are not directly interested. At the same time it is realized that some of the recipients may wish to cover additional points, and it is not intended that the study necessarily be limited by the outline, which seeks merely to take account of various questions which have been raised from time to time but do not reflect any preconceived views of the committee.

For the purpose of obtaining background material, consideration is being given to scheduling a series of informal discussions in Washington with those most actively interested in this subject. In view of the confidential nature of some of the material or opinions sought in the study, the discussions would, of course, be treated in that light. Since time would not permit discussions with all who are interested in varying degrees in this study we would welcome written responses from anyone on phases of particular interest to them.

After you have had an opportunity to examine the outline, we would appreciate it if you will advise us of the extent of your interest in this study.

Sincerely yours,

WM. MCC. MARTIN, JR.,
Chairman, Federal Open Market Committee.

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APPENDIX B

ANALYSIS OF DISCUSSIONS ON SCOPE AND ADEQUACY OF THE GOVERNMENT SECURITIES MARKET

This analysis endeavors to evaluate the testimony and to reach some tentative conclusions as to the consensus of views presented by the various individuals interviewed on some of the more important aspects of the study. For this purpose, the analysis has been divided into four major categories: (1) The adequacy of the dealer organization to provide an efficiently functioning machinery and a broad market place for Government securities, (2) the relationship of the open market account to the market and to the dealer organization, (3) techniques

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governing open market account operations, and (4) organization of the open market account.

Adequacy of the dealer organization

The majority of the respondents advanced the view that the framework of the existing market mechanism is adequate to service the needs of investors efficiently and to provide a broad market in Government securities under normal conditions. The amount of capital committed to the business was considered sufficent and it was indicated that any material increase in the number of dealers would tend to be cumbersome. This opinion also was substantiated by the nondealer bankers, who indicated that consideration from time to time of the formation of dealer departments by the institutions they represented invariably had resulted in rejection of the proposal on the grounds, first, that the market was being serviced adequately and, second, that the volume of business and profit potentials were not sufficient to justify augmenting the existing machinery. It was further indicated that capital available to some of the larger dealer organizations is not being utilized fully at present. The impression was gained that, if the volume of trading were to expand and if the business were to become sufficiently attractive profitwise, more dealers and more capital automatically would be attracted.

The difficulty of obtaining competent personnel was deemed to be a condition common to the financial community, because of the current preferences of college graduates for careers in nonfinancial fields. This, however, was not adjudged by the dealers to be a serious problem.

Distinction was made between primary dealers, who generally make markets on a wholesale basis and maintain retail contacts with the larger investors, and secondary dealers, who perform more of a brokerage function and rely to a great extent on the primary dealers for execution of their orders. For the most part, respondents indicated that both types of dealers serve useful purposes in the market place. Local dealers are considered particularly helpful in providing coverage to some parts of the country which cannot be serviced economically by the primary dealers.

Many of the smaller institutional investors are serviced by the larger correspondent banks, which in turn funnel this business through the primary dealer organization. Although there was some indication that expansion of this activity might be desirable, there was no evidence that smaller investors do not enjoy adequate facilities for transacting business in marketable Government securities.

The Federal Reserve banks and branches probably could supplement the existing system in servicing the smaller banks, but question was raised about the propriety of engaging in this activity and some expressed the opinion that absorption of the cost of handling such transactions would constitute a subsidy which could not be justified.

Considerable discussion by representatives of the New York Stock Exchange and by one stock exchange member firm was directed to the possibility of attracting odd-lot business to that auction market. Figures submitted by exchange officials indicated that even during the most active years of bond dealings the volume on the exchange represented a very minor percentage of the total. Since the beginning of the period of pegged markets, however, Government bond business on the exchange has been virtually extinguished. This was directly attributed to the practice of the Open Market Committee of confining its business to over-the-counter qualified firms and apparent unwillingness of the account to transact business on the exchange. The existing exchange facilities appear to be well suited to the handling of odd-lot transactions, but stock exchange firms have been unable to compete effectively for this business, because of the fact that the over-the-counter firms generally are willing to absorb the costs of small-lot transactions as a side line to their regular business. In view of the unprofitability of the odd-lot business to the over-the-counter dealer firms, however, it is reasonable to assume that these firms would be anxious to cooperate in the development of a plan that would shift odd-lot business to the exchange. This is a problem susceptible to further study, but its satisfactory solution would appear to depend in part upon the resourcefulness and ingenuity of exchange officials and interested member firms and in part upon the adoption by the open-market account of a different attitude should it become necessary in the future to engage in open-market operations in other than short securities. Some possibility of attracting additional business to the exchange lies in the establishment of a specialist system, which was a suggestion advanced by one

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dealer. That dealer also felt that there is a place for an auction market alongside the over-the-counter market.

No apprehension exists about assuring adequate coverage for the weekly bill auctions. It was pointed out, however, that long holiday weekends during a tight-money period restrict nonbank dealers' willingness to bid for bills which may have difficulty in distributing immediately and are thus forced to carry at a costly interest penalty. In such cases, dealers indicated that it would be helpful for them to know in advance if repurchase facilities would be made available. This subject will be discussed more fully under a separate heading.

Diverse opinions were expressed about the desirability of establishing a functioning trade organization to formulate and effectuate a plan for uniform dealer practices. There now exists a dormant organization which could be revitalized if the need should arise, but in order to avoid any implication of Open Market Committee regulation, it was felt that the impetus for such a move should come from within the dealer organization rather than from the open-market management. In opposition to formalization of a dealer organization, possible legal entanglements were cited.

Although the letter accompanying that outline of study specifically excluded any discussion of debt-management policies, this subject is so inextricably interwoven with central banking functions that responses inevitably referred to it. For example, a number of dealers indicated that any inadequacies in the present market stem not only from some of the actions of the open-market account but result also from debt-management policies pursued over the past several years. Emphasis was placed on the concentration of debt in short-term securities and the use of nonmarketable obligations as factors that tend to narrow the market. Others felt that the publicized rifts between the Treasury and the Federal Reserve before the "accord" contributed to the impairment of confidence in the freedom of the market place and that this has not been fully repaired by the events since the "accord." There was general opinion, however, that the lessened degree of interference since the "accord" has tended to strengthen and broaden the market for Government securities and that, as investors generally come to recognize that the Open Market Committee does not intend to intervene, the market will become increasingly broader.

Relationship of the open-market account to the market and to the dealer organization

With minor exceptions, the view was expressed that the objective of the Open Market Committee should be to reduce intervention in the market to an absolute minimum and that a free market without interference best serves a free economy.

Both qualified and nonqualified dealers expressed a definite antipathy to any extension of policing or regulation of dealer activities by the open-market management. In fact, there was almost unanimous opinion that the degree of control that had been exercised over the dealers in the past had exceeded the need.

In specific reference to the standards for qualification, the view was expressed that too precise rules encourage circumvention and the adoption of devious tactics on the part of the dealers to the detriment of the entire market. More particularly, it was indicated that the imposition of restrictions on the operations of dealers tacitly implies the assumption of an unwarranted degree of responsibility on the part of the open-market account to protect qualified dealers against loss and, in fact, to relieve them as a special group from all of the extraordinary risks inherent in the business.

One of the disadvantages attaching to qualification cited by most of the dealers is the serious handicap under which they are forced to operate during periods of refunding operations when rights values are being supported and at other times when quotations are being maintained at artificial levels by the open-market management. Qualified dealers strongly objected to the fact that in these circumstances they were not only excluded from the privilege of disposing of the supported securities held in their own positions to the only buyer—the open-market account—but were prevented from selling these securities at any price to others, because of their tacit agreement not to trade below official quotations. In many cases their inability to deal during the period of support operations forced the dealers subsequently to accept sizable losses.

Serious complaints were lodged by nonqualified dealers in connection with the effects of open-market operations during the period of supported markets. During that period they contended that inability to conduct business with the only purchaser—the open-market account—represented severe discrimination and forced the nonqualified dealers virtually to suspend operations or conduct their business consistently at a loss. In addition, these dealers pointed to the fact

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that they suffered loss of customer contacts which had been developed only over a period of many years of effort and service. The discrimination during that period was described by some as an operation in restraint of trade. Nonqualified dealers also considered it discriminatory for the open-market account to relieve only qualified dealers of their positions during periods of stress and to force nonqualified dealers to accept the losses that resulted from the sharply lower level quotations subsequently posted by the Open Market Committee. As mentioned previously, one stock exchange member indicated that the practice of confining open-market-account business solely to the over-the-counter qualified firms also had the effect of completely eliminating the exchange as a market place for Government securities.

With further reference to the distinction between qualified and nonqualified dealers, respondents in all categories stated that some of the presently qualified firms do not appear to possess as many of the attributes for qualification as some of the nonqualified dealers. This emphasized the difficulty of formulating a set of standards that properly can be applied to permit sufficient flexibility in open-market operations and at the same time avoid recurring criticisms of the nature that have been lodged in the past.

Many supported the view that the distinction between qualified and nonqualified firms might have been necessary as a wartime expedient but that the need for this arrangement had long since expired. Some indicated that the present formalized distinction should be abandoned entirely.

Although close supervision and regulation of dealer practices were considered to be antithetical to the establishment of an efficiently functioning dealer organization and to the creation of a broader market, there was general recognition of the need for a continuing liaison between the open-market management and the dealer organization. Most of the dealers indicated, however, that the regularly scheduled morning meetings prior to the opening of the market are not the best means of accomplishing this objective and, in fact, many thought that these should be discontinued. As a substitute, some suggested that the press type of meeting that had been employed on occasions in the past, and at which dealers met in a group with some of the top officials of the New York bank, would provide a medium for a more satisfactory exchange of views. In the intervals between such meetings it was suggested that individual dealers should be encouraged and should feel free to call on the account manager for the purpose of discussing any matters of mutual interest.

There also was general support of the view that the open-market management should have access to whatever data is considered necessary and proper to aid in the efficient conduct of open-market operations. For example, disclosure to the open-market management of the general sources of buying and selling was deemed to be useful and proper information to assist the account manager in appraising market factors, particularly during periods of upset conditions. The dealers felt that disclosure of specific names was not justified in any circumstance, however, and indicated that such description always should fall short of establishing the identity of the buyer or seller.

Similarly, the need for apprising the open-market management of the size of dealer positions was recognized. It was suggested, however, that such information should be used purely for statistical purposes in evaluating money-market conditions. This objective could be achieved if figures on such positions were assembled by a source other than the management of the account and reported to the management of the account only in the aggregate. If handled in that way, the account management would not be open to the criticism that they were accepting responsibility for influencing individual dealer positions directly or indirectly. The general view was that the size of positions carried by any one dealer should be left to his independent judgment, limited only by access to private credit facilities.

There were a number of other more or less isolated complaints lodged by both classes of dealers. These will be detailed in the summary and for the most part were based also on the period of pegging operations; thus they are not as applicable under present conditions. In this connection, it should be emphasized that most of the criticisms were ascribable to the difficulties of operating under the compulsion to maintain a fixed pattern of prices and rates. Relatively few of the respondents were critical of the personnel of the open-market management, and most of these indicated that the inflexible system was largely responsible—that any personnel operating under such a system inevitably would be subjected to criticism.

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It was clear also that most of the problems having to do with qualification arose from the past techniques employed by the open-market account, which are treated more fully in the following section. In further support of the view that distinction between qualified and nonqualified dealers should be eliminated, it was stated that the open-market management should be free to transact business with those dealers who in the judgment of the management were best equipped to handle transactions for the account in the most efficient and least costly manner. It was indicated that, if operations of the account were confined to more or less routine transactions in the short-term area, the need for requiring dealers to comply with a rigid set of rules obviously would be considerably diminished. For that matter, the same line of reasoning could be applied if intervention in other sectors of the market were at times considered necessary. In the event of a national emergency, rules governing dealers' conduct readily could be reinstituted if necessary. In the present situation, however, some felt that a more proper relationship between the open-market account and the dealer organization would be one that would conform as nearly as possible to that which exists between dealers and other customers.

Techniques governing open-market operations

Nonbank dealers presented a strong plea for the use of repurchase agreements to aid them in functioning efficiently in short-term securities. In substantiation of the need for repurchase facilities, these dealers pointed to the concentration of activity in the short-term market, the importance of that market in effectuating credit policy, and the frequent exorbitant cost to which dealers are subjected in carrying positions. With the abandonment of the call money post on the stock exchange dealers are forced to rely largely on the New York money market banks for credit facilities. Resort to out-of-town banks and to repurchase arrangements with corporations severely restricts flexibility, which is so necessary in dealing efficiently in short-term securities.

Some opinion that repurchases tend to reestablish a peg in the market was refuted on the ground that the same objection was applicable to the discount rate. Dealers contended further that, if this objection had any validity, it could be overcome by the adoption of a flexible repurchase mechanism. Some advanced the line of credit theory as a means of assuring dealers in advance of bill auctions that they would not be too severely penalized in borrowing costs during a tight money period. Others took the position that repurchase facilities should only be granted at the option of the open-market management but that advance notice of intention to make repurchases available should be given. One point of view in connection with a flexible repurchase arrangement was that the open-market account should be prepared to terminate or reinstitute repurchases from day to day based on the open-market management's judgment of the needs of the market.

The privilege of substituting securities as a means of enabling dealers to perform their normal market functions more efficiently was considered a desirable refinement. Under the present arrangement, dealers frequently are unable to meet specific market demand because of their inability to deliver the bills that have been sold to the Federal under repurchase agreement. Some also recommended that repurchase facilities should be extended to those presently nonqualified dealers who participate regularly in the bill auctions and who are adjudged by the open-market management to be real factors in the short-term market. Most of the bank dealers and nondealer bank representatives opposed the use of repurchase agreements on the grounds that they represent a form of pegging and that private credit extension is a banking system rather than a central banking function.

Some of the dealers recognized the desirability of a device designed to avoid temporary excessively easy money conditions which occur during tax rate periods but felt that 1-day resale agreements were not feasible because such an investment would not permit of any profit margin to the distributor. The subject, however, deserves additional consideration, and some means of private participation in Treasury overdrafts should be explored.

Dealers, generally, stated that commissions on open market account transactions during the war and postwar years have been largely responsible for narrowing dealers' quotations. It was contended that the setting of low commissions on agency transactions for the open-market account encouraged unwillingness of investors to accept dealers' efforts to quote securities at more reasonable spreads. Recognized dealers, generally, felt that open-market account commissions were to small, especially in the case of short-term issues. It was suggested that commissions should be enlarged in order to permit dealers to transact

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open-market account business profitably and also to encourage customers to trade on spreads that would provide reasonable profit margins to the dealers. There also was dissatisfaction expressed that open-market account commission rates had been adopted arbitrarily and without consultation with the dealers as to whether or not these rates represented reasonable compensation. The view was advanced that this inequity could be corrected by abandoning the practice of paying commissions on open-market transactions and by adopting the more general practice of trading with dealers on a net basis. That procedure also would eliminate the difficulties that the open-market account has experienced from time to time in operating on an agency basis.

As a matter of operating technique, it was suggested that the open-market management might find it desirable at times to employ the services of only one dealer in connection with a specific transaction. Nondealers indicated that they had obtained better executions by lodging sizable orders with one dealer who was fully informed of the immediate aim of the investor. It was suggested that this procedure might also be adaptable to open-market operations.

The question involving the adaptability of the secondary offering type of technique to open-market account operations was misinterpreted by most of the respondents. Those few who eventally came to understand that the question was directed primarily to operations in the short-term sector of the list conceded that the technique might have some merit. On the whole, however, there was little enthusiasm for this type of procedure.

In the matter of the approach to broader techniques, the discussions clearly established strong sentiment for adoption of a set of ground rules that would conform to the principle of achieving as free a market as practicable—a market which under normal conditions would reflect solely the forces of supply and demand.

In support of the free-market thesis, dealers pointed to the disadvantages and unfortunate consequences that had resulted from some of the techniques that had been employed in the past. Reference was made particularly to (1) the policy of distinguishing between selling sources, (2) unwillingness to purchase securities that had been acquired by dealers on a cash rather than a regular basis, (3) unannounced changes in technique, (4) methods employed during Treasury financing operations, and (5) "reluctant buying."

It was indicated that refusal to take securities from dealers' positions at times when the open market account was maintaining an artificial level of quotations either encouraged evasive actions on the part of dealers, which they considered to be inconsistent with their functions, or resulted in the acceptance of sizable losses at the termination of a specific supporting operation. It also was contended that the psychologic effect of distinguishing between selling sources among investor classes was to build up potential selling rather than to discourage selling.

Dealers stated that unwillingness of the open market account to purchase securities acquired by dealers on a cash basis restricts dealers' ability to function efficiently during a period in which they are increasingly becoming obliged to conduct cash transactions with customers. This objection did not extend to the suggestion that the Open Market Committee deal on a cash basis but rather that the Open Market Committee be prepared at such times as it is operating in a specific class of securities to purchase from dealers without distinction as to whether the securities originally had been acquired on a cash or regular basis. A few dealers suggested that the Federal also should be prepared to operate on a cash basis at all times but most recognized the mechanical obstacles involved.

The frequently changing technique was described as a condition in which certain buying levels had been established by the Open Market Committee early in the day, temporarily abandoned and reestablished, usually shortly prior to the close of the market. This created a great deal of confusion in the minds of dealers and investors. Dealers suggested that they could better serve the objectives of the account managers if they were apprised sufficiently in advance of a change in technique to permit them to comply with the objectives.

With respect to refunding operations, the majority felt that only under conditions in which the Treasury recognized the needs of the market in the pricing of new and refunding issues could the dealers be expected to take positions in such issues and do the essential work of secondary distribution. It was pointed out that, if the Treasury were consistent in pricing its offerings in a manner to generate natural premiums, the need for open market account intervention and underwriting would be obviated. In the event that the natural premium

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originally placed by the market on a refunding issue was not maintained, because of some unexpected development between the period of the announcement of the terms and the closing of the books, some felt that the Federal would be justified in maintaining the rights value by direct purchase of the maturing issues at prices that originally had been set by the market. Others indicated that, if possible, it would be preferable to support such offerings indirectly by placing additional reserves temporarily at the disposal of the banking system through purchase of short-dated bills; in the case of short-term refundings it was stated that the Federal indirectly could influence the price of the issue being offered by purchasing bills "down in rate" to the point that the issue being offered would become sufficiently attractive comparatively to assure success of the financing. An operation of this nature would have the advantage of permitting the Open Market Committee to reestablish the former member bank reserve position with less permanent disturbance to the market. Many held the view that any attempt to establish artificially high rights value encouraged greater than normal selling and thereby added to investor attrition. From the dealers' standpoint there was dissatisfaction about the unwillingness of the Open Market Committee to buy from their positions during periods when the direct purchasing technique had been used.

The principal criticism revolved about the "reluctant buying" technique that had been employed during periods of Treasury refundings and disorderly markets. The principal determinant of an orderly market was considered to be ability to consummate transactions at a price rather than the degree of fluctuations in prices themselves. This opinion was supported on the thesis that it is often better to allow an abrupt price decline and to support aggressively at the lower level than to engage in a step-like process of support. It was stated that the latter technique ordinarily contributes to a greater eventual price decline. Lack of orderliness was characterized more as the urgency of selling pressure and the volume of offerings than the degree of change in prices. Some felt that the System should confine its thinking to the correction of disorderly conditions rather than to the maintenance of orderly markets, because the term "orderly" connotes a market in which there is frequent intervention. One dealer characterized the most disorderly market in recent years as that which existed when the open market management was insisting on the maintenance of an artificial price level and simultaneously refusing to do business at that level.

The "reluctant buying" approach during those periods was considered to be a self-defeating policy and one which should never be employed if the objective is to maintain a specific level of prices. Respondents emphasized that inability to trade on quotations within a reasonably short time invariably heightens the uncertainty in the mind of the investor and usually encourages him to attempt to sell a larger volume of securities than he normally would wish to sell if the transaction were completed without hesitancy. It was almost unanimously recommended that, on occasions when intervention is necessary to correct disorderly conditions in the market or to support Treasury refunding operations, the open market account should adopt an aggressive policy by placing bids on as widespread a basis as possible. This, in the judgment of the respondents, would remove question from the minds of investors as to their ability to sell and thereby tend to discourage them from selling. It further was suggested that, during periods of market upset, the open market account should assume more prompt leadership by communicating its intentions to the dealers before the opening of the market.

In general, respondents felt that the System would be called upon rarely, if ever, to intervene in securities with longer than 1-year maturity and that the only justification for System intervention would be to correct disorderly conditions in the market resulting from an emergency, such as an unexpected development in international relations.

With two exceptions, respondents unanimously supported the view that the Open Market Committee should not operate in any manner to offset day-to-day fluctuations in the market and that without official interference the scope of the entire market would be considerably broadened.

As justification for a free market, some respondents pointed to the surprisingly good behavior of the market in the period following the "accord." This was considered particularly significant when viewed in the light of the sudden and unexpected abandonment of the pegged policies to which the financial community had for so long become accustomed.

In appraising the factors governing the present market, some comparison was drawn between the type of markets that existed prewar and that which exists

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today. Under present conditions, the large concentration of longer-term marketable securities in the hands of sophisticated investors effectively precludes the possibility of market raids, rigging of prices, or abnormal gyrations. The general investor consciousness of arbitrage possibilities tends to prevent other than temporary disequilibrium in prices between specific issues in one sector of the market. If left to the market mechanism, adjustment to a proper relationship should promptly occur. In general, the large concentration of holdings and increased investor astuteness are factors that naturally will tend to prevent inordinate price swings under normal conditions.

Most dealers clearly indicated their unwillingness to take even modest positions in a supported market in which there is any uncertainty as to the degree of support, pointing out that in such circumstances dealers function solely as agents for the open market account and not as dealers. On the other hand, if there were assurance that Federal operations would be confined to the short-term area except for aiding in Treasury financing and correcting disorderly markets, dealers, generally, stated they would be considerably more willing to carry positions and operate more actively in the long-term sector of the market. They invariably pointed to the difficulty of exercising independent judgments when forced to operate against the unknown of the Open Market Committee when a frequent intervention technique was employed. The majority view was that the private market mechanism would be greatly strengthened and that the interests of the investor, the dealer, and the Open Market Committee would be best served if open market operations were confined to (1) correcting disorderly markets, (2) aiding the Treasury in assuring successful refunding operations, and (3) effectuating credit policy and alleviating temporary money stringency through the medium of as short securities as possible.

Organization of the open market account

The majority feeling was that the present organization of the account is best suited to the needs of the Open Market Commitee from the standpoint of providing an information gathering post on market developments and of carrying out transactions for system account. This view appeared to be predicated, however, on the assumption that the account intended to continue to function much in the same manner as it has in the past, involving more or less frequent intervention in all sectors of the market for one reason or another. Those who responded to the tion on the basis that future operations might be considerably more restricted indicated that there probably was no need for as large personnel as now exists, and some took the view that several people would be adequate to handle System account transactions and other general market information in the event that operations were confined solely to the short-term area.

One respondent subsequently submitted a long memorandum, in which he recommended that the open market account operation be transferred to Washington for the purpose of eliminating the lack of coordination between the Committee and the management of the account. Two other respondents suggested that, in order to establish more complete responsibility for open market operations where it is now vested by law—in the Open Market Committee—the account manager should be an employee of the Committee and made directly responsible to the Committee, rather than an employee of the New York bank.

Appendix C

Ground Rules

The Federal Open Market Committee can make a major contribution to the depth, breadth, and resiliency of the Government securities market by formulating a general set of ground rules to govern its transactions in the market. Dealers cannot be expected to take positions and make adequate markets at their own risk in the absence of reasonable assurance as to the circumstances under which the Committee might intervene in the market, the purpose of the intervention, and the sector of the market in which such intervention would occur.

One of the dominant facts which emerged from discussions with dealers and nondealers alike was the belief that real freedom does not yet exist in the Government securities market. Skepticism that the Federal Open Market Committee has abandoned the theory that the Government securities market

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must continue to be controlled within limits has not been dispelled. The fact that a deeper, broader, and more resilient market could best be achieved by reducing open market account intervention to a minimum was a point repeatedly emphasized throughout the hearings.

In a fully controlled market such as prevailed in earlier postwar years dealers are obliged to operate under serious handicaps. Under a policy of intervention dealers become brokers, are unable to perform their normal functions of making markets, rendering independent advice to customers, and engaging in normal arbitrage transactions. A natural corollary to a controlled market is the impairment of the health of the dealer organization because of removal of incentive and restriction on profits. These same handicaps operate, though in lesser degree, in a fluctuating market subject to intervention by the open market account. The mere fact that there is uncertainty surrounding the Federal Open Market Committee's attitude causes unwillingness on the part of dealers to carry positions or to make markets. As dealers increasingly look to and depend upon System guidance, markets tend to become more limited and narrower.

By nature, a guided market must rely on a closely knit System dealer or broker organization, e. g., a group of so-called qualified dealers. This raises accusations of discrimination by those dealers who are not eligible to conduct business with the Federal open market account. Investors likewise become inhibited because knowledge of System objectives is inaccessible to them and they are unable to appraise the significance of various account operations.

There can be little question that dealers are capable of operating far more effectively if left to exercise independent judgments and to perform their normal functions, based on these judgments, without interference from the open market account. This was brought out time and again in the discussions. Dealers are much better prepared to accept the business risks inherent in a market that is governed solely by the interplay of demand and supply forces than in a market subject to the hazard of unpredictable Committee action. This hazard is greatest when intervention occurs in the intermediate and long sectors of the market. Certainly a strong, alert, and efficiently functioning dealer organization can best be promoted by abandonment of open market account intervention outside the very short category.

The surprisingly good behavior of the market in the period following the accord is significant. It substantiates faith in the ability of the dealer organization to operate efficiently in flexible markets. This is particularly significant when viewed in the light of the sudden and unexpected abandonment of the pegged policies to which the financial community had for so long become accustomed. Market experience since the accord does not, however, represent a fair test of the inherent breadth of a free market place. Even during this period dealer and investor activities have been continually inhibited by the fear that freedom had not been fully restored to the market. If assurance could be obtained that intervention would be held to a minimum and confined to the short-term area, better market behavior could be expected in a technical sense, but, more important, System action could better be appraised and the Treasury would be provided with a clearer view of basic money market trends.

There should not be too much concern over the success of attempts to raid the market in the absence of account operations. The large concentration of marketable securities in the hands of sophisticated investors militates against the possibility of market raids, rigging of prices, or abnormal gyrations. The general investor consciousness of arbitrage possibilities tends to prevent other than temporary disequilibrium in prices between specific issues. If left to the market mechanism, adjustment to a proper relationship ordinarily will occur with reasonable promptness.

There is danger that continuous intervention for the purpose of setting prices or yields may vest too great a responsibility in the hands of a few whose market judgments cannot usually be expected to be a satisfactory substitute for the composite judgments of the wide variety of market participants. As was pointed out, the Government marketable debt is held in considerable degree by an investing group of unusual sophistication. This group also possesses the desirable characteristics of a wide and diversified economic and institutional interest.

Obviously, somewhat more erratic movement of prices can be expected in a free market than in one that is subject to intervention, but the guidance of economic decisions by free markets is a characteristic that has effectively served the American economy and for which there is no satisfactory substitute. Moreover, the Government bond market cannot be isolated from other markets nor can its influence on the policies of all lending institutions be minimized. That has been amply demonstrated in the past. The fact is that rates for Government securities

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are closely related to and affect interest rates on all classes of loans and investments. Indirectly the Government yield curve heavily influences policy decisions and choice of investments by all lending institutions and ultimately capital commitments by all borrowers.

Arbitrary System intervention in the intermediate and long-term areas can hardly fail to create a degree of artificiality in those markets. Establishment of any artificiality in the level of prices or yields on Government securities inhibits investment decisions and inevitably obstructs the ability of the System to influence financial institutions' lending policies. The results of a credit policy directed solely to controlling the volume and availability of credit can be much more accurately appraised. Only by permitting normal price and yield relationships to develop from an appropriate credit base can the value of an interest rate signal be realized.

The view that a modest amount of intervention is not harmful cannot be rationalized. The underlying situation is not corrected by such action. In fact, by preventing normal demand and supply forces from establishing proper relationships at a new price level such intervention tends to magnify the market imbalance.

A controlled market also encourages participation by speculative interests in the hope of profit but with a guaranty against loss and also encourages banks to finance such positions. Speculative holders are the first to react to any minor adverse development in the market. This in turn magnifies any subsequent problem of support, leading inevitably to greater intervention. Exposure to the risk of day-to-day fluctuations inherent in a free market tends to eliminate this speculative element from the market.

Perhaps an even more undesirable feature of System account intervention is the unsatisfactory position in which it places the Treasury. A System guided market seriously hampers debt management decisions. Only by permitting a market to develop from the free interplay of demand and supply forces can the Treasury accurately determine investor preferences. Beyond this, a policy of intervention inescapably results in the acceptance of continued System responsibility to underwrite Treasury offerings that do not conform to investor preferences.

It seems essential that every effort should be made to eliminate any basis for misunderstanding of Reserve banking functions and responsibilities. The Treasury should be fully apprised of what can be expected from the Federal Reserve System. Although progress in this direction has been made since the accord, there nevertheless exists a number of areas in which the working relationship leaves something to be desired. The present would seem to offer a propitious opportunity to clarify the position, based on the experience since the accord.

Decisions on which Federal Reserve credit policies are based must be subject to a variety of influences, such as the level and trend of commodity prices, the level of employment, the trend of credit demands, and uses to which bank and other credit are being put. Policy decisions to guide the timing and degree of credit actions cannot be governed by a rigid formula. From this it does not follow that, once policy decisions have been reached, effectuation of policy cannot best be achieved under a set of simple rules that are fully understood by all participants in the market.

Factors to be considered in formulating such ground rules fall into four general categories: (1) The most appropriate and efficient methods for effectuating general credit policies, (2) methods to relieve purely temporary and self-correcting disruptions in the money market, (3) operations of the account in connection with Treasury financings, and (4) methods of dealing with disorderly markets.

1. The most appropriate and efficient methods for effectuating general credit policies

The case for believing that open market operations in support of general credit policies can most effectively be carried out through the medium of very short securities—the nearest money equivalent—is persuasive. Account operations normally confined to Treasury bills would permit much greater flexibility in open market account operations, with a minimum of disturbance to prices and yields on longer maturities, permitting them (*a*) to reflect the natural forces of demand and supply, and (*b*) to furnish a signal of the effectiveness of credit policy aimed primarily at the volume and availability of bank reserves.

Treasury bills possess the unique attribute of near-term self-liquidating paper, in that they represent the one class of open market securities for which the

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Treasury does not offer a refunding issue in exchange. Rather, these are paid off at maturity and the Treasury's needs in the short-term category are replenished by new cash offerings of whatever amount is necessary to cover the Treasury's short-term money requirements at the time. Thus there is no compulsion on the System to replace any maturing issues of bills that are held unless general credit policy at the time dictates replacement. Unlike other issues, Federal Reserve participation is unnecessary to assure the success of any new issue of Treasury bills. The market for this type of paper is so broad that coverage of the auction is assured by other investors at whatever rate the market considers the paper attractive for investment in the light of prevailing credit conditions.

The situation is quite different with respect to all other issues of marketable Treasury securities. So long as the Treasury is operating at an even balance or at a deficit, it usually is necessary to refund any other security by offering a new issue in exchange. In that circumstance and without regard to System policy existing at the time, the Federal Open Market Committee, practically speaking, is under compulsion to accept the refunding offer for any System holdings of the maturing issue, in order to avoid Treasury cash attrition. In effect, the System account thereby becomes a permanent holder as such securities are continuously refunded. In practice, therefore, acquisition by the System of any issues except Treasury bills results in a permanently frozen System portfolio and severely restricts flexibility in open-market operations to effect late general credit policies. In the rare cases where a short-term security is refunded with an intermediate or longer term bond, the open-market account becomes an involuntary investor in a closs of security that is not appropriate for inclusion in its portfolio and one in which freedom of action subsequently is even more severely restricted. The impact on the market of sales of intermediate and longer securities by the System tends to distort disproportionately an otherwise natural market level.

All things considered, it appears that normal credit control functions directed primarily at the availability and volume of bank reserves can best be effectuated through operations confined to Treasury bills. Adoption of such a guiding principle for normal open market operations would go far toward eliminating all of the criticisms and handicaps that attach to intervention. For example, the basis for criticism that dealers' normal market functions are hampered by a policy of intervention in other issues would be eliminated. Operations confined to bills would remove the need for continuing a closely knit dealer organization and would permit abandonment of the policy of distinguishing between firms that are and are not qualified to do business with the account. In such circumstance the System would be free to conduct its business with those firms best equipped to function in the short-term market; more particularly, the Federal Open Market Committee would be relieved of any responsibility for protecting the qualified dealer.

One of the most beneficial results would be that the Federal Open Market Committee would be relieved of the necessity of involving itself in a discussion of technical methods of effectuating policy and would be able to devote its attention primarily to policy decisions with respect to the need for credit actions, based upon an appraisal of economic factors. Use of bills for effectuating general credit policies would permit of much greater flexibility in moving in and out of the market than would longer securities. The timing of the purchases and sales of longer securities is much more difficult because of the inability of anyone to appraise accurately the market effect of System operations. All too frequently the effects are out of proportion to the volume, solely because of the importance attached by the professional elements in the market to System operations. For these reasons, operations in intermediate and longer term bonds might prove to be self-defeating from the standpoint of achieving the desired effect upon the volume and availability of bank reserves.

2. Methods to relieve purely temporary stringencies in the money market

Although sufficient experience has not yet been gained to warrant the adoption of a specific formula under which repurchase agreements would be made available to dealers, some such mechanism appears to be best adapted for use in moderating purely temporary and self-reversing tight money periods, such as occur around tax dates and during temporary periods of currency expansion and decreases in float. Repurchase agreements would be especially useful over long holiday weekends when dealers are severely penalized in the interest cost differential of carrying short securities. Repurchase agreements should be extended to all dealers who regularly participate successfully in the weekly bill offerings.

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3. Operations of the account in connection with Treasury financings

Obviously the Treasury should be completely apprised of Federal Reserve policies and objectives at all times. This is essential to the formulation of intelligent long- or short-range debt management plans.

Beyond this, the Treasury should be fully informed of the extent to which it can expect aid from the System in carrying out its cash-offering and refunding operations. Here, two choices are available. The first assumes that the System should be committed to a policy at all times of underwriting Treasury financing operations by direct participation to the extent necessary. In the case of refundings, this would involve the maintenance of a sufficiently high rights value on maturing securities to assure a minimum of overall attrition regardless of the natural preferences of holders of these issues. Of necessity, the maintenance of a rights value sufficiently high to encourage holders to sell to the System tends to discourage other investors from purchasing rights at levels they believe to be attractive from those holders who may not wish to acquire the specific securities offered in exchange. Of course, the support of issues of comparable maturity to those being offered in exchange automatically creates an artificial level of rates and results in the acquisition of other securities into which the account is frozen.

There are many other obvious disadvantages to such an approach.

(1) It seriously hampers freedom of action in effectuating general credit policy.

(2) It temporarily reestablishes a pegged market.

(3) As pointed out previously, it tends to freeze the open market portfolio permanently into whatever securities have been purchased, because at maturity of the securities the committee is again expected to avoid forcing attrition and thus becomes obliged to roll over. Resale before maturity would involve a judgment as to timing and could not avoid disruption to the normal demand and supply relationships, in some cases in disproportion to the actual volume of sales.

(4) It creates a false impression to the Treasury of the worth of Treasury securities and eliminates a guide to the Treasury of the classes of securities most sought after by investors, thus precluding an accurate appraisal of the maturity areas in which Treasury refundings or cash offerings could best be achieved.

(5) It tends to encourage the Treasury to rely too heavily upon System support and thus tempts the Treasury to borrow at lower rates than the market justifies.

(6) It eliminates dealers as such and turns them into brokers for the account.

(7) Experience has indicated that System sales of securities that are approaching maturity frequently are purchased by corporate and other nonbank investors who have a specific need for funds which coincides with the maturity of these issues. Thus such sales by the System frequently result either in cash attrition to the Treasury or subsequent reacquisition for System account. In the latter case, the System is obliged to roll them over into the new security that is offered in exchange at maturity.

In summary, such a policy embraces a multitude of problems, but it points up particularly the difficulty of achieving the desirable degree of flexibility so necessary to the effectuation of credit and monetary policy. This factor has been apparent in recent refunding operations. The System has created reserves in the banking system contrary to general credit policies. It has either purchased rights during refundings at an artificial level or other securities of comparable maturity to those being offered in exchange. These cannot be resold for the purpose of reestablishing the desired level of bank reserves (or borrowings) without unduly affecting the then existing structure of prices and yields.

Responsibility for debt management decisions clearly belongs in the Treasury. As stated previously, the Treasury should be completely informed at all times of the current credit and monetary policy objectives of the Reserve System. The Federal Open Market Committee should accept no responsibility for initiating advice to the Treasury as to the terms of new issues that the Treasury contemplates offering either for cash or for refunding. The Federal Open Market Committee might be expected upon request of the Secretary to render advice to the Treasury, based on its best judgment of the attractiveness of any issues that the Treasury proposes to offer in the light of the Federal Open Market Committee's appraisal of market and credit conditions prevailing at the time. Beyond this, the System should assume no responsibility for directly underwriting any issues offered by the Treasury. It would follow from this that the System would refrain from purchasing any maturing issues for which an

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exchange was being offered, when-issued new securities, or any outstanding securities of comparable maturity to those being offered for cash or refunding.

Treasury offerings should be priced in line with market conditions and expected credit policies of the System and be sufficiently attractive to assure ready market acceptance.

Appropriate pricing by the Treasury can best be determined by announcing in advance the general terms of the issue to be offered, in order to give the market an opportunity to adjust to the impact of an additional volume of securities in any one maturity area. After sufficient time for such adjustment the specific terms should be announced, the books opened for subscriptions, and subsequently closed at the earliest possible time thereafter. This technique, which is particularly important in the case of new cash offerings, would also be desirable in the refunding of a short security into a longer-term issue.

Assuming that Treasury financings are sufficiently infrequent, it would not appear unreasonable for the Federal Open Market Committee to agree to suspend during these periods any open-market operations in which it normally might be engaged. Under such a commitment it might be agreed that the Federal Open Market Committee would refrain from any sales in the market beginning with the period of the Treasury's preliminary announcement of the general terms. Such commitment would permit natural market adjustment to the impact of the new offering. Further, it would appear that the only other justifiable deviation, least inconsistent with the rule of nonintervention, would be for the Federal Open Market Committee to assure the Treasury that it would take such steps as might be necessary to prevent a rise in open-market Treasury bill rates from exceeding the highest rates that had prevailed during the period between the preliminary announcement and the announcement of the specific terms. This commitment would promote arbitrage favorable to the offering. Such a commitment, however, would be in effect only during the period that the books were open. It would appear that this set of conditions would best assure proper pricing and successful offerings.

As a corollary to the commitment to maintain bill rates, however, it also should be understood both by the Treasury and the market that once the subscription books had been closed the Federal Open Market Committee would be entirely free to engage in open-market operations to effectuate whatever credit policies it considered appropriate at the time without regard to the effect of such open-market operations on the prices of the newly offered or any outstanding securities. This would involve freedom to dispose of any bills that might have been acquired during the period that the books were open or a lesser or additional amount of bills that it might be necessary to sell to accomplish the objectives of credit policy.

4. Methods of dealing with disorderly markets

Intervention by the System outside the bill market should be strictly limited to the correction of disorderly conditions in the market. To accomplish this, the directive to the manager of the open-market account should be changed to supplant the present directive of maintaining orderly conditions in the market. Since conditions of such disorder as to require account intervention are likely to be remote, judgment as to whether intervention is necessary probably should rest with the executive committee. The System account manager should be charged with the responsibility of informing the executive committee of developments in the market that in his judgment would justify intervention. While it is not possible to set specific criteria of what constitutes disorderly conditions, it might be advisable for the Federal Open Market Committee to describe generally the type of circumstances which could be adjudged to constitute disorderly conditions in order to avoid the risk of too hasty intervention.

CONCLUSION

Adoption of the foregoing set of ground rules, as a basis for System open market operations, would go far toward solving the problems to which this study has been directed and to achieving a deeper, broader, and more resilient market for Government securities.

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Appendix D

Call Money Facilities

In the American money market of today there is no counterpart for the highly organized call money market which has been a principal feature of other great money centers, past and present. There is no place at the present time where a lender can offer temporarily idle funds for loan, confident that the loan will be well secured and that the funds will be available on demand completely at his convenience and option. Conversely, there is now no place in the American money market to which a dealer in money market securities can go for loans to carry his position, confident that with suitable collateral money will always be available to him on a completely impersonal basis, repayable at his convenience at any time, and at a cost which on an average will be reasonable as compared to other money market yields. In other words, there is no truly open market for call loans or demand money in the United States at the present time.

The famous New York call loan market which was centered during the twenties at the money post on the New York Stock Exchange has disappeared. It long served as a medium for the employment of liquid funds and the adjustment of bank reserve positions. It ceased to operate in any important sense during the thirties when excess funds were so plentiful and so widely held that resort to an open market mechanism offered little advantage to either lender or borrower. It came to an official end in 1946 when its very convenient technical facilities for making loans and handling collateral were dismantled.

Now that the long era first of huge redundant excess reserves and then of very low pegged interest rates has come to an end, the lack of an open market for call loans is being felt. Member banks outside the money centers, in the absence of such an outlet for short funds, offer money in the Federal funds market or invest in Treasury bills. Funds can only be put to work in the Federal funds market on a one-business-day basis. The mechanics of bill purchase or sale, the minimum inescapable costs of handling the transactions, are such as to make this outlet unprofitable for money that will be available for only a small number of days. Large corporations and other potential nonbank lenders with temporarily idle balances face the same cost handicaps when they attempt to invest in very short-term bills.

Nonbank dealers in Government securities, on the other hand, in the absence of an open market for call loans, have found it difficult on a number of recent occasions, and even for some sustained periods, to borrow money except at rates which penalize their functioning as dealers. In addition to usual market risks, nonbank dealers have had to assume the burden of a negative carry on their portfolios at such times, and there has been a tendency for them to limit their participation in the market and to maintain very small positions.

Such a dealer reaction naturally weakens the entire market in periods of strain. A market with depth, breadth, and resilience needs instead a dealer group functioning on completely different inventory policy. For such a market, credit must be available to dealers on terms that will permit and even encourage them to absorb a substantial volume of securities when market pressures are most severe as well as to hold large positions in short-term issues on a continuing basis. In terms of today's debt, a fully satisfactory market would probably require that dealer positions regularly run several times larger than in recent months.

Some important elements of an organized call money market are already present in the current American money market. New York City banks have always felt a responsibility to the Government securities market and they offer loans to dealers on what is in many respects a call money basis. These banks use the Government security dealer loan as one instrument for adjusting their reserve positions. When a New York bank has surplus funds, it posts a lending rate designed to attract dealer loans; conversely, when its reserve position is deficient, it in effect calls dealer loans by posting a noncompetitive rate for new loans and renewals. With the development of sustained general tightness in the reserve positions of member banks, however, the New York banks have come under special pressures and the volume of money they have had available for this

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purpose has in general not been adequate. Accordingly, their rates on loans to Government security dealers have frequently been substantially above market yields on short-term Government securities. As a consequence, dealers have for some time been cultivating additional money sources through a series of individually negotiated customer transactions with larger banks outside New York and with some of their major corporate customers.

These facts suggest that some of the ingredients of a national call money market are forming under the pressure of need. There would seem to be considerable scope, however, for further and more organized development. Certainly, the present institutional gaps in the credit market are made clear by the fact that in recent months, when the money market has been tight, lenders throughout the country have been willing to hold bills and other short-term Government securities at considerably lower yields than the rates at which loans have been available to dealers, who offer these same Government securities as collateral and who assume the full risk of declines in security prices. Such a rate relationship may reflect the fact that many loan contracts with dealers have been on a customer basis in which the lender has not felt free to call in his funds without concern for possible inconvenience to the borrower. The relationship would be an anomalous one, however, if the dealer loans were essentially impersonal and could be called completely at the convenience of the lender. Then the loans would in fact be more liquid than the securities.

In a fully organized market, it would ordinarily be expected that the credit involving the lesser risk and greater liquidity to the lender would command the more favorable terms. In such a market Treasury bills should under most circumstances yield more in the market than a dealer loan made on an impersonal call basis and secured by bills. Investment in bills carries some market risk should the funds be needed before maturity. The dealer credit is virtually without risk of any kind since even the risk of adverse changes in the market for bills is underwritten by the dealer's capital. Loan rates to dealers should be much lower than the market rate on bills when the money market is tightening, when bill yields are rising to previous peak levels, and when uncertainty as to possible future yield increases is widespread. In such a situation, if there were facilities for doing so, many investors who are ordinarily fully prepared to accept the market risk of holding short-term Government securities would doubtless be glad to accept a lower return on their money in order to shift to another the risk of further price declines.

Except in a period of continuing ease, rates on dealer loans made on an impersonal call basis and fully secured by United States Government securities would tend to average below market rates on short-term Governments, provided there were an efficient mechanism for drawing call money together and making it available to dealers. Use of repurchase facilities would limit the upper range of fluctuations of such rates.

Under normal conditions there would seem to be large amounts of funds throughout the country which could be marshaled by a properly organized call money market. Banks, including many of the thousands of smaller banks, and large corporations hold millions in secondary reserves or idle balances which, if employed, must be available on very short notice. Much of this money cannot ordinarily be invested to advantage in short-term Governments, since the uncertainty of the period for which it might be invested, together with the trouble and risk involved in investment, tends to outweigh the interest that might be earned. It could be made available, however, for loans which are fully secured and subject to immediate call.

The potential supply of funds to a call-money market goes beyond this, however. A number of nonfinancial corporations and outlying banks are presently attempting to maintain reasonably fully invested positions in short-term Government securities, although they may not have the skilled personnel needed to limit risk while taking full advantage of the investment opportunities. Such investors might be better off to lend on call to Government security dealers rather than to hold securities themselves. On an average, a larger proportion of their secondary reserves could be safely invested in the day-to-day call loan. Thus, although they would ordinarily get a lower gross rate on a dealer loan than on the securities, the total net return to such lenders from the fuller use of their secondary reserve funds might well be larger in case dealer loans were available than the return they now obtain from more limited investment in Government securities. In addition, the time devoted by those who are following the Government securities market could be diverted to other activities.

It seems clear that the existence of an organized call-money market would be a major factor in encouraging dealers to assume a more active role in the Govern-

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ment securities market, thereby enlarging the scope of that market. It also seems likely that recent changes in the role of credit in the economy and the resulting greater need to economize on financial resources enlarges the potential demand for such an institution on the part of both lenders and borrowers. Banks outside the money centers would find it very useful for close administration of their reserve positions. Business corporations would find it an outlet for surplus idle balances. New York City banks could service the loans for a fee.

The feasibility of a call-money post using such arrangements was demonstrated by the experience with the post of the New York Stock Exchange in the twenties. In the money-post operation of that decade, the New York banks made the loans for their correspondents on an agency basis. Low-cost techniques for handling collateral, including the substitution of collateral, were worked out. Considering the greater ease of handling Government securities and the larger loan unit that might be used, it may be that even more efficient procedures could be developed now for loans to Government security dealers. It was also the experience with the old call-money post that this market provided banks with a very useful mechanism for the rapid adjustment of reserve positions and that it served as a ready outlet for idle business funds.

It is fully recognized that one major question regarding the feasibility of a present-day call-money post for loans to Government security dealers would be whether lenders could safely depend on it as an adequate, consistent outlet for credit. Could such a call-loan market be large enough and stable enough to be a reliable mechanism for handling the secondary reserve positions of outlying banks? Obviously, a call-loan market of this size would require time for development. Dealers now are carrying positions which are small in relation to the size of the market. Nevertheless, in view of the fact that dealers are making outside arrangements for credit at considerable cost, it may be worth while to explore the possibility that an organized market might again be developed.

Comments of the Federal Reserve Bank of New York on Report of the Ad Hoc Subcommittee on the Government Securities Market

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PREFACE

The Ad Hoc Subcommittee on the Government Securities Market addressed itself to a study of the market under the changed conditions that have resulted from abandonment by the Federal Reserve System of its support of a relatively fixed pattern of prices and yields, and to an examination of the relevance and adequacy of the Federal Open Market Committee's own procedures and operations in the context of a market free to respond to changes in supply and demand. The report of the subcommittee emphasizes that the Federal Open Market Committee should be in a position to operate promptly and in appropriate volume at all times without fear of disruptive technical repercussions on the market. This,

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it is suggested, requires a market characterized by "depth, breadth, and resiliency." Consequently, the subcommittee says, "It is with these characteristics of the market that this report is mainly concerned."

The subcommittee concludes that the best way in which the Federal Open Market Committee can promote the development of these market characteristics is to reduce its intervention in the market to the minimum required for the execution of monetary and credit policies. Furthermore, it recommends that such intervention be limited to short-term securities, preferably Treasury bills; that the operating techniques and relations with the Treasury of the Federal Open Market Committee be changed to conform with the principles of minimum intervention; that "ground rules" be made known to the dealers, which will henceforth govern the transactions of the Federal Open Market Committee with dealers; and that specific measures be adopted to facilitate the financing of dealers (and in this connection, revival of a call loan market be studied). Finally, "The subcommittee finds many anomalies in the structure and organization of the Federal Open Market Committee * * *" and recommends "that the Committee reexamine and review its present organization, and in particular that it consider the advantages and disadvantages that would ensue, were the manager of the open-market account made directly responsible to the Federal Open Market Committee as a whole, and not, as at present, responsible through the Federal Reserve Bank of New York."

The Federal Open Market Committee, with the general concurrence of other officials of the System, has already moved a considerable distance in the direction of certain of the recommendations. Other recommendations, however, raise a number of questions. Among them are the following:

1. May not there be overemphasis on promoting the "depth, breadth, and resiliency" of the market for Government securities as an appropriate aim of the Federal Reserve System? And will those characteristics, in fact, be promoted at all times by minimizing System intervention in the market and by confining System operations to short-term securities?

2. Are such market characteristics always essential to the effective execution of the monetary and credit policies of the System? Or may there, at times, be conflict between efforts on the part of the System to promote these characteristics and achievement of the aims of monetary and credit policies?

3. Is limitation of Federal open-market operations to very short-term securities necessarily consistent with minimum intervention in the Government securities market in all circumstances? May not such limitation, in fact, require larger-scale intervention at times, with resulting unnecessary expansion in the volume of Federal Reserve credit outstanding? Also, may it not risk unnecessary repercussions and distortions in one sector of the market?

4. In view of such questions, how far is it necessary or appropriate for the Federal Open Market Committee to go in making commitments limiting its scope of action for the future?

5. (A related question) Are 'ground rules" of the kind suggested necessary to enable dealers to operate effectively, and would they constitute any guaranty of dealer operations of such a character as to promote the "depth, breadth, and resiliency" of the market? Can we be sure that they would contribute to, and not interfere with, the effectiveness of System operations?

6. Would extension of repurchase facilities more freely to the dealers be consistent with the principle of minimum intervention in the market? Or would it constitute a new and indirect form of market support?

7. If the system of recognized dealers were abandoned, should the manager of the open-market account be left to decide in his own discretion with whom he will deal? Or what criteria should he observe in declining with whom he will deal?

8. If the system of recognized dealers were retained, but the list of such dealers revised, what are the qualifications that should be observed in determining which dealers to "recognize"?

9. If, in conducting certain special types of transactions, such as those designed to correct disorderly market conditions, the manager of the account is to do business with dealers outside the recognized group (if that group is continued), on what basis should he distribute the business?

10. What advantages to the Federal Open Market Committee or to the System as a whole are expected to result from curtailing the sources of information available to the manager of the account? What disadvantages might result?

11. Is it correct to say that the aspects of the present organization of the Federal Open Market Committee mentioned at the bottom of page 85 are "anom-

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alous"? Or are there good reasons based on past experience for the present type of organizational arrangements?

12. Are the presumed disadvantages of the present status of the manager of the account valid? Would it be a feasible and effective arrangement to have the manager of the account conduct day-to-day (and, in fact, hour-to-hour) operations under the direction of the Federal Open Market Committee as a whole or its executive committee?

These and related matters are discussed in the following pages in three main sections. Part I deals with broad questions of policy; part II with the details of procedures and relations with dealers; and part III with organizational arrangements for conducting open-market operations. A final section sums up the conclusions indicated by the preceding sections.

I. THE SYSTEM'S INTEREST IN AND GENERAL RELATIONS WITH THE GOVERNMENT SECURITY MARKET

Continued active interest of the Federal Open Market Committee and of the Federal Reserve System generally in the market for Government securities is inevitable, despite the withdrawal from active support of the market early in 1951. That action could not mean complete divorcement of the System from any involvement with the market, since, as the subcommittee points out, the Federal open market account is still the largest single holder of Government securities. Not only do the System's open market operations have greater potential effects on the market than those of any other investor (because of their effect on bank reserves), but even inactivity of the System account—in the form of declination to participate in arbitrage operations, for example—may have an important influence on the market. The "accord" had as its major objective freeing the System, not to withdraw from the market entirely, but rather to operate in a manner consistent with the dictates of monetary and credit policy, and thus to restore open market operations to their potential position as the one most important instrument of System policy.

Unquestionably, as the report of the subcommittee points out, effective execution of open market policies requires a Government securities market of some "depth, breadth, and resiliency," yet there may be danger in going quite so far as the subcommittee has done in accepting the promotion of such market characteristics as a major objective of the Federal Reserve System. In order to promote them, the subcommittee proposes various commitments with respect to open market policies and operations which require the most careful consideration by the System to make sure that any such commitments, if adopted, would not prove a handicap in carrying out effectively the System's major responsibilities for monetary and credit policy.

The market characteristics just mentioned, and repeatedly emphasized in the subcommittee report, unquestionably are desirable from the viewpoint of debt management, but is it equally clear that the interests of debt management and of monetary policy necessarily coincide in this respect under all circumstances? May it not, in fact, be more desirable from the viewpoint of monetary policy to inhibit some types of market activities at times—particularly those which tend to facilitate expansion of bank credit in periods when the System is endeavoring to restrain credit expansion?

Still fresh in our minds is the extensive discussion of the question of shifting the public debt more largely into nonmarketable form and of compartmentalizing the debt to a much greater extent as a means of reducing potential offerings on the market of Government securities. It is true that such proposals were most relevant before the System had freed itself from the responsibility for maintaining relatively stable prices and rates in the Government securities market, and have become less relevant since the "accord." In any event, the subcommittee report reflects a strong tendency in the direction of broadening the market by permitting and encouraging the free play of the forces of supply and demand, rather than of recommending measures designed to narrow the market, and with that general tendency we would express no disagreement.

A related question, however, is whether to aim for a market which will be capable of absorbing the purchases and sales which the Federal Open Market Committee deems necessary or desirable to achieve a given effect on the reserve position of the commercial banking system with a minimum of price reaction in the Government securities market, or whether in some circumstances the System's major objectives may not be promoted by the effects of its open market operations on prices of Government securities and the resulting impact on financial markets generally. The inhibiting effect of price reductions for market-

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able Government securities since the "accord" on the tendency of savings institutions and banks alike to shift from Government securities to loans and investments for the financing of private activities is a case in point.

But even from the viewpoint of promoting the "depth, breadth, and resiliency" of the Government securities market, it may be questioned whether the program suggested by the subcommittee, involving as it does assurances that the System will reduce its intervention in the market to a minimum and that it will limit its operations to very short-term securities, will be the most effective in all circumstances. For example, the assurance [1] given by the System during World War II that it would maintain a fixed pattern of rates was probably more effective than any other that could have been given in promoting the "depth, breadth, and resiliency" of the Government security market at that time. Undoubtedly there are a variety of circumstances in which many individuals and institutions would be attracted to Government securities if they felt confident that the System would act to maintain the prices of such securities, but would not want to assume the risks of price fluctuations in a free market. Obviously, the subcommittee would not favor a return to such practices, even though failure to do so may sometimes result in a more limited market.

Furthermore, the idea that the dealers will be encouraged to take larger positions and to make broader and firmer markets, once the System gives assurance that it will stay out of all but the short-term sector of the market, deserves scrutiny. The argument is that "a disconcerting degree of uncertainty exists among professional dealers and investors in Government securities with respect both to the occasions which the Federal Open Market Committee might consider appropriate for intervention and to the sector of the market in which such intervention might occur, an uncertainty that is detrimental to the development of depth, breadth, and resiliency of the market." It is hard to believe that such a degree of uncertainty still persists after 2 years in which intervention by the System in the Government securities market has been progressively reduced and for some time has been limited almost exclusively to short-term securities. Perhaps to some considerable degree this aspect of the report may already have become outdated. In any event, it must be remembered that the dealers are operating primarily with a view to making profits, and consequently that their inevitable tendency is to sell short and back away from offerings in a declining market and to extend their positions in a rising market. Thus, instead of exerting a stabilizing influence on the market, they tend to accentuate its swings—at least over short periods. Clearly it is the appraisals of the outlook for interest rates and security prices by dealers and investors, much more than any fear (or hope) of intervention by the System in the market for particular securities, that determine the "depth, breadth, and resiliency" of the market at any given time. Fear of adverse trends, or uncertainty as to what the trend is likely to be, is the predominant reason for thin markets, rather than apprehensions concerning System intervention in particular sectors to limit price movements.

From all this, the conclusion seems inescapable that the operating policies of the System most conducive to the market characteristics emphasized by the subcommittee will not always be those most conducive to effective monetary and credit policies. And, where the two considerations conflict, it must be assumed that the Federal Open Market Committee will wish to follow the course of action most favorable to the latter. It is on the basis of this assumption that the specific recommendations of the subcommittee should be examined.

Assurances or commitments

The major commitment which the subcommittee suggests as a means of eliminating uncertainty in the market with respect to the operating policies of the Federal Open Market Committee is "an assurance from the Federal Open Market Committee that henceforth it will intervene in the market, not to impose on the market any particular pattern of prices and yields but solely to effectuate the objectives of monetary and credit policy, and that it will confine such intervention to transactions in very short-term securities, preferably bills." With the first part of this assurance we can readily agree, provided the objectives of monetary and credit policy are not interpreted too narrowly. The last part of the suggested assurance, however, is much more questionable. It is quite likely that in most circumstances the System will be able to attain its policy objectives by operating only in the market for Treasury bills and other short-term securities.

[1] There was no formal, publicly announced, assurance of this kind, but the System's actions were tantamount to such assurance.

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It is at least possible, however, that on some occasions the System might better be able to effectuate its policies by operating in other sectors of the market—even the longest maturities—depending on the economic conditions then prevailing, investor and market psychology and expectations, the structure of the public debt, etc. In most circumstances, when intervention in the long-term market by the System was considered appropriate or necessary, restriction of operations to short-term securities would probably either make the System's intervention ineffective or require larger scale intervention to achieve the objectives.

To illustrate the last point, a situation such as that created by the outbreak of war in 1939 may be cited. This would come under the heading of a potentially disorderly situation, of course, and the subcommittee would doubtless agree that the System could not then have corrected conditions in the market by operations limited to Treasury bills. The bill rate was already close to zero and the banks held large amounts of excess reserves, so that there was little likelihood that injections of Federal Reserve credit into the short-term market could have been effective in remedying the acute weakness in the long-term market. It may be conceded that the same conditions are not likely to recur in the foreseeable future, but in the event of a sudden shock to the long-term market of such a nature as to call for intervention by the System it is probable that the only effective form of action would be to make purchases in that sector of the market.

Furthermore, confining operations to very short-term securities might involve other problems. Frequently there is a heavy demand for such securities—for example, for temporary investment of corporation funds pending dividend and other disbursements—and System purchases in that sector of the market might cause distortions in the interest rate structure and interfere with the legitimate investment operations of others. It is emphasized in the preface to the subcommittee report, "that the possibility be minimized of disruptive technical market repercussions from Committee transactions." Limiting the scope of System operations too narrowly might increase, rather than reduce, the likelihood of just such disruptive repercussions. Bearing in mind the unforeseen developments that may arise in the future, it would seem better to keep a free hand to conduct System operations in such a way as to avoid distortions in the market and in the interest rate pattern which would serve no good purpose.

Against the background of System account operations for some months past, the emphasis in the report on avoiding operations in longer term securities seems rather outdated. Probably some of those who appeared before the subcommittee and complained of various aspects of the System's open market operations were still thinking in terms of certain practices that were followed at the time when the System was endeavoring to maintain the stability of Government security prices with a minimum extension of Federal Reserve credit. Surely, "the market" has now had enough experience with the System's changed operating policies so that trading in the intermediate and long-term maturities is no longer appreciably affected by any fear (or hope) of System intervention.

But there are broader grounds for questioning the advisability of a commitment to operate only in the short-term market. First of all, there is serious question whether the facilities for market "arbitrage" are so highly developed, or could be, as to assure a smooth flow of reactions from any System action in the short-term area throughout the longer sectors of the market in all circumstances. The subcommittee refers to operations in the short-term market as traditional central banking policy, but one of the major questions raised concerning traditional central banking policy concerns its ability to achieve the general restraint or ease intended solely through action in the short-term market.[2]

The degree to which arbitrage operations between different maturities of Government securities or among different types of investments could be expected to prevent unnecessary price fluctuations or to encourage a freer flow of investor funds in the market for Government bonds is extremely uncertain. The record indicates that little may be dependably expected through movements of funds from short- to long-term Government issues. In fact, in the conditions of market uncertainty characteristic of an incipient disorderly market, short- and long-

[2] This criticism was made strongly, for example, by J. M. Keynes in A Treatise on Money. (1931), particularly in vol. II, pp. 362–63. In the preceding pages he referred to evidence taken from W. W. Riefler, Money Rates and Money Markets (1930), showing that changes in the short market at that time did exert some effect on the long market, but he questioned whether such effects were adequate and dependable. Riefler himself said (p. 218), "Whether the effect of credit policy on money rates * * * could ever seriously affect the level of bond yields * * * raises a question * * * that does not lend itself either to categorical affirmation or denial."

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term rates might be expected to move counter to each other under the impact of a disequilibrating, rather than an equilibrating, movement of funds. At periods of temporary money-market ease or tightness, the resulting yield movements on short-term securities might encourage a trickle of funds into or out of longer maturities, but this marginal movement very probably would be insignificant in influencing long-term prices by contrast with the particular set of longer-run expectations prevalent in the bond market at the time. These expectations might or might not be pushing long-term prices in the same direction of movement prevailing in the short market. At several places in the subcommittee's report a close positive correlation is described between very short-term and long-term yield movements; the fact that such a correlation would be least likely to exist at some times when it was wanted and would be fortuitous, at best, at others casts doubt on the wisdom of relying upon short-term securities, and "market arbitrage," to effectuate all phases of open-market policy.

Outstanding commitments

In connection with the major "assurance" which it recommends, the subcommittee refers to two outstanding commitments "that may require intervention by the Federal Open Market Committee in other than the very short-term sectors of the market, and that may add to or subtract from reserve funds available to the market for purposes other than the pursuit of monetary policies directed toward financial equilibrium and economic stability." These are the commitment to maintain orderly markets and the practices involved in aiding Treasury refunding operations. (The latter, however, can hardly be called a commitment, since actual intervention by the System in connection with Treasury refundings has varied in recent months from very sizable operations to none.) With respect to the first, the emphasis within the System has already been shifting from maintaining orderly market conditions to preventing disorderly conditions, and formalization of the change, as suggested by the subcommittee, would seem quite appropriate.

Consideration of the course of action most likely to be effective in dealing with disorderly market conditions, however, provides a good illustration of the questionability of a commitment to confine the System operations to short-term securities. If the disorderly conditions developed at a time when the general policy of the System was to restrain credit expansion, it would be most desirable to hold the injection of Federal Reserve credit into the market to a minimum. But if the disorderly conditions were most acute in the long-term sector of the market, it is most likely that the greatest effect could be achieved with the smallest extension of Federal Reserve credit by operating directly in that sector of the market. In fact, it is questionable whether the desired results could be achieved at all by operating only in short-term securities. Furthermore, it is quite possible that the purchases of long-term securities could be offset by sales or redemptions of short-term securities. On the other hand, if an attempt were made to deal with the situation by buying only short-term securities, no offsets would be possible—at least until after some considerable lapse of time.

As for the second so-called "commitment," involving support of Treasury refunding operations, the active participants in the market know by this time that intervention by the System cannot be counted upon, and presumably the Treasury has the same understanding. (In this instance, also, actual events may have overtaken the subcommittee's report.) Nevertheless, it may be worth considering in this case, specifically, whether it is desirable for the Federal Open Market Committee to make definite commitments as to what it will not do. In some circumstances the Committee might (provided the maturity distribution of securities in the Federal open-market account permits) find it advantageous to reduce attrition through swaps—on whatever price basis seemed appropriate—and to that extent reduce the need for subsequent Treasury financing and avoid unnecessary interference with the execution of the System's credit policy. In connection with certain refunding operations, it might conceivably be useful to have in the Federal open-market account more of a new issue than would be acquired through the direct exchange of existing holdings. Swaps to obtain the "rights" would not involve any extension of Federal Reserve credit and, unless

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they involved depletion of the System's holdings of maturities which might be needed later, would not interfere with the System's credit policy.[3]

Repurchase facilities

One recommendation of the subcommittee, which is classified among "operating techniques," but which involves a matter of System credit policy, is the proposal "that repurchase facilities at an appropriate rate and with appropriate limitation as to volume be made regularly available to nonbank dealers over weekends." To be of any material assistance to the dealers, and effective in enlarging the market for Government securities, presumably the repurchase facilities offered would have to be substantial. That might mean fairly regular extension of Federal Reserve credit at the option of the market, which would correspondingly increase member-bank reserves and reduce the need of member banks to borrow from the Reserve banks. In fact, the arrangement would probably be used frequently to enable the dealers to make temporary purchases of securities from banks and thus to bolster their reserves during tight-money periods. Consequently, it might tend to undermine the System's credit policy at times when the System was trying to restrain credit expansion by forcing member banks to borrow in order to maintain their required reserves. Furthermore, the fact should not be overlooked that extension of repurchase facilities to dealers constitutes, in effect, indirect intervention in the market and so tends to conflict with the objective of promoting as free a market as possible.

In general, it would seem more in keeping with the recommendation that intervention in the market be "solely to effectuate the objectives of monetary and credit policy," to reduce any form of automatic access to Federal Reserve credit to a minimum. Difficulties experienced by dealers in financing their portfolios on satisfactory terms and their consequent unwillingness to buy additional securities may, in fact, be helpful in making restrictive System policies effective. This is another illustration of the way in which the objective of promoting the "depth, breadth, and resiliency" of the market may be inconsistent with the objective of pursuing effective monetary and credit policies.

This discussion, however, should not be interpreted to mean that making repurchase facilities available to the dealers will never serve a useful purpose from the viewpoint of System policy. Unnecessary disturbances in the money market and wide fluctuations in interest rates caused by purely seasonal or other temporary phenomena serve no good purpose and can at times be avoided or minimized by opening the repurchase agreement window to dealers. But it would seem more consistent with the policy of limiting System intervention in the market "solely to effectuate the objectives of monetary and credit policy" that it be done deliberately on the System's initiative and not as a matter of routine.

Ground rules

The suggested "ground rules" to be made known to Government security dealers to clarify the System's relations with the market involve mainly the assurances or commitments discussed above as well as the matter of repurchase facilities. They also involve the specific relationships of the System with dealers which are discussed in section II which follows. Dealers, of course, would very much like the Federal Reserve System to telegraph its intended actions in advance, so that they could conduct their affairs in such a manner as to maximize their profits and minimize their losses. They would like to be in the position of "shooting fish in a bucket," but there is no obvious reason why the System should cater to that desire. The more understanding and self-reliant among them do not expect anything of the sort, but realize that they must draw their

[3] Incidentally, the danger that the open-market account might become frozen as a result of acquisitions of securities involved in refunding operations (discussed on pp. 35 and 36 of the report) raises the question of whether more could not be done toward redistribution of maturities in the account by responding to swap offers from dealers between Treasury offerings, if and when they suited our convenience. Such swaps (or practically simultaneous sales and purchases, sometimes involving different dealers) were made frequently in past years. Far from constituting undesirable intervention in the market, they frequently contributed to the "depth, breadth, and resiliency" of the market, and were advantageous to the System as well.

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own conclusions as to what lies ahead and assume their own risks in return for the profits they hope to make. The advisability or inadvisability of promulgating any suggested ground rules will have to be decided, not on the basis of dealer preferences, but on the basis of the conclusions reached as to whether such rules would contribute to the effectiveness of the System's operations.

There are times when uncertainty in the market as to what the System will do may be helpful in promoting the System's credit policy objectives. To illustrate, if dealers are uncertain whether or not the Reserve banks will take Government securities from them under resale agreement—over weekends or at any other time—they will be more cautious in buying additional securities; potential sellers will find that they cannot so readily convert Government securities into cash; and the System will avoid opening its doors to ready access to Federal Reserve credit. Such effects of uncertainty in the Government security market may at times be highly desirable from the viewpoint of monetary and credit policy, even though they may limit the breadth and activity of the market for Government securities.

To the extent that is considered desirable to promote a better understanding of the general character of the System's operations that may be expected, may it not be better to convey to the market, through a consistent pattern of operations, a good understanding of the general principles and procedures of the Federal Open Market Committee than to make specific pronouncements which might, in some circumstances, be unnecessarily restrictive and embarrassing? If the recent operating policies of the System are continued, operations in the short-term sector of the market will soon come to be regarded as the normal expectation, and it will be observed that operations in other sectors are undertaken only for good reasons.

Relations with the Treasury

Mr. Sproul's notes on this subject were presented at the meeting of Reserve bank president with members of the Board of Governors on January 27. A copy of his notes is attached as an appendix.

II. SPECIFIC RELATIONS WITH DEALERS

General comment

It is the view of the subcommittee report that, despite the presence of generally satisfactory organizational elements, the market currently lacks "depth, breadth, and resiliency" to the full degree that would be desirable for the efficient conduct of effective and responsive open market operations. This condition, in the view of the subcommittee, is in part a product of the character of Federal Open Market Committee market relations which have, in the present context, become a barrier to the full development of the attributes considered necessary for an efficient market. The reasons for this, the subcommittee believes, are to be found in (1) the existing dealer-qualification procedures which, on the one hand, limit the advantages to the System accruing from the market's facilities and, on the other hand, inhibit the development and effective operation of dealer firms by denying to them the "privilege" and advantages of handling transactions for the System and obtaining credit through repurchase agreement, and (2) the operating techniques of the Federal Open Market Committee which involve paternalistic interference with dealer activities and an undue "personal" intrusion in their operations and business affairs.

The specific recommendations of the subcommittee for remedial action in these general areas are reviewed and examined in this section. A few broad observations appear to be in order, however, before turning specifically to individual recommendations. The Federal Reserve Bank of New York recognizes much that is sound in the detailed proposals covering our specific relations with the dealer market. Many of those proposals are an acknowledgment of a changed situation—a situation in which we have shed as much as possible of the role of price fixing in the Government securities market. Most of them are broadly consistent with the procedures followed over the past 20 months, since the "accord," by the Federal Open Market Committee and by the manager of the account in areas where he had discretionary authority. Hence, some of the practices and procedures singled out for review and corrections have already been modified or discarded in response to new conditions in the Government security market and to the requirements of a more nearly traditional approach in the application of a policy of general credit control. To some extent, therefore, actual events have overtaken the subcommittee's report. Other proposals of the subcommittee have not been tried, or recommended for trial by the Federal Reserve Bank of New

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York because they either present no clear-cut advantages or raise new problems requiring further examination and experience for solution.

It is important to bear in mind in considering this section of the report and the contributions to be expected from the proposed change in operating techniques that "breadth, depth, and resiliency" are not absolute concepts as they relate to the Government securities market; they can at best be realized only in a relative sense and gains or progress to this end should not be bought at too high a price in terms of credit policy or by inviting new and possibly more difficult problems in market relationships and policy implementation. There must be assurance that the basis of the account's dealer relationship, if appreciably broadened, does not invite more, rather than less, activity in the System account by widening dealer access to Federal Reserve credit, that the System has the technical information necessary to enable it to render informed judgments as to the need and the character and timing of operations in the market, and that it avoids the dangers of extreme reaction in attempting to be too impersonal in a market that is itself personal in character, based on the principle of negotiated transactions.

Dealer qualification

The ad hoc subcommittee finds no present or prospective justification for continuing the present system of rigid qualification for dealers with whom the account will transact business and recommends that the system be dropped. As an alternative, the subcommittee suggests a revision in the list of qualified dealers and the abandonment of a policy of differentiating between qualified and other dealers in the case of repurchase agreements, purchases of "rights" (if any) in support of Treasury refunding operations, and transactions to correct disorderly markets. This is a case of Hobson's choice; to accept the second alternative is in effect tantamount to concurring on the first, or basic recommendation.

For a full understanding of the present qualification procedures a brief description of its antecedent is necessary. The whole question of dealer relations was reexamined by the Federal Open Market Committee in 1943. Early in 1944 the Federal Open Market Committee formally approved tthe procedure currently in effect governing System-dealer relations. In explaining that action in the Record of Policy Actions of the Federal Open Market Committee in the Annual Report of the Board of Governors of the Federal Reserve System for 1944 the following statement is made:

"The * * * action of the Federal Open Market Committee followed a thorough study of the relationships with the dealers and brokers through which transactions for the System open-market account were executed. The Committee felt that, although the informal arrangement that had existed previously was satisfactory for a period when tthe volume and amount of transactions for the System open-market account were relatively small, the increase in the activity of the account, and the likelihood that operations in very large amounts would continue during the remainder of the war and into the postwar period, made it desirable to place the existing relationships on a formal basis. The terms of agreement represents in substance the informal agreement that had been in effect between the Federal Reserve Bank of New York, as agent, and the dealers and brokers with whom the Reserve bank previously had transacted business for the System open-market account."

Qualification procedures, involving dealer "recognition," in some form have always been used in dealing with the market. Formalization of those procedures in 1944, as the culmination of a thoroughgoing review in 1943 of the System-dealer relationship, was not consciously or deliberately related to, or developed as an integral part of, the whole apparatus of pegged markets which reached its zenith some 4 years later. It was, on the contrary, recognition of a need to lay down principles governing operating procedures which would be understandable and defensible in the circumstances then existing or likely to eventuate; and in serving that purpose it formalized and continued in operation a system of market contact that was originally set up at the Federal Reserve Bank of New York to serve the interests of credit policy.

The Federal Reserve Bank of New York holds no brief for the present qualification procedures or for their maintenance on a formal footing. They are admittedly imperfect procedures which have been under almost continuous criticism and review at the Federal Reserve bank since their formal adoption. In considering this aspect of the System's market relation the Federal Reserve Bank of New York does, however, start from the premise that some procedure for the designation or the qualification of dealers for transactions with the Federal

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Reserve banks is both necessary and desirable if our dealings with the market are to be handled in the most effective way. It is, therefore, no wholly constructive or final solution to advocate the dropping of current qualification procedures; for that course leaves unanswered more questions than it settles.

The basic recommendation on dealer relationships in the ad hoc subcommittee report points up the need for a redetermination by the Federal Open Market Committee, of its position on dealer qualification and a decision by it as to whether the details of System account contact with the dealer market are to be laid down by it, as a policy body, or are to be delegated to the Federal Reserve Bank of New York, chosen as the executive agent of the Federal Open Market Committee, and the officer of the bank selected to serve as manager of the account. Once that basic question has been answered, there remain the subsidiary matters of appraising the advantages and drawbacks of a formalized procedure whose inflexibility precludes operations, in special situations, with some of the smaller dealers, as against an informal procedure with latitude for discretion in action. Finally, the Committee itself or the Federal Reserve bank, acting as the agent of the Federal Reserve System as a whole with the aid of the manager of the System open-market account, would be still faced with the task of developing workable criteria governing the choice of dealers eligible for handling transactions with the System open-market account.

Either way, the "problems" of dealer-Federal Reserve System relations will not be easy. The Federal Reserve Bank of New York, as fiscal agent of the Treasury and in its agency capacity for various foreign central banks and others, will continue to be an important factor in the Government securities market and it will, through its directors, continue to make a determination with respect to those dealers through whom it is prepared, as agent, to execute orders in Government securities. Insofar as practicable, those procedures would have to be broadly consistent with those governing open-market operations if it were intended to screen from the market the account for which particular operations are carried out. On the other hand, if different procedures were used and if the market were able to distinguish between transactions by the bank, as agent for the Federal Reserve System and transactions by it in its other agency capacities, dealers and others might continue to be dissatisfied and articulate in their criticism of the System on the grounds that its choice of dealers was a wholly capricious one. If any disinction is made between dealers serving the bank as it functions in its two leading capacities in the market, the question will inevitably arise in the public mind as to why two sets of standards are utilized.

Whichever way these decisions may go, however, difficulties in connection with the question of qualification will be faced by the Federal Reserve Bank of New York and the Federal Open Market Committee in justifying whatever procedure is adopted governing their relations with dealers; for no matter what their formality or their informality may be, or their criteria or the lack of them, those procedures will inevitably involve the recurring questions of the marginal firm and the equity or justification of excluding it. We shall always have the problem of differentiating between one set of dealers and another on some basis. For even if there is no list of qualified dealers, the bank cannot do business with everyone all the time. That would be an administrative impracticability. How, then, shall the bank distribute its business? There will have to be some principles, and their effect will have to be to include some dealers and exclude others, whether that is formalized as a qualification procedure or not.

The alternative to discarding existing qualification procedures presented by the subcommittee, i. e., revision of the list of qualified dealers, and limited qualification of "nonrecognized" dealers—presumably any dealer—for certain types of transactions, is not a promising line of approach. Under existing practice, the qualification procedures are applied by the manager of the account. By and large the factors to be taken into account in determining qualification have been applied with reasonable flexibility and all decisions by the manager have received Federal Open Market Committee approval. It is true that there is some room for revision of the list of presently qualified firms within the existing framework, but any such revision might, if based on stricter interpretation, result in a contraction rather than an expansion in the number of dealers serving the account, a course which would presumably be at cross-purposes with the objective of the ad hoc subcommittee. To do otherwise would be to vitiate the standards, and then new ones would have to be substituted. The subcommittee does not suggest any different standards. Consequently further study of that question will have to await the development of substitute criteria.

Related to the suggestion for a revision in the list of qualified firms is the recommendation that the account undertake transactions—to the extent that such trans-

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actions are called for—with dealers, other than those qualified, in the case of transactions in "rights" to support Treasury refunding operations and to correct disorderly markets, and to enter into repurchase agreements with all dealers who participate regularly in the weekly bill auction. Taken collectively, these are, of course, important areas of System intervention, although each is of shifting relative importance, repurchase agreements being currently the most significant. Viewing the use of repurchase agreements as an orderly market operation, this is little more than a recommendation that the System use various dealer groups on the basis of a functional distinction in System open-market operations which would limit outright transactions for purely credit purposes to qualified firms. This dual standard of qualification is questionable, for it breaches the qualification procedure not for the purpose of promoting the System's major policy objectives, but for the sake of secondary purposes—for what are, in effect, "orderly market" operations and support of Treasury financing. It would seem preferable from the standpoint of the market and the System to have a uniform, defensible, and easily understood procedure for all transactions under Federal Open Market Committee direction.

Operating techniques

Under the heading of "Operating Techniques" the subcommittee report recommends the discontinuance of the following practices:

1. "Reluctant buying";
2. Agency transactions for the System account;
3. Refusal to purchase "rights", to the extent that any "rights" are purchased, from dealer positions as well as from customers; and
4. Refusal to buy bills acquired by dealers on a cash basis.

These proposals for change in operating procedure are among those which have now been overtaken by actual events insofar as their immediate application is concerned. The practices cited were initially undertaken at different times in the past for valid reasons with the knowledge or approval of the Federal Open Market Committee, but have since been virtually abandoned as operating techniques following the "accord" with the treasury and the subsequent development of a freer market for United States Government securities. In general, the recommendations in this section of the report represent desirable procedures at this time which are in conformity with current practice but it would seem that there are not, and probably cannot in practice, be any iron-clad rules governing Federal Reserve System open market techniques under the full range of unpredictable market circumstances and credit policy problems arising out of alternating programs of restraint, neutrality and ease.

"Reluctant buying."—The subcommittee favors the complete abandonment of "reluctant buying." The practice of "reluctant buying" predates World War II although it found its most extensive use during the periods of heavy support of the long-term market at fixed prices in the early postwar years. It was used primarily in dealing with sophisticated investors who were large holders of Treasury bonds and who were anxious to sell but were not easily stampeded by rumors. Its use was based on the belief that it was the best way to hold the line on security prices without unnecessarily large expenditure of Federal Reserve credit. Support operations, to which this practice was primarily related, have long since been abandoned. If applied to operations undertaken to correct disorderly market conditions, the recommendation for "aggressive" as opposed to "reluctant" buying may require further consideration.

In certain types of situations "reluctant buying" rather than "aggressive buying" can be a technique which tends to support rather than defeat a restrictive or neutral credit policy. There would appear to be no immediate use for this device as an operating procedure in the context of current credit policy and prevailing market conditions and, therefore, it would seem unwise to advocate either "reluctant" or "aggressive" buying at this time. The use of either technique in the future, as in the past, should depend on the circumstances and on other System policies.

Abandonment of transactions for the System account on an agency basis.—The subcommittee recommendation that "agency transactions be abandoned and that the account conduct its transactions with dealers as principals on a net basis" seems appropriate so long as open market operations are limited almost exclusively to the execution of credit policy. When the System is undertaking to provide the banks with additional reserves through open market operations, there is no apparent reason why it should matter whether the securities come from the portfolios of dealers or from investors so long as the price is satisfactory.

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It is essentially a practice that has primary reference to price support activities and not the realization of credit objectives.

In the pre-accord years, the Federal Open Market Committee showed a pronounced preference for effecting transactions with dealers in United States Government securities acting as agents rather than as principals. The Committee's concern with the capacity in which a dealer acted in connection with a System transaction was an outgrowth of the increase in the public debt, an expansion in over-the-counter activity in Government securities and the need for more active participation by the System in the market in connection with wartime rate stabilization operations. It reflected, in part, an effort to limit dealer revenues arising from System operations and, to that extent, to encourage the conduct of business "away from the System" insofar as commissions might be an influence, The practice was continued in the postwar years along with market stabilization policies. At a meeting on June 10, 1946, the executive committee of the Federal Open Market Committee decided that transactions in which a dealer was acting as principal should be limited to exceptional cases. Two years later further consideration was given to the question of agency and principal transactions, and at the meeting of the Executive Committee on May 20, 1948, it was decided to permit transactions in Treasury bonds between the Federal Reserve Bank of New York and qualified dealers, with the dealers acting as principals rather than as agents in cases where it appears desirable, in the interest of maintaining an orderly market, to avoid identification by the market of System operations. The latter action reflected only a nominal relaxation in the Committee's preference for effecting transactions with dealers on an agency basis.

Agency transactions by the dealers worked well in a supported market when the System was dealing with a "residue" which was in reality a large part of one side of the market. But it has little relevance to the present market and the effort of the System to regain initiative over the availability and supply of reserves on the basis of its own criteria. Actually no transactions have been made on an agency basis for over a year except those connected with the support of certain Treasury refundings where it was desirable to limit the dealer incentive to buy "rights" for resale to the System account.

In line with the subcommittee's recommendation, it would appear desirable in terms of both policy execution and market mechanics that the current direction from the Federal Open Market Committee regarding transactions for the account on an agency basis be revoked and that in lieu of it the manager of the account be granted full discretion as to whether System open market account transactions are to be conducted with dealers acting as principal or as agent.

Purchase of "rights" from dealer positions.—The subcommittee report recommends that if "rights" are acquired during Treasury refunding operations they be purchased from dealers without regard to whether or not they come from dealer positions. In considering this proposal it should be said that the manager of the account has never followed a specific policy of deliberately abstaining from purchasing "rights" from dealer positions. In fact, transactions in support of Treasury refunding operations have more often than not included purchases of "rights" from dealer positions, depending upon the particular circumstances governing the refunding operation. The manager has felt justified, on occasions, in refusing to relieve dealers of all "rights" offered to the account for sale in this situations where—

1. the dealers needed to be reminded of their stake in the market and of their responsibility as dealers to carry in position reasonable amounts of such "rights," and
2. it was necessary to avoid exploitation of System operations in support of Treasury refundings by dealers who had acquired "rights" on a speculative basis in advance of such refunding operations and later attempted to unload on the Federal those "rights" when the anticipated demand for the new securities into which the "rights" were exchangeable failed to develop.

Such occasions arose mainly when the System was pegging rates, and the dealers were understandably unhappy over the responsibility placed upon them for sharing the task of maintaining the market.

Recent practice of the System in supporting Treasury financing operations (when there has been such support) by either paying only par or a nominal premium for "rights," or by limiting such support to Treasury bills and the use of repurchase agreements, should remove any hope that the System will, in the future, buy "rights" on a basis that would guarantee a quick profit. In these circumstances it is not likely that the dealers would acquire substantial amounts of

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"rights" for their own accounts until it is clear that the new securities would sell at appreciable premiums within a reasonable period. Consequently unless some unforeseen development should occur to change that expectation, they would be unlikely to press their "rights" on the system and if such a development occurred there would seem to be no reason why the System should not take "rights" from dealer positions as readily as from anyone else.

It seems clear that a fixed refusal to buy "rights" from dealer positions is in principle an undesirable procedure at this time.

Refusal to buy bills acquired by dealers on a cash basis.—The subcommittee recommends the discontinuance of a refusal to buy bills acquired by dealers on transactions for cash delivery. This practice was adopted at a time when the System was supporting a fixed structure of rates based on transactions for regular delivery and attempting to maintain reserve positions conducive to market stability. It was, therefore, trying to avoid market practices which would tend to cause sudden fluctuations in bank reserves (particularly of the money market banks) to which open market operations could be adjusted only with a short time lag. Since the System is no longer supporting a structure of rates and attempting such day-to-day stabilization of reserve positions and money market conditions and, in general, buys securities only to meet somewhat longer-run needs for reserves, the System account no longer refuses to buy bills on the grounds that they have been bought by dealers for cash delivery. Accordingly, the subcommittee's recommendation that this consideration now has no place in the conduct of the System open market account gives appropriate recognition to current practice.

Information from dealers

Another phase of dealer-Federal Open Market Committee relations which is the subject of criticism and of recommendations by the subcommittee concerns the personal contact with, and the information obtained from, dealers in Government securities. It is the view of the subcommittee that the existing relationships between the System account and the dealers are not as impersonal as is desirable now that the Committee is no longer trying to peg prices and yields on Government securities and, further, that the manager of the account obtains from dealers information that is unnecessary in amount and too complete as to detail for his needs in the day-to-day operation of the account. As a corrective, the report recommends—

1. that the morning conferences with the dealers be abandoned,
2. that no effort be made at the trading desk to identify customers of dealers.
3. that independent reports of individual dealer positions and trading volume be prepared by some officer of the System other than the manager and only the aggregate of volume and position for all reporting dealers be turned over to the manager, and
4. that the present practice of asking dealers to report transactions in detail during the trading day be discontinued.

These proposals reflect the view that in the overall framework of the subcommittee's recommendations there is, or will be, less need for market information as a guide to the successful conduct of open market operations. There is also implicit in these proposals the belief that there is no need for more than a restricted contact on the part of the management function with dealers and that it would be desirable to eliminate any possibility of undue interference with or improper influence over the dealers, on the one hand, and the opportunity, on the other hand, for loose inferences by them regarding the policies of the Federal Open Market Committee. These recommendations are discussed in the following paragraphs.

Morning conferences.—An important phase of the bank's contact with the market consists of daily conferences prior to the opening of the market at 10 a. m. between representatives of qualified dealers, appearing on a rotating schedule, and those officers directly responsible for the conduct of open market operations. At these conferences, the representatives review the more important developments in the market, summarize their transactions and pass on to the officers of the Reserve bank any comments they wish to make or any suggestions that they have gathered in their conversations and contacts with the investment public in general. These conferences serve to amplify the bare statistics of the written reports and offer a closer, somewhat more intimate sidelight on a firm's policy and on the market's general psychology. Recently attendance at these meetings has been curtailed and only one, or at most two, officers of

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the New York bank are in attendance. The fact that no notes are now made or kept of the interviews should help to allay possible feeling among the dealers (if it exists) that the information they furnish may be subject to improper use or incorporated in a formal record.

These meetings are of long standing—they were started many years before there was any thought of pegging the market for Government securities. Their original purpose was to keep the manager of the open market account and the principal officers of the System well informed on developments in the market, and to enable them effectively to respond as fiscal agent to requests from the Treasury for advice concerning its public debt operations. There is no reason to believe that these morning conferences gave rise to objections from the dealers prior to the postwar period of support operations, and until the report of the ad hoc subcommittee appeared we did not know that they were resented in the more recent period. Presumably the officers of the System should continue to keep well informed, for the reasons mentioned above, if for no other.

In the absence of such conferences it is believed that dealers would, as in the past, call upon the manager of the account in person just as they now make regular calls at the offices of their customers and others in the pursuit of information and business. Such occasional informal and unscheduled interviews, while they have their place, would not seem to be an adequate substitute for regularly scheduled morning conferences of the kind now held. The question whether to discard or retain this point of contact with the dealers turns on whether the dealers wish voluntarily to continue the meetings and whether such meetings contribute enough in the way of market information and policy guidance to justify their continuance by the manager of the open-market account. The answer to the latter question will, in turn, depend on whether the operating officers of the System charged with the responsibility for the conduct of open-market operations can keep easily and adequately informed through their other contacts with the dealers. It is the opinion of the operating personnel at the New York bank that these interviews serve a real purpose and meet a real need as a source of information for the execution of open-market policy and for reports of conditions in the money market and the Government securities market which are made on both a formal and informal basis to the Federal Open Market Committee, the Treasury, and the Board's staff. They enable the officers to maintain contacts on a much more efficient and less time-consuming basis than would be involved if the sole source of contact were visits from individual dealers at various times during the working day. For these reasons, the bank cannot agree with this recommendation. It wonders how general was the criticism of the morning meetings and what were the specific grounds of criticism.

Identification of dealers' customers

The report recommends that the information concerning dealers' operations obtained at the trading desk be restricted so as to prevent identification of individual customers. This recommendation evidently refers to past operations by the System account during periods of fixed-price support when at times the System tried to avoid unnecessary purchases of large blocks of securities from individual investors. Under the policy of fixed-price support and a practice of "reluctant buying," occasional attempts were made by investors and by others to liquidate blocks of securities by dividing large offerings of such securities into smaller amounts among various qualified dealers. In a number of cases this led to the identification of customers by the manager through indirection; the name of the seller was not requested, but the identity was made clear by qualified dealers who were attempting to cooperate.

The needs of the System in this connection are adequately met by obtaining general information regarding classes of investors rather than the names of individual investors. As the subcommittee indicates, System personnel should not and do not currently ask for the latter type of information.

Independent tabulation of reports of dealer positions

The subcommittee recommends that reports on dealer positions be collected by an officer of the System, other than the manager of the account, and that only the totals of such positions be furnished to the manager. This is, like the question of dealer conferences, a matter of judgment as to the amount and character of information necessary for the effective conduct of open-market operations, whatever their specific purposes. The manager has received and compiled this information since the decade of the thirties from the dealers who were qualified or recognized, as well as from others who voluntarily submitted detailed data regarding their trading volume and position. The manager has found this infor-

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mation of basic value in the effective management of the account in the various circumstances and conditions prevailing in the past. It is important in judging the degree of self-interest in dealer opinions regarding the position of the market at any given time and in judging the need for repurchase agreements. And it is also helpful as a guide to future developments and a useful key to market psychology and the role of individual dealers in its formation. This is not to say that the information is needed and used daily, but only that there are times when it can be critically important.

Information on individual dealer positions is an integral part of the whole body of data intended to give an insight into the technical position of the money and Government securities markets. The aggregate of the dealer positions is not enough in itself, for such an aggregate is the sum total of net positions of each individual dealer. That necessarily means that the short position of one dealer and the long position of another in a given issue, or issue category, is netted, so that the account manager could only get from the totals either an incomplete, or a wholly misleading view of the position of market professionals. In the event of the need for System intervention in the market to correct disorderly conditions, it would be helpful for the manager to have information concerning individual dealer holdings in particular issue categories, the purchase of which, in whole or in part by the System, might help to relieve the situation quickly. Such information is also needed by the manager whenever extension of repurchase agreements is under consideration.

To withhold this kind of information from the manager would imply that he could not be trusted to use it impartially in the best interests of the market and in effective expression of System policy. If the information is to have any value to the manager and to the Federal Open Market Committee, it is inevitable that at times it may be disadvantageous to the individual dealer to have his position known in detail, just as at other times it may be advantageous to him. But that does not mean that in a broader sense the market as a whole does not gain. The case against current practice with respect to the collection and use of data on dealer positions is essentially the risk that it will be misused. The case in favor of continuing the present practice is the demonstrated value of this information in providing one more element in a balanced and informed view of the underlying position of the market which is vitally necessary in connection with the administration of repurchase agreements and any operations intended to correct disorderly conditions.

Detailed reports of transactions.—The report recommends that we discontinue asking dealers to report their transactions in sufficient detail to permit the computation of current individual dealer transaction sheets. The origin and the nature of this recommendation is obscure. The Federal Reserve Bank of New York does not compute current transaction sheets for each dealer. It does maintain an informal record of the larger transactions reported so as to maintain a current picture of the supply and demand in the market but this record is not kept in such form as to show the activities of one dealer as compared with another. Any less information than we are now receiving would be clearly inadequate to form the basis for reports on market conditions. Sometimes the information about a sizable order received at the trading desk is compared as a matter of interest with the volume figures reported by a particular dealer but this is not done on a regular basis.

It would appear that the subcommittee's recommendation is based on a misunderstanding.

Information required by the Manager.—The Federal Reserve Bank of New York believes that effective administration and execution of open market operations (even if more narrowly circumscribed than at present) require close and continual contact with the money and Government securities markets as necessary sources of technical information for the constant rendering of judgments regarding the timing, the form, and the amount of System intervention. Adequate information could not be obtained from statistical evidence alone. The most important aspects of the System's contact with the market and its primary source of market information are (1) the daily conferences with the representatives of the dealers in rotation, (2) the confidential daily written reports submitted to the Federal Reserve Bank of New York and (3) continuous contact maintained over the private wires between the bank and the dealer houses. Their purposes have much the same general objective but each complements the other making its own special contribution to a rounded integrated picture of actual and prospective developments in the market.

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Such channels of information are a necessity if the System is to play an effective role in meeting its primary responsibilities for credit policy and its secondary responsibilities for preventing disorderly market conditions and for cooperation with the Treasury in its financing operations. The volume and character of information which the manager has sought and obtained through these channels has shown appropriate variation over the years with changes in policy. In general it would seem preferable to maintain those contacts and those sources of information which have proved useful to the Federal Open Market Committee through the operating personnel in the field and to leave some discretionary latitude to the manager for appropriate and flexible variations in the operating relationship with dealers.

Call money post

The subcommittee recommends that the feasibility of reestablishing a central call money post for dealers be explored. This proposal has some attraction for, if successful, it would fill a gap that has been created in the money market by the demise of the call money market of earlier years.

If it worked as anticipated, the result probably would be for dealers to hold considerably larger amounts of Government securities and for corporations and other temporary investors to put at least some of their funds on loan instead of investing them directly. Whether or not that would result in a broader and more stable market for Government securities, however, is questionable; it is quite possible that dealers' holdings would prove to be more volatile than holdings of those who now invest directly instead of making call loans.

The availability of such a facility would probably be useful at times, but can we safely generalize for the future and say that an active call money market would be helpful in all circumstances? Is there not the possibility that the volatility of such a market might sometimes become a disturbing influence?

In any event, it is not clear how the proposal can be implemented satisfactorily. It is very doubtful whether the New York City banks would be interested in promoting a mechanism which might take business away from them, and it is most unlikely that the New York Stock Exchange would be interested in reestablishing a money post which would largely serve nonmembers of the exchange. Government security dealers presumably would be interested, but would not care to have the money post in the hands of anyone who might be interested in their positions as reflected in their borrowings. The Federal Reserve Bank of New York might be accepted as a neutral spot, but it is not clear why we should undertake a function of this sort serving one particular type of private interest.

Federal Reserve reports

The subcommittee recommends that, with a view to improving the data it makes available to inform the public of its operations, the following information be shown in the weekly statement of condition of the Federal Reserve banks:

(*a*) Securities held on repurchase agreements,
(*b*) Special certificates of indebtedness held by the System,
(*c*) Weekly averages of member bank borrowing.

It is presently possible for those who are skillful in interpreting Federal Reserve statements to get a fairly accurate idea of the amounts and types of securities involved in repurchase agreements. Nonetheless, there may be some question whether the System should facilitate a more complete and accurate determination of the amount of repurchase agreements on grounds that such a disclosure might be detrimental to the dealers at times of money-market stringency insofar as those agreements provide an accurate measure of dealer positions in short-term Government securities. The decision here thus seems to turn on whether the System should take any official action which would broaden public knowledge of the dealers' positions at times when credit is tight and repurchase agreements are outstanding in volume.

Information regarding Treasury use of special certificates of indebtedness is now carried in the Federal Reserve Bulletin with a considerable time lag and on a more current basis in the debt section of the daily Treasury statement.

How much interest there would be in the record of weekly averages of member bank borrowing is questionable. Apparently little attention has been paid to the figure now given on weekly average excess reserves.

All things considered there would appear to be no objection to the inclusion of all these items in the statement on a separate basis if it is concluded after full consideration that the matter of dealer positions raises no problem. If the decision is in favor of separating repurchase agreements from other security

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holdings, an alternative form of publication which might be considered would be to show them as "other loans." (They should not be included in "Discounts and advances.")

III. "HOUSEKEEPING" IN THE FEDERAL OPEN MARKET COMMITTEE

Under present arrangements the responsibility for executing transactions of the Federal open-market account is delegated to the Federal Reserve Bank of New York, and one of its officers has customarily been appointed manager of the account subject to the approval of the full committee. The manager conducts operations under the general directives of the full committee and the specific articulation of those directives provided by the executive committee. The day-to-day performance of the manager is under the continuing surveillance of the president of the New York bank, both in his capacity as vice chairman of the Open Market Committee (and of the executive committee) and as senior executive officer of the bank which must answer to the committee for the satisfactory performance of the manager's functions.

The subcommittee considers these arrangements anomalous and proposes study of methods for separating the management of the account from the Federal Reserve Bank of New York. The subcommittee's report covering these matters raises three importat questions. Question 1 is whether the present arrangements are in fact anomalous, or more broadly, whether they fail to conform with the letter and spirit of existing law. Even if there are in fact no anomalies, question 2 is whether the New York bank and its president should, for other reasons, be relieved of direct responsibility for the conduct of the account. And question 3 is whether performance could be improved by making the account an independent entity within the System, separate from the Board of Governors and from all of the Reserve banks, with the manager of the account responsible only to the Committee as a whole.

The anomalies

An anomaly is something abnormal, peculiar, or in the historical sense, "out of date" or incongruous. But the subcommittee seems to mean even more than this—something which has grown into a form that no longer fits the intention of the law. Specifically, the subcommittee suggests as inconsistent with the statutory position of the Federal Open Market Committee:

(*a*) The absence of a separate budget covering its operations;

(*b*) The absence of a separate staff responsible only to the Committee; and

(*c*) The delegation of the management function to an individual Federal Reserve bank.

It makes no firm recommendations as to changes, but suggests "that the Committee reexamine and review its present organization, and in particular that it consider the advantages and disadvantages that would ensue, were the manager of the open-market account made directly responsible to the Federal Open Market Committee as a whole, and not, as at present, responsible through the Federal Reserve Bank of New York."

This line of thinking seems to be predicated on the premise that the Federal Open Market Committee should be not only a policymaking body, but also an operating organization. There is no apparent basis for this premise in the provisions of the Federal Reserve Act governing the Federal Open Market Committee. Section 12A provides for the creation of the Federal Open Market Committee and specifies its membership, prohibits the Federal Reserve banks from engaging or declining to engage in open-market operations except in accordance with the direction of and regulations adopted by the Committee, and sets forth the governing principles of open-market operations. There is no suggestion, however, either in this section or in section 14 that the Federal Open Market Committee is itself expected to conduct open-market operations. The implication would seem to be that the Reserve banks are to perform these operations, but subject to the policies and regulations of the Committee.

Nor is there any suggestion that the Committee should be provided with funds with which to engage in operations or to set up a separate organization with a separate budget. On the contrary, the clear inference is that the Federal Open Market Committee was expected to be solely a policymaking body consisting of members with other primary duties in the fields of System policies and operations, and that the Reserve banks were expected to buy and sell Government securities in accordance with the direction and regulations of the Committee.

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There is also at least an implication that the policymaking body was expected to fulfill its functions best if it were closely interrelated, through its membership, with all other policy and operating responsibilities of the System—rather than standing apart as an independent unit within the System.

The open-market account was created under the regulations of the Committee as a means of coordinating and centralizing the operations of the Reserve banks. Experience showed that as a practical matter these operations had to be closely coordinated as to timing and impact. Consequently, although all Reserve banks had the power to act, it was found administratively essential to pool all of their activities into 1 account, and to designate 1 Reserve bank to conduct all operations. The Federal Reserve Bank of New York was delegated the responsibility for executing transactions because it is the bank located in the central market for Government securities, and one of its officers has been appointed manager of the account subject to the approval of the Federal Open Market Committee. The intent and spirit of the law would seem to be that only the Reserve banks, or one acting for all, should conduct operations in Government securities. To take this function away from all Reserve banks and place it in a separate entity would seem to depart from the intent of the statute and also from the "Federal" structure of the Federal Reserve System. That is, instead of allocating System functions among the 12 Reserve banks as the operating arms of the System, the new procedure would be to create a unit of a different type, outside all of the banks—a "thirteenth" operating institution to handle some of the System's most important kinds of transactions.

Just why presently existing arrangements should now be regarded as in any way anomalous is far from clear both in view of their legal basis and because they have emerged in response to needs over a period of years, and are not in any sense an historical accident. Moreover, the usual practice in all the committee activities of the System is to draw on available personnel at the Reserve banks and the Board, rather than to set up separate staffs with separate budgets. That is the way to assure strong staffs at the Board and in the Reserve banks, and to assure the most efficient use of all of the talent available throughout the System. The Federal Open Market Committee does differ from other System committees in having been specifically set up by statute. But, as has been pointed out above, that very statute confirms the usual System practice by placing on the Federal Open Market Committee only members having other major responsibilities, rather than members having no other functions or responsibilities.

The report states that the Federal Open Market Committee "is especially charged, also, to use its powers to provide an elastic currency for the accommodation of agriculture, commerce, and business, i. e., to promote financial equilibrium and economic stability at high levels of activity." That stretches considerably the statutory provisions now governing the Committee. The statement better describes the responsibilities of the System as a whole, and even for the System as a whole it is based in part on inference rather than any specific provisions of the Federal Reserve Act. In any event, whatever the merits of giving new status to the Open Market Committee as the single embodiment of all System authority—and there may be such merits, to be sure—the Committee does not have that comprehensive authority now. The proposals for a separate budget and separate staff thus rest on a false premise. The effect of creating a separate staff and separate budget might actually be to weaken the participation of the Reserve banks in the work of the Committee. This risk could only be justified, as the subcommittee seems implicitly to recognize, if a major change in the structure of the System were to be made—placing upon the Committee responsibility for all of the policy actions of the System.

Consideration of changes in the organizational arrangements for carrying out the policy decisions of the Committee, therefore, must depend primarily on the question of whether present arrangements have serious shortcomings and, if so, what arrangements might be made that would give assurance of substantially better results. The report points out that "It would be extremely difficult to build up a new and independent staff as qualified as the personnel which it now enlists to work on its problems." It goes on to state, "It would be equally unfortunate to lose the contributions of that staff to System problems that fall outside the limited area of responsibility of the Federal Open Market Committee. Yet there are equal dangers in a situation where the time of no one person on the whole staff of the Committee is wholly devoted to its responsibilities, where everyone wears two hats, and where each must fulfill duties separate and distinct from those imposed by the Federal Open Market Committee." Just what the dangers are, to which the last-quoted sentence refers, have not been specified

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in the report. The fact of the matter is that the manager of the open-market account and his principal assistants devote their attention and efforts almost exclusively to the interests of the System's open-market operations, and engage only to a minor extent in other activities. In any case, there is no conflict between their primary activities in behalf of the open-market account and any secondary responsibilities; the latter serve generally to broaden their knowledge and capabilities for performing their primary duties for the account.

Removing the responsibility of the New York bank and its president

Even though present arrangements are the consequence of statute and experience, and do not involve any apparent anomalies, it is nonetheless proper to inquire whether some changes in arrangements could materially improve the functioning of the Open Market Committee within its present range of responsibilities. The subcommittee does not ask whether some other Reserve bank might better manage the account. Presumably that is not suggested because the present organization of the Government security market makes it inevitable that the major point of System contact with the market must be in New York.

With respect to the delegation of the management of the open-market account to the Federal Reserve Bank of New York, the report points out that the present arrangement has the advantages of being able to use the personnel of the bank for all the operational aspects of open-market operations and of having the directives of the Federal Open Market Committee and its executive committee carried out under the supervision of the president of the bank (who is also Vice Chairman of the Committee), thus assuring "that policy is made effective in operations."

The report goes on to suggest, however, that this arrangement "has the disadvantage that the president of the Federal Reserve Bank of New York sits at meetings of the Federal Open Market Committee and of the executive committee necessarily in a somewhat different role from that of his colleagues. He comes not only as a contributor to the discussion on policy formation but also necessarily as a protagonist for the actual day-to-day operations of the account. These operations are his responsibility. He cannot criticize them without criticizing his own staff. The Committee, therefore, in some part loses contact with the critical insight of its best-informed member. It has the disadvantage also that other members of the Federal Open Market Committee, reluctant to seem critical of a colleague, may hesitate to scrutinize adequately the technical operations of the account. This is a serious deficiency because the other bank president members of the Committee are usually scattered and out of intimate touch with one another as well as with the market. They must depend on give-and-take discussion at Committee meetings and at the meetings of the executive committee to sharpen their appreciation of the Committee's operating problems."

These statements are not intended, we know, to be critical of the individual who is now the president of the Federal Reserve Bank of New York, although they do seem to assume that through negligence or lack of capacity he, as president of the institution delegated the responsibility for executing operations, is likely to be unable to live up to those responsibilities. They imply that he must always defend what has been done, cannot admit mistakes, or learn from them, and must be a "protagonist" rather than a full participating member of the superior body—the Open Market Committee. If that is true of the president of the Federal Reserve Bank of New York, situated as he is, who can be expected to do a better job? Is it to be assumed that the Committee as a whole, or its executive committee as a group, or some other individual can better supervise day-to-day and hour-to-hour operations? Or is it assumed that the manager of the account, if he were separated from the Federal Reserve Bank of New York and from the supervision of its president (and the Vice Chairman of the Federal Open Market Committee), could operate the account more competently? It would be helpful in giving further consideration to this part of the subcommittee's report, to have the answers to these questions.

Historically, it has been a source of strength for the Federal Reserve System that it possessed unique facilities for accomplishing an integration of the national and regional aspects of its overall policy. Through the Reserve banks, men of high competence are available in all parts of the country to carry out, or to report upon, the credit developments resulting from a unified System policy. To create a parallel organization outside the Reserve banks, for the particular problems that come into focus through the Government security market in New York, would risk impairing the strength and usefulness of the present regional organization. A conscientious president of the New York bank would continue to maintain close contact with the market, and with the account, regard-

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less of any change in the New York bank's responsibilities for the conduct of the account, but he would not be in as good a position to apply his knowledge and ability to the formulation of System policy and to the operations of the Federal Open Market Committee if a separate organization were set up to execute transactions.

The position of the New York bank is the inescapable outcome of geography. A Reserve bank located in New York, if it is fully to discharge its responsibilities for special competence in the credit problems of particular importance in its area, must maintain close contact with the Government security market. To lose that contact would be as harmful to the System as for the Board of Governors deliberately to cut itself off from all political developments in Washington, for example, or for any Reserve bank to ignore the characteristics of borrowing member banks. Thus the New York bank should, by the sheer fact of location, always be the best informed unit of the System on developments in the Government security market. To lose any of that insight would be harmful to the System. To try to separate the president of the Federal Reserve Bank of New York from the operations of the Federal open-market account would only make it more difficult and more burdensome for him to do all that he could and should to contribute to the effectiveness of system policies and operations. There does not seem to us to be a practicable way, consistent with his duties either as a Reserve bank president and his location in New York, or as Vice Chairman of the System Open Market Committee and its executive committee, to lessen the real and special responsibility of the New York president for system operations affecting the Government security market.

A separate management for the account

Even though the New York president should be encouraged to maintain a close watch on the System account, it is worth considering whether the account itself could function better under a separate management, instead of using officers and staff of the New York bank. How? Is it unwise to have the manager of the account under more or less continuous surveillance by the resident member of the Open Market Committee? Does the manager need independence from the experience and associations provided by his position as a senior officer of the New York bank? Does the New York president present an unwelcome buffer between the manager and other members of the Committee (or of its staff)? Has the New York president made less than a desirable contribution to open-market policy because of his assumed protective or defensive attitude, suggesting that his critical faculties have been impaired by a desire to rationalize mistakes in the execution of policy directives? These are the unspoken questions raised by the subcommittee report.

In the absence of these specifics, what about some of the problems of detail that would arise? If the manager of the account were to be separated from the organization of the Federal Reserve Bank of New York, presumably he would have to be supplied with assistants and staff to carry out all aspects of open market operations. If he alone were employed directly by the Federal Open Market Committee, it would become necessary to appoint a replacement for him every time he was absent for any reason, and presumably the alternate would have to be drawn from the staff of the Federal Reserve Bank of New York, which would involve the same questions that are seen in the present arrangements. The only real alternative would be to establish an entirely separate staff and that would undoubtedly involve additional expense, since the personnel engaged by the Committee presumably could not be used for any other work of the Federal Reserve Bank of New York, such as executing security transactions for foreign accounts or for the United States Treasury. To some extent, therefore, duplication of staffs would be unavoidable. From this narrow point of view, then, the question is whether there is sufficiently strong evidence of unsatisfactory results from the present arrangements (and sufficiently strong reasons for believing that a separate staff would produce much better results) to justify the duplication and additional expense. The expense aspect, however, while probably considerable, would be a relatively minor consideration if it would assure substantially better results. But the subcommittee report has not provided the basis for such assurance.

In any case, this would appear to be a good time to settle the question of how the policies of the Federal Open Market Committee and the directives of its executive committee are to be carried out. The manager of the account cannot be expected to take instructions as to specific transactions from several different individuals, although he may reasonably be expected to listen to suggestions from

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those who have a proper concern and to supply information on market conditions and on the details of his operations to the members of the Committee on request. Should he operate only under the direct supervision of the president of the Federal Reserve Bank of New York, acting as the chief executive officer of the institution delegated the responsibility of carrying out for all Reserve banks the directives of the committee, so that the president can be held responsible for the way he operates? Should he be autonomous and operate according to his best judgment, without interference or supervision from anyone, and be answerable only to the Committee or the executive committee as a whole for the manner in which he carries out its directives? Should he operate directly and solely under the supervision of the chairman of the executive committee? If so, would not the Chairman be placed in the same position as the Vice Chairman under the present arrangement, but without the same advantage of proximity to the manager of the account, the operating staff, and the market? (Presumably under either the second or third of these possible arrangements the manager of the account would operate independently of the Federal Reserve Bank of New York, which would then assume no responsibility for his acts.) These are the kinds of questions that should be faced, considered carefully, and decided upon.

In so deciding consideration should also be given to the possibility that the suggested change might create an undesirable island of autonomous or independent authority within the System. The high degree of complexity in Government security market operations, and the need for some dependence upon judgments that can only be formed on the basis of actual operating experience, make it unlikely that a successful transference of authority for hour-to-hour surveillance of the manager's performance can be made to someone located outside New York. The transfer could be attempted, of course, but would the recipient be able to maintain the kind of intimate, continuous knowledge of the market that is needed for best exercise of such surveillance in the System's interest? The result might well be a less effective ("remote control") conduct of System account operations. And in that case the System might find that, instead of the present medium of reliance on the New York bank, it had created a "free planet" in the form of an independent manager of the account. Such a manager, while not a member of the Federal Open Market Committee, and not in a position to share the full breadth of responsibility for overall System policy, might be able (if he chose) to "make a lot of policy on his own."

SUMMARY AND CONCLUSIONS

The study conducted by the ad hoc subcommittee provides a useful review of past workings of the market for Government securities, and of the System's open market organization and its relations with the market. On the basis of its study the subcommittee has made a number of recommendations dealing with matters of general policy, relations with the market, and details of operating practices and organization in conducting open market operations.

With some of the recommendations we think there will be general agreement. The most important of these is that the Federal Open Market Committee give further assurance "that henceforth it will intervene in the market, not to impose on the market any particular pattern of prices and yields, but solely to effectuate the objectives of monetary and credit policy * * *" (provided that assurance is interpreted broadly enough to cover the item mentioned next). Another is the recommendation that the emphasis in one phase of System open market operations be changed from maintaining orderly market conditions to correcting disorderly conditions. Still another is that the Committee henceforth "refrain, as an official body, from initiating regularly proposals with respect to details of specific Treasury offerings." We can also agree that in most circumstances transactions in short-term securities will probably be found the most appropriate form of System open market operations (although a commitment to make such transactions the sole form is decidedly questionable). The Federal Open Market Committee has, in fact, been moving progressively in the directions suggested by these recommendations.

One of the most important questions raised by the report of the subcommittee is how far the Federal Open Market Committee should go in promoting the "depth, breadth, and resiliency" of the market by making commitments as to what it will or will not do in its future operations. Part I of the preceding discussion suggests that efforts to promote these market characteristics may not always be helpful in achieving the System's major policy objectives, but may at times conflict with those objectives. Especially questionable is the proposed assurance

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that the Federal Open Market Committee henceforth will confine its intervention in the market "to transactions in very short-term securities, preferably bills." Restriction of operations to short-term securities, while appropriate as the normal practice, might in some circumstances interfere seriously with the effectiveness of the System's operations. There is, as yet, no valid basis for the assumption that the market has attained, or will soon attain, such a degree of fluidity as to assure dependable effects in the long-term sector of injections of Federal Reserve credit in the short-term sector. Furthermore, undue emphasis on operations in very short-term securities might at times cause the very distortions in the market which the subcommittee seeks to avoid.

The Federal Open Market Committee has already gone a long way toward carrying out the recommendation of the subcommittee that direct support by the System of Treasury refunding operations be discontinued. The only remaining action that might be taken would be a formal commitment that the System open market account would not in the future purchase "rights," when-issued securities, or outstanding issues of maturities comparable to those of the new securities. It is here suggested that any such commitment is unnecessary and undesirable; that in this case, as in others, the Federal Open Market Committee might better keep a free hand to take such action as it considers best designed to promote the System's major policy objectives in the light of all the circumstances at any given time. It is further suggested the Committee consider the feasibility and desirability of "swap" operations—either in connection with Treasury refinancing operations or at other times—when it appears that such transactions would be useful in achieving a better maturity distribution in the open market account and in avoiding a "frozen" condition in the account.

Another questionable point is the recommendation that repurchase facilities be made regularly available to nonbank dealers over weekends (and the related proposal that dealers be notified in advance when repurchase facilities will be made available to them). These proposals appear to be in conflict with the basic recommendation that intervention by the System in the market be "solely to effectuate the objectives of monetary and credit policy," as they would constitute an indirect form of intervention designed to facilitate the functioning of the Government security market, rather than to effectuate the objectives of monetary and credit policy. They would also conflict with the tendency of the past 2 years to reduce any form of automatic access to Federal Reserve credit to a minimum. The desirability of making repurchase facilities available to dealers in certain circumstances on the initiative of the System, however, is recognized.

The question of promulgating "ground rules" which would henceforth govern transactions with dealers is closely tied in with the whole question of how far the Federal Open Market Committee should go in giving public assurances as to what it will or will not do in its future operations. The dealers would, of course, like to know in advance what the System can be expected to do in its dealings with the market. It is quite possible, by following a consistent pattern of operations, to convey to the market a reasonably good understanding of the general character of the System's policies and operations that may be expected under various types of circumstances, without making specific commitments which, at times, might prove to be a serious handicap to effective operations. In other words, action rather than words is considered the better way to convey to the market an adequate understanding of the general operating policies of the System. It avoids the constriction of the scope of action available to the System that is involved in the enunciation of any definite set of "rules."

In fact, the general conclusion suggested by part I of this discussion of the subcommittee's report is that it is likely to be most conducive to effective implementation of the System's monetary and credit policies if the Federal Open Market Committee avoids commitments which would tend to tie its hands in dealing with whatever situations may arise in the future. There is always danger in attempting to formalize for all time the principles and procedures that have grown out of current experience. There is particular danger for a central bank, which depends for its effectiveness upon psychological as well as direct influences, in making formal and comprehensive public declarations on such matters.

Relations with dealers

There is much that is sound and constructive in the discussion in the report of the subcommittee of the specific relationships of the Federal Open Market Committee with the dealer market. Many of the recommendations put forward

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have already been applied in our market relationships as an aid to the expression of current open market and credit policy. These changes have been made over the period since March 1951 and have been appropriate to the circumstances of this period. It would be a mistake, however, to go so far as the subcommittee in presuming that the new procedures should have universal application under any and all sets of circumstances. Some of them might better be subject to continuous consideration in the light of credit policies adjusted to a constantly changing economic and credit situation; it is conceivable that revival of some of the now abandoned proceures might be found advisable at some future time, depending on the current aim of the account's operations.

In other aspects of the System's market relationships, especially those dealing specifically with the information obtained from, and contacts maintained with, Government securities dealers, some dissent is taken from the recommendations of the subcommittee. The Federal Reserve Bank of New York believes that this information does, and should, vary in both amount and content with the changing requirements of policy and market conditions, and it believes that appropriate adjustments in these respects have been made in response to recent developments. These channels of communications and sources of information should be kept open and operative and used with discretion. Disagreement here between the bank and the ad hoc subcommittee as to the amount and content of information is primarily a matter of degree rather than of kind, and involves questions of judgment as to what is needed by the operating personnel in the conduct of open market operations under the direction of the Federal Open Market Committee. The bank considers the information it now receives to be necessary for the effective execution of Open Market Committee policy, and at the present time this is particularly so in connection with the judicious use of of repurchase agreements. We do not consider that current practices with respect to information and dealer contacts are an unjust personal intrusion into dealers' affairs that threatens to exercise a harmful influence on the efficiency of the Government securities market; or that they are not warranted by the System's responsibility to and position in the market and the personal character of the market. The matter of market information would seem to be an area where the System might well have and use its own criteria rather than those of the dealers. The components of the dealer market are apt to see the problem of the manager of the account and the Federal Open Market Committee more in terms of the relationship of the individual firm to the System, than of the dealer market as a whole to the System, and of the System to the Nation.

The most difficult problem of Federal Reserve-dealer relationships that is a subject of subcommittee recommendation concerns existing qualification procedures for dealers in Government securities. The System has not in the past found it feasible or desirable to deal at random with any and all of the dealers specializing in Government securities, but has limited its transactions to certain firms which, by meeting specific standards, become qualified. These procedures are of long standing and reflect principles which have been considered necessary in governing the relationships between the Federal Reserve Bank of New York, as agent of the Federal Open Market Committee and of the other Federal Reserve banks, and the market for Government securities. They were not designed specifically as part of the rate-stabilizing operations which the System undertook during the Second World War and continued into postwar years.

Certainly the System should avoid any action which would justify a charge of conferring "privilege" on any group of Government securities dealers, and it would seem that qualification of dealer firms for transactions with the System open market account on the basis of demonstrated performance, trade position, integrity, and financial resources, if fairly and honestly administered, would preclude any valid accusation of that sort. At the same time, however, it is clear that mere abandonment of the present system would constitute no solution of the problem; criticism of the distribution of the System's transactions among dealers might be accentuated, rather than reduced, if there were no "recognized" dealers and no definite criteria for the selection of dealers. The central problem is that of determining the most effective basis on which the System can make contact with the dealer market in the expression of credit policy; what principles should govern and how they are to be implemented. The subcommittee is silent with respect to these aspects of the problem, limiting its comments largely to the expression of dissatisfaction with existing qualification standards and procedures.

"Housekeeping"

The subcommittee makes no firm recommendations as to changes in the organization arrangements for carrying out open market operations, but suggests that

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the Federal Open Market Committee reexamine and review the present arrangements and specifically that it consider making the manager of the account directly responsible to the Committee as a whole, rather than indirectly through the Federal Reserve Bank of New York. The report characterizes the present arrangements as anomalous for reasons which include: (a) The absence of a separate budget covering its operations; (b) the absence of a separate staff responsible only to the Committee; (c) the delegation of the management function to an individual Federal Reserve bank.

This approach to the problem of the System's organizational arrangements for the determination and execution of open market policies raises the fundamental question of whether the Federal Open Market Committee was intended to be, or should be, an operating body as well as a policymaking body, and the further question of whether the open market organization should be something apart from either the Board of Governors or the Federal Reserve banks. Careful examination of the provisions of the Federal Reserve Act governing open market operations reveals no basis for the assumption that the present arrangements are anomalous. On the contrary, section 12A and 14 clearly suggest that the Federal Open Market Committee was intended to be solely a policymaking body and that actual operations were intended to be conducted by the Reserve banks in accordance with the direction and regulations of the Committee. There is at least an implication that the policymaking body was expected to fulfill its functions best if it were closely interrelated, through its membership, with all other policy and operating responsibilities—rather than standing apart as an independent unit within the System.

As a practical matter, most of the actual transactions in Government securities have necessarily, from the earliest development of open market operations as an instrument of monetary and credit policy, been conducted for the Reserve banks by the Federal Reserve Bank of New York, since it is located in the central market for Government securities. This inescapable fact of market location is the historical reason for the designation of the Federal Reserve Bank of New York as the institution assigned the responsibility for executing transactions and for the appointment of an officer of that bank as manager of the open market account.

It is, of course, entirely appropriate for the Federal Open Market Committee (or for the System as a whole) to review its organizational arrangements from time to time and to make such changes as appear to offer definite prospects of improved performance. In considering changes, however, it is important to make sure that any assumed deficiencies in existing arrangements do, in fact, exist, and that there are sound reasons for expecting that alternative arrangements will offer real advantages. The statements and inferences in the report of the subcommittee concerning present arrangements for open market operations do not seem to us to give such assurance.

The subcommittee recognizes the advantages to the System in being able to use the staff of the Federal Reserve Bank of New York not only in executing purchases and sales of securities, but also in conducting all the other operating details incident to management of the open market account. But the report sees dangers (unspecified) in the fact that members of the staff have other duties. And most important of all, it implies that the president of the Federal Reserve Bank of New York comes to the meetings of the Federal Open Market Committee and of the executive committee not with an objective approach to the problems of the Committee, but as a biased protagonist of the operating staff. The obviously unconscious inference of such statements is that the president of the Federal Reserve Bank of New York is likely to be compromised by being at the same time Vice Chairman of the Committee and head of the institution to which is delegated the responsibility for carrying out the directives of the Committee. If the president of the New York Reserve Bank, with his intimate knowledge of the objectives and intentions of the Committee, his close relationship to the operating staff and his proximity to the market, and his consequent ability to keep fully informed on current developments, is unable to provide a connecting link between policy formulation by the Committee and the operations for the account, who is in a position to do so? Is not such a connecting link necessary or at least desirable?

The answer to these questions which seems to be suggested by the Ad Hoc Subcommittee for consideration by the full Committee is that the manager of the account operate under the direction of the Federal Open Market Committee at a whole or its executive committee. Careful consideration of just how these committees might direct the daily or hour-to-hour operations of the manager of the account will demonstrate, we believe, the impracticability of such an arrangement. As part III of the preceding discussion points out, the result

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might be to make the manager of the account a "free planet" without effective supervision either by the Committee or by anyone else, and consequently to place him in a position to "make a good deal of policy on this own." And while the duplication of expense that would be involved in setting up an entirely separate operating staff, paralleling the staff which the Federal Reserve Bank of New York would have to maintain to execute transactions for foreign accounts, for Treasury accounts, and for others, is not the most important consideration, it would be difficult to justify such duplication in view of the statutory basis for the Federal Open Market Committee and for open-market operations, unless serious deficiencies in the existing arrangements can be demonstrated and alternative arrangement offer definite prospects of superior performance.

We do not think the report of the Ad Hoc Subcommittee has demonstrated deficiencies in the present organization or offered suggestions for a better organization which would provide the basis for a change. It is true that it makes no definite recommendation on this point, except to recommend study and consideration. Our study and consideration does not support the view which, apparently, is held by the subcommittee that a change should be made.

APPENDIX. NOTE ON RELATIONS WITH TREASURY AD HOC SUBCOMMITTEE REPORT

(For meeting of the executive committee of the Federal Open Market Committee, January 27, 1953.)

Like some of the other recommendations in the report, the recommendation with respect to relations with the Treasury is really a recognition of a changed situation; a situation in which we have shed as much as possible of the role of price-fixing in the Government security market. So long as we were maintaining a pattern of rates, and so long as we were the established underwriters of all Treasury issues, there was a basis for our having some initiative with respect to the terms of the securities issued. The locus of primary responsibility had already been blurred. This was particularly so in view of the attitude of the Treasury toward monetary policy during this period.

Now that we are no longer pegging prices and are trying to shrink our underwriting function, the new approach to relations with the Treasury seems to me, in general, to be the appropriate one.

We do not want to become too doctrinaire about this matter of areas of responsibility, however. With a Federal debt which is so large a part of all debts, public and private, which permeates and dominates to some extent the whole securities market, and which has become a principal medium for adjusting portfolios of financial institutions, and the reserves of banks and others, we are not and won't be wholly free to administer credit policy without regard to the Government security market, and without regard to Treasury financing requirements. It won't be enough to say to the Treasury, Here is the credit policy we are going to follow; now you manage the debt. These are areas of overlapping secondary responsibilities and opportunities.

While the Secretary of the Treasury can and should consult with whomever he wants, inside and outside the System, therefore, I don't think we should demote the Open Market Committee to the status of the ABA or the IBA or any other groups or individuals when it comes to debt management. Nor do I think we should commit ourselves to never taking the initiative. We are a statutory public body with public responsibilities in a field closely related to debt management, and there should be a maximum of coordination consistent with the primary responsibilities of the Treasury and the Committee.

It seems to me that it would be consistent with the spirit of the subcommittee recommendation, to have the Chairman and Vice Chairman of the Open Market Committee inform the Secretary of the Treasury—

1. Of the desire of the Committee to work with him closely as possible.
2. Of the intention of the Committee to keep him informed of the credit policies of the System, and particularly of open market policy.
3. Of the willingness of the Committee to have its representatives consult with him concerning credit-policy or debt-management problems whenever he requests such consultation.
4. Of the intention of the Committee to have its representatives bring to his attention, if and when it seems desirable, matters which may be of mutual interest.

I think this can be done quite naturally, orally, with the new people at the Treasury, without in any way perpetuating the situation which the subcommittee seeks to correct.

(Whereupon, at 4:10 p. m., the subcommittee adjourned.)

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