Congress of the United States

JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)

March 12, 1960

The Honorable William McChesney Martin, Chairman
Federal Reserve Board
Washington 25, D. C.

My dear Chairman Martin:

We are addressing this letter to you in the hope that the Federal Reserve Board may adopt certain very definite reforms which, if accompanied by parallel action on the part of the Treasury, may remove or greatly lessen the very real dangers to the people of the United States which we believe would be created by the lifting or removal of the interest ceiling on long-time government bonds. Combined with needed Treasury reforms, these would have the effect of increasing the price and lowering the yield and hence the interest rate on government bonds without resorting either to "pegging" the market or inflationary devices. Somewhat similar proposals for reforms were made to you during 1959 and in January of this year by certain majority members of the Joint Economic Committee. At those times you were firm in your refusal to accept these reforms.

We wish to help the country and reduce the tension which is developing between the Board and a large section of Congress, and we hope that further reflection upon these matters may have induced a greater willingness on your part and that of the Board to reconsider basic issues of policy.

We now appeal to you to signify your intent and that of the Board to make at least four basic reforms or improvements in the conduct of the Board's affairs:

1. To recommend the establishment of margins on the purchase of government securities by customers of security dealers, and to regulate the activities of the security dealers themselves.

As the debacle of the summer of 1958 clearly showed, it is intolerable that there should be such widespread speculation in government securities on infinitesimal or non--existent margins. This can be damaging to the credit of the United States of America. We have waited for you to give us a lead on this matter on the basis of your long study of the incident and have been disappointed by your silence and your failure to act.

This offers the possibility of fruitful cooperation between your Board and Congress, and if you will assign some of your experts to work with us, we shall be glad to draft legislation which will deal with the great abuses which have been revealed and yet be fair to all parties.

2. A second reform which we believe the Reserve Board should adopt is to abandon its "bills only" policy. We have scarcely been able to find a single competent economist who endorses this policy to which, with rare exceptions, you have held for so many years. The abandonment of this mistaken policy would be desirable in itself and would clear the way for further reforms.

3. In our judgment, it is imperative that you should, over a period of time, permit an increase in the money supply (currency plus demand deposits) at approximately the same rate as that at which the real gross national product is growing. This would not be inflationary. Rather it would be a stabilizing force.

We regret that, during the years from 1953 to 1959 when the economy was growing at the excessively slow rate of 2.3 percent a year, your Board would only permit the money supply to grow at the still slower rate of 1.8 percent a year. The increase in population cut the growth of the money supply on a per capita basis to .1 percent per annum. In our judgment, this slow rate of growth was one of the causes which artificially increased the interest rate and hence retarded home building, expansion by small business, and state and local investment. It was therefore one of the causes for the increasing unemployment during this period and for slowing down the rate of growth itself.

We must honestly state that your failure to expand the supply of money at an adequate rate has been in large part responsible for this.

Let us, however, emphasize two things: First, we want relative stability in the price level, with the long-time growth in the money supply only matching the long-time growth in the real gross national product.

Second, we are not opposed to some cyclical variations in the growth of the money supply. The availability of credit could, for example, be relatively increased in periods of recession or depression, or slightly dampened down in an undue upswing. But these variations should not be used to alter the long-run policy of expanding the money supply in line with the increase in the production of goods and services so as to avoid both inflation and deflation, but also with a view to maximum employment and adequate growth.

4. The Federal Reserve should use open market purchases to provide the increase in member bank reserves for the needed long-time or secular expansion of the money supply. Taking normal velocity into account, this would be at the rate of about 3 to 4 percent per year.

As you know, such expansion could be achieved by one of two ways: a) the reserve requirements of the member banks could be lowered; or b) the same end could be accomplished by open market purchases.

You have stated publicly that you felt that the reserve ratios should be lowered still further and the banking system appears to be aiming for an ultimate average level of about ten per cent as preferable to the present level of approximately 16 per cent. A reduction in reserve requirements from 16 to 10 per cent would support, with present member bank reserve balances, an expansion in demand deposits from the present $110 billion to about $190 billion, or an increase of $80 billion.

If the creation of this $80 billion is accomplished by lowering reserve requirements, it would be done without any increase in the capital assets and earnings of the Federal Reserve System. The interest on these additional sums and the profits from this great expansion of credit would accrue entirely to the private commercial banks, without the Reserve System or the government sharing in the profits then made through having delegated the government's power to create monetary purchasing power or money to the banks. In other words, private banks will get all the interest and profits on this money, with little or no cost to themselves. In these circumstances, one can understand why the banks are so anxious to use this method and why' those who support the banks find it possible to justify this method. Huge sums are at stake.

According to Federal Reserve System figures, the average rate of earnings of member banks on their combined capital, surplus and undistributed profits in 1958, the last full year for which figures are available, was 17.3 per cent before taxes and 9.7 per cent after taxes.

In view of the fact that the risks of bank stockholders have been decreased in the last decade by the guarantee of bank deposits and the abolition of double liability, this rate of earnings on capital and surplus (accumulated from prior earnings) would seem to be amply adequate.

Now, if you feel that the private banking system of the country, whose major source of profit is the loans and deposits created by the fractional reserve system at little cost to the banks themselves, deserves higher rates of earnings than these, then you should frankly say so for the record and justify your reasons. You should do this for that would be the effect of creating the long-run needed expansion of the money supply by the method of reducing reserve requirements which you advocate.

If instead, the creation of these amounts is done by open market purchases, the government will get 90 per cent of the interest and profits on one-sixth of the $80 billion, or on about $13-1/3 billion. The banks will still receive the interest and profits on $66-2/3 billion. Certainly the banks should not be unhappy to see the government and the people get this small profit for the delegation to them of the Constitutional power of the Congress to "coin money and regulate the value thereof."

As you understand, if the expansion were accomplished by open market purchases, then the Federal Reserve System would acquire added earning assets of approximately $13-1/3 billion in government bonds over the years at an initial rate of about $570 million a year and an average rate of about $740 million per year.

At 4 per cent interest, this would mean initial earnings of approximately $23 million a year and rising by slightly more than this amount each year to over $46 million in the second year, $69 million the third year, etc., until at the end of the period, the annual added earnings would be approximately $940 million a year and would continue from then on. The cumulative amounts of these earnings which would accrue to the Federal Reserve system in the period would be over $4.5 billion. Under prevailing practices, at least 90 per cent of these sums, or over $4 billion, would be turned over to the Treasury.

These may seem to be small and inconsequential amounts to you, Mr. Chairman, but to the hard-pressed taxpayers of this country and the members of Congress charged with the duty of fiscal responsibility, they are of great importance. They would help to balance the budget and provide needed services. Moreover, the large volume of annual purchases of government bonds would raise their prices and lower their yields and hence lower the basic interest rates on governments about which you and the Treasury have been complaining.

This action, along with a more appropriate fiscal policy, would result in long-term interest rates well below the 4¼ per cent ceiling and would make the question of whether the ceiling should be removed largely an academic one.

Instead of focusing on the question of the symptoms of our problem, namely the 4¼ per cent ceiling, we urge you and the Treasury to get at the basic causes of the problem, namely excessively high interest rates in a period characterized not by full employment, forced draft growth, and inflation but one characterized by excessive unemployment, a slow rate of growth, and stable prices.

We should emphasize that we are not proposing that present reserve requirements be raised but that they be kept at existing levels. Thus, we are not advocating that the government's share in the creation of additional purchasing power be increased, but merely that it not be reduced, as you would have it done.

When we have questioned you on this issue, you have objected on the grounds that in times of recession, lowering reserve requirements may be a faster and quicker way of expanding credit than through achieving these effects by open market purchases.

However, this answer has to do with the short-run and does not affect the question of the secular or long-run expansion about which we are concerned.

The Honorable William McChesney Martin

It may be proper to lower and raise reserve requirements for cyclical or short-run purposes. Yet during the years 1951 to 1960, a period dominated by the tight money policy of the Federal Reserve System, the Federal Reserve has lowered reserve requirements during recessions but has not subsequently raised them during periods of expansion. The effects, therefore, have been to lower reserve ratios permanently.

In other words, since 1951 you have not raised reserve requirements and hence have not used them as a counter cyclical weapon in periods of expansion. This fact seriously diminishes the force of the single argument you have used in opposition to our view that open market operations are to be preferred to the method of lowering reserve requirements for secular expansion. In the first place, you have been using a short-run argument in reply to our point that the long-run expansion should occur by open market purchases. In the second place, even in the short run you have not used reserve requirements fully as a counter cyclical weapon for they have been changed only downward and have not been raised.

With respect to the long run, the ultimate effects of the two methods would, as you have admitted, be the same. Even the immediate effects would be substantially similar. The public interest calls for using the open market purchase method for the long run or secular expansion of the money supply and we call upon you and the Federal Reserve Board to issue a clear statement of policy to that effect.

In short, we believe that a proper sense of fiscal responsibility should lead you (1) to work cooperatively with Congress for requiring margins on the purchases of government bonds and for proper regulation of that market, (2) to abandon the discredited "bills only" policy, (3) to effect the long-time increase in the money supply at approximately the same rate as the growth in the real national product, and (4) to do this by open market operations rather than by lowering reserve ratios.

We will welcome your cooperation for these worthy ends.

With best wishes,

Sincerely yours,