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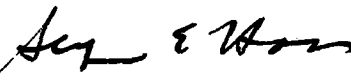
The Hon. John W. Snyder
Department of the Treasury
Washington, D. C.

Dear Mr. Secretary:

I enclose a more extended discussion of the Treasury-Federal Reserve controversy which may be of some interest to you. The original, which I sent you sometime ago, was as you know, published in the HERALD-TRIBUNE of March 30, 1951.

The enclosed, together with comments by various economists and others will be published in the Review of Economics and Statistics, and I shall see that you receive a copy of it.

Sincerely yours,


Seymour E. Harris

H:B

The Debate over Monetary Policy¹

Seymour E. Harris

I.

In 1914, with the establishment of the Federal Reserve System, high hopes were held that our monetary problem had been solved; and that stability was on its way. Assuming that our monetary problem had been solved, a Harvard professor advised his students against writing in the field of money. But our monetary problems are still with us, in part because since 1914 the Monetary Authority has sought ways to evade responsibility, rather than accept it. In the early years of the Federal Reserve System, despite the limitation put upon the System by the commercial theory of lending, the Authority found ways to provide the supplies of money required to fuel an inflationary financial policy. In the twenties, they failed to use their potent weapon, open-market operations, which had fortuitously been discovered, to stop excessive expansion; and indecision and lack of courage once more showed the problem to be not weapons but the attitude towards their use. The early thirties again were a period in which the Monetary Authority acted late and inadequately. Again, there was a search for new weapons and particularly qualitative control and greater control over reserve requirements of member banks. As in the past, the new weapons in the reserve arsenal seemed to make little difference. In World War II, the main task of the reserve banks seemed to be to provide enough excess reserves to assure the absorption of Treasury securities not salable to genuine savers. Again, in the postwar period, the potent weapons of the Monetary Authority have not been used to any substantial degree -- in part because the Treasury objected.

1. I asked Professor Hansen to write a piece on this problem which might serve as a focal point for discussion. But when he read my piece on the government's monetary policy (New York Herald-Tribune, March 30, 1951), he insisted that I write the piece. This is a new and longer note, though the general position is that presented in the Herald-Tribune.

It is well to keep our history in mind when we discuss monetary policy. The problem has not been one of impotency of weapons. The reverse is true. The Federal Reserve has had powerful weapons which it has not used when it was free to use them, and we can only guess how far they would have used them had they the freedom to do so.

II.

In the year 1951, the debate is hot. The Federal Reserve, with more than \$23 billion of government securities at its disposal in February, considerably more than the reserves of member banks (\$19 billion), is surely in a position to deny the economy the money without which a large inflation could not be carried out. It is a far cry from the time that we feared the Federal Reserve might not have assets to sell. In fact, the Federal Reserve even today could impose a drastic deflation on the country.

Failure to use monetary policy to fight inflation is not primarily the result of Treasury pressure. Much more important is the fact that there is no disposition to fight inflation among the powerful interests that control the country: labor, farmers, business. They all give lip service to the fight; but in their activities they are highly inflationary. These same groups will also contest any monetary policies which might seriously impair the inflationary processes; and if past history is any guide, the Monetary Authority will yield to these pressures. It is not possible in a democratic society to set up an independent agency which would be free of political influences and thwart the desires of the public. I am not arguing here against use of all anti-inflationary weapons, but am expressing doubt concerning the disposition to use them.

Monetary restraints are the easiest approach to inflation control -- much less painful than more taxes or less public expenditures, or than wage or price control, or than control of supply and demand of commodities. Their atrophy is the result not of ignorance, but of the determination not to fight inflation

which prevails in the country.

Failure to use monetary weapons may be associated then with a reluctance that goes back to 1914 and earlier. The same pressures that weaken all anti-inflationary measures preclude the effective use of monetary weapons.

III.

This is, however, far from the entire explanation. New weapons have become available which are sharper and more precise than the monetary weapon. In 1931, when Keynes wrote his Treatise on Money, the emphasis was still on monetary policy; but in the next few years attention began to be focused on fiscal policy. It has been said that monetary policy should be used at the beginning of an inflation or a decline, if it is to be effective, and especially since fiscal policy¹ requires time for application. Actually, a tax system, with much built-in flexibility (or better, with formula flexibility) may respond quickly to inflationary or deflationary pressures; and the difficulty of applying monetary policy is related to the problem of discovering the early stages of a rise or decline.

²
In January, 1950 when the Douglas Committee reported, the case for greater emphasis on monetary policy was stronger than it was early in 1951, when Senator Douglas made his famous speech (Congressional Record, February 22, 1951) on the clash between the Treasury and Federal Reserve. In a semi-war economy, the monetary weapon becomes especially dulled and the other weapons sharpened. Even from the second quarter to the last quarter of 1950 (the first half year of the Korean War), personal taxes in absorbing \$3 $\frac{1}{2}$ billion of the \$18 billion of additional income contributed something to the fight against inflation, whereas in the eight months ending February 28, 1951, the amount of Federal Reserve credit increased from \$18.5 billion to \$23.2 billion. The inflation^{ary}/effects were not fully felt, however,

1. R. V. Rosa, "The Revival of Monetary Policy," The Review of Economics and Statistics, February, 1951, p. 30. (Interpreting Senator Douglas and Dr. Goldenweiser.)

2. Senate Document No. 129, Report of the Subcommittee on Monetary Credit and Fiscal Policies, on S. Con. Res. 26, January 4, 1950; also see Joint Committee Report on Monetary Credit and Fiscal Policies, November 1949.

because the System lost \$2.1 billion of gold and the amount of money in circulation rose by \$200 million. Member bank reserve balances rose by \$3 billion,¹ however.

In 1951, for restraining inflation we can depend also upon control of investment and ultimate control of wages and income. Monetary supplies and demand for money will respond to these forces -- as in World War II, when restrictions on investment and various other controls, and unavailability of consumers' goods not only were reflected in reduced creations of new money but also in increased demands for money for holding. Use of these anti-inflationary measures also depends on a willingness to apply them which, unfortunately, still is not evident. But in the war years these measures proved more effective than monetary measures.

IV.

Senator Douglas and the Federal Reserve are against Treasury policy on the grounds that the support of the securities market forces the Federal Reserve to purchase government securities in amounts that result in excessive bank balances and hence of bank money, and that the resulting rise of prices is costly to the economy and even to the Treasury, for a rise of prices of 10 per cent would cost the Treasury \$7 billion on the 1951-52 budget and an increase in the rate of interest of $\frac{1}{2}$ of 1 per cent only \$1 billion. So long as the Treasury insists upon a $2\frac{1}{2}$ per cent long-term rate and other rates to match, so long, in the view of the opponents of Treasury policy, is the Monetary Authority stymied in its control over monetary supplies.

We must be clear on objectives. The official discussion is in terms of a rise of rates of $\frac{1}{4}$ - $\frac{1}{2}$ per cent -- not one of, say, 1 - 5 per cent. A rise of rates of 2 - 4 per cent might achieve a great deal; but it is dubious that one of $\frac{1}{4}$ - $\frac{1}{2}$ per cent would result in much beyond a partial demoralization of the securities market,

1. A transfer of Treasury balances of \$400 million from reserve banks to member banks accounted in part for the rise of member bank reserves.

with investors awaiting further declines in prices and rises in rates. Such operations may be hazardous when \$50 billion of securities mature in a year and the country faces large deficits.

The main objective of a rise of rates is to increase savings and reduce investments, for it is the excess of investments over savings that is inflationary. (Official and supporting statements seem to rely too much upon the old-fashioned approach of the money-price relationship, and seem to reflect unawareness of the fact that the monetary supply is but one aspect of the general picture.)¹

In the writer's opinion, Senator Douglas is altogether too sanguine concerning the rise of institutional investments in public securities following an increase in the rate of interest of $\frac{1}{2}$ of 1 per cent. The fact is that in the five years ending June 30, 1950 the issues held by financial institutions declined from 55 to 45 per cent of all issues, with commercial banks disposing of \$18.5 billion of securities. Yet the rate of interest on short-term issues rose greatly, the computed rate on all issues rose by $\frac{2}{10}$ of 1 per cent (10 per cent of the 1946 rate) and the rise of rates was concentrated on the short-term issues, largely held by financial institutions. Although total debt outstanding declined by \$1 billion in these five years, the short-term issues outstanding fell by \$22 billion. Apparently, despite higher rates (and the rise in rates despite smaller amounts outstanding), the financial institutions were losing interest in public securities. It is interesting that in the year ending December 29, 1950, the Federal Reserve increased its investments in short-term securities by \$5.1 billion and disposed of \$3.2 billion of bonds.

1. The reader might consult the replies of the Federal Reserve Board (op. cit., esp. pp. 21-44) to the Douglas questionnaire. This is an able statement of the objectives of policy and the manner of achieving them. But the association of monetary policy with the savings-investment relationship, or with income and other policies that affect prices, is not presented. And the discussion of fiscal policy has a ring of pre-Keynesian days.

I do not believe that a rise in the rate of interest of $\frac{1}{2}$ per cent is going to increase savings greatly, and certainly the additional savings will not go into government securities in large amounts. An increase of 2-4 per cent is another matter, although even against increases of these proportions the rise of incomes, the unavailability of goods and the promise of price stability are likely to be more important in stimulating savings than even a rise of interest rates of 2-4 per cent.

With prices rising by 10-15 per cent per year and large profits to be made in private enterprise, an increase of long-term rates on public securities of even 1 per cent is not going to carry much weight. A revolution in savings is required. From 1941 to 1945, the public saved \$129 billion and put \$54 billion into Treasury issues, but from 1946 to 1950, out of \$45 billion of saving only \$6 billion went into government securities. The record for corporations is even less encouraging. Note, also, \$35 billion of personal savings, or 31 per cent of GNP, in 1944 and \$11.3 billion, or 3 per cent of GNP, in 1950.

A rise in the rate of interest of $\frac{1}{2}$ per cent is not going to depress investments substantially. Even Senator Douglas admits this -- and especially when prices are rising at the rate of 10-15 per cent a year and corporate profits are running at the rate of \$50 billion yearly. The effective attack on investments is likely to be the one used in the last war; e.g., determination of what is to be produced, allocation of scarce resources. Indeed, Senator Douglas would control investment by denying the economic system money; but here we run into the practical problems of (1) how much money should be denied the economy; (2) will the sacrifices be imposed on the industries and firms that should bear them; (3) will the money in fact be denied them; and (4) the competition offered by existing supplies of money. Who would insist that there would not have been a substantial inflation in the first year of the Korean War without large additional expansion of money?

Is it possible that a rise in the rate of interest of, say, 3-5 per cent may have considerable effect. But here we run into the general problem that those who urge freedom for the Federal Reserve to manipulate monetary supplies do not generally support a long-term high-rate policy. In fact, they express satisfaction with the 2 per cent rate in the forties as compared with the 4 per cent rate in the twenties. At current rates of interest and prices, the servicing of the national debt of \$250 billion costs as much as a debt of \$600-\$700 billion would have cost in the twenties. An ultimate rise in the cost of the current debt from \$5-6 billion to \$10-12 billion should not be accepted with equanimity. Nor is the more important problem of the importance of low rates of interest for the economy to be dismissed lightly.

A case can be made out against certainty in the long-term rate, as the Federal Government discovered in the latter part of the war when the increased awareness of the pegging of rates by investors encouraged a movement from low rate short-term securities into high rate long-term securities. Why accept less than 1 per cent on a short-term security when 2 per cent might be had by holding a long-term issue for a year? And a case may be made out for higher rates in inflationary periods and lower rates in deflationary periods. But we should be clear on the issue of long-term low rates and the greater requirements of stability in view of the problem of debt management.

V.

Before concluding we should perhaps expand a little on the recent Federal Reserve-Treasury debate and on the responsibility of the banks.

In the debate of 1950-51, much was made of the large expansion of bank loans. The growth from \$52 billion in June 30, 1950 to \$61 billion in January, 1951 was at a record rate. But the rise was largely at the expense of investments in government securities which declined by \$6.4 billion. The banks were deserting the government security market in order to expand loans and (to some extent) purchase

other securities (a rise of \$1 billion in the latter). With short-term Treasury issues yielding 1.17 to 1.47 per cent in June, 1950, according to maturities, and bank loans paying 2.70 per cent, the banks could not resist the temptation to shift -- especially since their liquidity position was guaranteed.

In these months, there was much discussion of the need of raising short-term rates. The contention was that a rise of these rates would increase the cost of borrowing for the banks and would discourage them from cashing in on these securities with the reserve banks. It was also contended that a rise of rates might bring about increased investments by financial institutions in these short-term issues. Yet despite a rise of rates in the eight months ending February 24, 1951, from 1.17 to 1.39, 1.23 to 1.52, and 1.47 to 1.67 for 3 month bills, 9 to 12 month issues and 3 to 5 year issues, respectively, all commercial banks reduced their holdings of government securities from \$77.3 to \$70.9 billion (7 months ending January 31, 1951) and Federal Reserve Banks added \$4 billion. (From the end of 1945 to January 1951, U. S. Government securities in the portfolio of commercial banks declined from \$90.6 to \$60.0 billion.)

There was also much talk of concentrating increases on short-term issues. But a rise in short-term rates is bound to affect long-term rates as investors shift to the short-term issues, now relatively more attractive. Yields on U. S. Government taxable bonds (10 years or more) rose from 2.33 per cent in June, 1950 to 2.40 per cent in February, 1951.

In these discussions, the authorities and experts emphasized the point that the increased cost of higher rates to the government would not be serious. Since the rise would apply only to new issues, it would take years before any rise in rates on new yields would apply to a large part of the debt outstanding. Besides, tax collections would increase. Insofar as the rise of rates should be substantial and deficits cumulate, however, the weight of this argument is lessened.

Perhaps more important is the point that the cost of the higher interest rates to the government is not so important as the unstabilising effect on the government security market, and the adverse effects on the economy of the reversal of the long-run low interest rate policy.

The Douglas Committee, the Joint Committee on the Economic Report in its most recent statement, the Federal Reserve, and the economist supporters of Congressional and Reserve position (e.g., notably Chandler and Bach), all emphasize the inflationary dangers of expanding supplies of money. In this note I have suggested that there is overemphasis of the monetary approach. But here I bring to the reader's attention a relevant factor which has been neglected. Messrs. Keyserling and Clark of the Council, in a letter to the Joint Committee, state well one aspect that has been rather disregarded. The rise of output is the primary objective; and if (unfortunately) the rise of money has contributed to inflation, it has also stimulated gains of output. Industrial output rose by 10 per cent in the first six months of the Korean War. Further additions of money will be required to assure a 25 per cent rise of output in the next five years and to provide the additional cash required for holding in a growing economy. The use of the monetary axe may interfere with this growth.

Later I suggest that the approach to the problem of monetary inflation and interest rates may well be a segmentation of markets, with the government security market protected by provision of special supports; the banks are to hold special reserves in government securities.

The banking business is a public utility business, as is recognized by the special regulations to which it is subject. One may raise the question, as Musgrave has, whether the government securities in World War II should have been issued to the commercial banks in the first instance. Might it not have been better to issue them to reserve banks, with adjustment of reserves of member banks? At any rate, the banks received generous compensation for undertaking the responsibility

of manufacturing money and buying securities. The banks surely should not be allowed the freedom to dispose of government securities at their discretion or, as an alternative, to be offered rates high enough to remove the incentive to switch to private borrowers. In part the liquidation of \$30 billion of securities by commercial banks since 1945 reflected attempts to demonetize the debt; but in part it reflects behavior by banks not fully justified in the light of their responsibilities.

VI.

Let me conclude by allowing that monetary policy has a place in the anti-inflationary fight. But on the basis of past experience, we insist that it is not likely to play an important part. Its relegation to a secondary role rests not only on history but also on the development of Keynesian economics. It is increasingly fashionable to attack the problem through fiscal policy, to concentrate attention on savings and investment and the variables which influence them. In a mobilization economy, there are also available controls to influence savings and investment. Money is only one approach to the rate of interest and the latter only one approach to savings and investment.

There can be no doubt but that the high degree of liquidity in the American economy of 1951 is a serious threat to stability. Should deficits continue to cumulate, then the problem may become even more serious. There is a case for reducing the magnitude of liquid assets. This may hold even if it is admitted that on the basis of American economic history the public needs more liquid assets not only (1) pari passu with the rise of output but also (2) because the proportion of liquid assets to incomes rises greatly with increasing standards of living.

1. Cf. Joint Committee on the Economic Report: General Credit Control, Debt Management and Economic Mobilization, 1951. Here is the latest statement of the Joint Committee supporting the Federal Reserve position; able supporting statements by Messrs. Chandler and Bach, the exchanges between the Treasury and Federal Reserve, the Keyserling-Clark letter on the relation of monetary expansion and output, and vigorous support by Messrs. Eccles and Musgrave of special reserve requirements in the form of additional government securities to be held by banks.

The crucial point is how do we attack the excess liquidity problem. The Federal Reserve and Douglas position is that we attack it through a rise in the rate of interest and monetary restrictionism. It may be desirable to provide tax money in exchange for liquidity, that is to increase the yield on government securities. But I suggest that before this is done, with its threat to the low-interest rate policy, other means be considered first. There is the old idea of immobilizing securities against deposits in the banks. Surely the banks, in a virtually riskless business, should not be allowed further rises in rates and profits as their portfolio of governments rises. The public generally may be enticed at a price to put money into illiquid government securities as deficits cumulate. But a simpler solution may well be heavier taxes and compulsory loans (i.e., tax-loans). These, together with income control and, where necessary, adequate price and supply controls, may keep the supply of money in check and induce additional demand for money for holding. Only in so far as the seriousness of the world situation does not justify generous use of controls and the liquidity problem continues to threaten stability, would special incentives to non-banking lenders be justified.

In short, we should seek help in the fight against inflation wherever it can be had; but we are not optimistic concerning the contribution likely to be had from monetary policy. In the present (Spring, 1951) state of the world crisis, we should depend primarily on fiscal policy and secondarily on limited income and other controls. Monetary policy may be helpful, but as the crisis deepens, it is likely as in the past emergencies to become increasingly passive.

In this discussion, I have not dealt with the restraints on monetary expansion exercised through controls of particular types of loans, or even rationing of total loans or freezes on the amount outstanding. These, in fact, belong to the category of direct controls and not to general monetary control operating through changes in the price of money.