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By

DEB

NLT Date 6-18-90

April 11, 1951

MEMORANDUM

To: The President  
From: The Council of Economic Advisers  
Subject: Supplement to Quarterly Report 1/

Credit and Debt Management Policies

The problem of combining fiscal policies and monetary policies which most concerned the President and the Council of Economic Advisers on February 26 has become far more serious. In his memorandum (released to the press) which on that day he placed before executive officers dealing with monetary and fiscal policies, the President united monetary and debt management and suggested that they be dealt with in coordination. He also made clear his viewpoint that these policies should be consistent with the program to carry forward the heavy refinancing operations of the Treasury in 1951 upon the pattern of interest rates then being maintained, unless further consideration clearly demonstrated a preferable alternative. He set forth as a prime objective that stability in the government security market be continued.

On March 8 the Federal Reserve discontinued the support of the government bond market which is indispensable in any program to stabilize the market. Within a few days the market prices of 7 issues of 2½ percent bonds maturing in more than 17 years dropped below par. This has greatly affected the pattern of interest rates, and at this time it would be impossible for the Treasury to succeed in selling to the public a new issue of long-term bonds bearing 2½ percent interest.

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1/ Mr. Blough requests that he be disassociated from this supplement to the Quarterly Report dealing with credit and debt management policies, and hopes to submit his views shortly in a separate statement.

In the opening section of the Quarterly Report we have discussed the lack of success of this monetary maneuver in bringing to a halt the increase in bank loans. This was the declared objective of the Federal Reserve in advocating an abandonment of the support program. How to attain that objective, which the President included in his February 26 memorandum, is a matter still unsettled. It is also necessary to consider how it is possible to accomplish the important purpose of establishing the foundation upon which the large refunding operations beginning in June can be conducted upon a stable market. No action has been taken to accomplish this purpose. What has been done, principally the lowering of the market prices of outstanding issues and the issue of a long-term bond carrying 2 3/4 percent interest, works in the other direction.

It is possible that forces external to the policies of either the Federal Reserve or the Treasury may restore the market to the February 26 condition. As economic controls tighten, bringing a cessation of inventory accumulation, a decline in home construction, and an inelastic price structure discouraging to many types of business expansion, the outlets for investment funds may be substantially restricted. At the same time, the increase in national income and in personal income which we have described as probable in Part I of the Quarterly Report will be establishing larger funds seeking investment. Under these circumstances, it is probable that the market for government securities would become very strong.

There is little likelihood that this process will start soon enough to have any influence upon the June financing, which is the first matter of concern. The refunding offer must be made several weeks before June 15. It must be related, in its terms, to the bond market conditions early in May, because the Treasury cannot take a chance with a bond issue which may not be successful.

If the accomplishment of the fiscal program is not to be intrusted to the caprice of a market which may or may not develop its own strength, the most positive measure would be to reconsider the recent policy of the Federal Reserve and return to a spirited market support program. The initial step has been taken. The stability of market prices since the longest term government bonds dropped to 99, which has caused much comment about the error of those who feared a catastrophic market collapse, has afforded comforting proof of the inherent strength of the government bond market. But that stability was first attained only because the Federal Reserve saw a collapse in the making and returned to its policy of market support. The market has possessed such basic strength that it has been possible for the Federal Reserve to stabilize it without overt acknowledgment that it is doing so, but this does not mislead financial circles, which know that the market is being supported.

The fact that the Federal Reserve has already learned that it must support the market before bond prices have fallen far enough to halt credit expansion may facilitate a second reconsideration of Federal Reserve policy. All those who have pressed the Federal Reserve to take the course which it began to follow on March 8 have argued that the expansion of loans by banks

and other institutions must be stopped, and that the way to stop it is through central bank operations. Quite apart from the serious question raised by recent events whether loan expansion can really be curbed by monetary policies, the argument can be stripped of importance if the President relieves the concern of the Federal Reserve over credit expansion. This he can do by an executive order prohibiting the making of a new loan which would increase the volume of loans of the bank or other institution.

A subcommittee, consisting of the general counsels of the Treasury, of the Federal Reserve, and of the Office of Defense Mobilization, with a member of the Council of Economic Advisers, was appointed by Mr. Wilson's four-member committee to consider the validity, character, and effectiveness of this kind of control by executive order. The group has reported that the President has undoubted authority to act, that the control would be immediate and positive, and that at the outset it would not be necessary or even desirable to establish any administrative procedure other than to authorize the several Federal Reserve banks to permit new loans in excess of the ceiling where necessary to the defense program or for desirable economic expansion. It was not within the assignment of the group to consider the several types of credit control and to recommend whether mandatory control should be established, but it recommended that if it were decided that private credit expansion must be halted and other available measures were either too slow or too ineffective, the action taken under this power of the President should be to freeze the volume of loans of banks and other institutions at the level thereof at the close of business on the day of the order, with an allowable 2 percent bulge for 30 days and with the foregoing exception of loans approved by the Federal Reserve banks.

We come finally to this same plan when we consider measures to accomplish the second objective defined by the President on February 26--the halting of the increase in private credit. This has not been accomplished by any action taken since that date. Despite its attainment of freedom to use central bank policies, as it has demanded, the Federal Reserve has proposed no action to curb credit which it could not have taken while carrying through the support program. What it has proposed holds little promise for effectiveness now, when effective action is needed.

The Council of Economic Advisers has recommended the earnest promotion of a program of voluntary restraint, but we have never suggested that it would be possible to suppress the strong forces of credit expansion now running through the economy by appeals for voluntary restraint, however thoroughly the propaganda effort may be organized.

We have recognized the considerable influence upon the volume of bank loans of increases in reserve requirements, and we have frequently recommended that the Federal Reserve be given authority to require such increases. We now favor the plan we supported in 1947, under which the Federal Reserve might require an additional bank reserve up to 25 percent of deposits, which the bank might hold, if it desires, in short-term government securities.

The plan might properly be extended to give the Federal Reserve supplementary power to require additional reserve measured by the increase in loans of a bank, but this reserve requirement as proposed by the Federal Reserve would of itself be too weak to have much effect.

These reserve plans contemplate legislation which would come slowly, and they have no relation to the problem of halting the expansion of bank credit at this time. Nor do they affect other lending institutions.

The only control measure which is immediately available and which would be immediately effective is mandatory control through the executive order of the President. Through that action it is possible to meet the requirement of the President that the expansion of private credit be halted. Through that action the way would be opened for the return to the policy of support of the government bond market which is indispensable to the attainment of the more important objective of the President--the stabilization of that market with the pattern of interest rates prevailing on February 26.

Respectfully submitted,

Leon H. Keyserling  
Chairman

John D. Clark

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By

DEB

NLT Date 6-15-90

April 13, 1951

MEMORANDUM FOR THE PRESIDENT

From: Roy Blough  
Member, Council of Economic Advisers

Subject: Credit and Debt Management Policies<sup>1/</sup>

Summary

The outlook for the success of credit restraint and debt management has, in my opinion, improved over the past sixty days. However, unless there is an effective attack on the underlying problems, the improvement is likely to be only temporary.

The principal kinds of action in this area, which I believe are called for at the present time, are as follows:

1. The Committee of Four, which was appointed February 26 to study the problems of bond market stability and bank credit expansion, should be pressed to make an early report.
2. Close watch should be kept on the Government bond market and the expansion of bank credit, but interference with Federal Reserve open market operations is not called for at this time.
3. Legislation should be requested and strongly pushed to empower the Federal Reserve System to require larger bank reserves along lines indicated later in this memorandum.
4. Plans should be placed in readiness to permit the quick imposition of ceilings on bank loans under emergency powers if a critical situation should develop, but such ceilings should not be imposed now.
5. Programs to increase personal saving and to cut down on capital investment, including construction, must be pushed vigorously if credit restraint and debt management programs are to succeed.

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<sup>1/</sup> In their "Supplement to Quarterly Report," dated April 11, 1951, on the subject of credit and debt management policies, the other two Members of the Council of Economic Advisers presented certain views in which I found myself unwilling to join. My views on the subject are presented in this memorandum. Points 2 and 4 of the above summary reflect an emphasis and perhaps an attitude different from that contained in their draft. On point 3, we are in agreement, and I believe this is true also of points 1 and 5, which were not covered in their draft.

Factors Indicating an Improved Outlook

In several respects, the outlook for the success of credit restraint and debt management has improved over the past sixty days.

1. The Treasury and the Federal Reserve are again working together on problems of mutual concern, and there seems to be no reason to doubt that this will continue to be the case. The re-establishment of close working relations between these two agencies is a fact of great importance.

2. The general attitude of the financial community seems to be more constructive than it was a few months ago. Several prominent bankers have told me that they now have more faith in the Government's will and ability to fight inflation than earlier in the year, and intend to support actively the savings bond campaign, about which they were dubious a few months ago. The voluntary credit restriction program is being placed in effect and has elicited a good deal of support, although there is substantial difference of opinion regarding its probable effectiveness. While I am hopeful of some constructive results, I am highly dubious that the voluntary program will have much effect unless it is given some mandatory teeth.

3. The recently signed law granting extension of time to the holders of "E" bonds should be helpful in reducing the problems of refinancing these bonds as they mature. This law does not, of course, bear directly on the heavy refinancing of marketable issues which will be necessary during the coming months, but every bond kept in the hands of the public will hold down the amount that must be borrowed.

Federal Reserve Bond Market Operations

The Federal Reserve operations in the bond market are, in my opinion, being carried on in good faith and with technical competence. The Federal Reserve is not trying to force up the rate of interest on Government securities. It is trying to find the market levels at which it will not need to buy large amounts of these securities to prevent their prices from falling. The fact that from March 26 through April 6 private owners of about 8 billion dollars worth of long-term 2 1/2 percent marketable bonds exchanged them for the new 2 3/4 percent nonmarketable issue suggests that the prices of marketable securities may not fall much farther before reaching stable levels. However, the prices were still drifting downward as late as yesterday. Moreover, selling of Government securities by banks and other private holders is continuing, although all but a few of these are being purchased by private buyers. Bank credit has continued to expand, although at a decreasing rate.

As a result of the lower prices, a seller of Government securities must take a capital loss on the sale. The prospect of this loss reduces the benefits which banks and insurance companies can expect to get from selling Government bonds to secure funds for private loans. This acts as a drag or brake on the expansion of loans, but is certainly not now powerful enough to stop it.

I understand that within a few weeks, before it is necessary for the Treasury to refinance maturing bonds and notes (beginning in June and July), the Federal Reserve will likely resume strong support of the

market, although not with a view to restoring the old interest rate pattern. Rather, a new somewhat higher rate pattern would be set for the future.

While the Federal Reserve has probably done more harm than good by withdrawing support from Government securities at prevailing prices, as it did beginning last August, the wisest course now would seem to be not to interfere with the Federal Reserve program of bond market action, at least until the results are more clearly evident. The financial community, which must buy most of the marketable securities, will undoubtedly be more willing to buy them if this is done. Moreover, the responsibility for any unfavorable results will be clearly placed, which would not be the case if efforts were made now to get the Federal Reserve to change its operations, against its best judgment.

#### Uncertainties and Problems Ahead

The Federal Reserve bond market operations, unfortunately, do not attack the underlying cause of the credit and debt management problem. This problem is to hold down the amount of credit and at the same time refinance a huge volume of Government securities. In normal peacetime, the savings which people make are sufficient to supply the demands of borrowers and also to hold Government bonds at low rates of interest. But in a period of inflation there is a big demand for loans and the rate of saving is low. Private borrowers are willing to pay high interest rates. To get this high interest, financial institutions which hold Government securities are likely to turn many of them in for cash when

they mature, and loan the money to private borrowers. Then the Treasury must try to borrow the money back. One of two things is likely to happen. The interest rate paid by the Government may continually rise as the Treasury in each successive refinancing is obliged to compete with private borrowers for available funds. Or, to avoid this, the Treasury may have to borrow from the Federal Reserve Banks, thereby increasing bank reserves and permitting further inflationary expansion of bank credit. Neither the continuing rise of interest rates nor the expansion would be desirable.

If the supply of savings can be increased and the demand for private loans decreased sufficiently, there will be no problem. For this reason, savings campaigns, strong price controls, and the selective cutting down of capital investment, including construction, by prohibitions or withholding of materials all make the credit problem easier. To the extent that such measures are not successful, more direct credit control methods must be used. But it is clear that the anticipation of price and wage escalations gives rise to an increased demand for loans and makes it difficult to sell savings bonds. Strong price and wage controls are thus closely related to credit restraint and successful debt management.

#### Proposed Measures

To put the Government in a position to deal positively with a serious inflationary credit situation if one should arise, several measures of credit control are recommended.

1. Bank reserve requirements. Congress should be asked to grant the Board of Governors of the Federal Reserve System additional power over

bank reserve requirements. What appears to be the most promising approach is a "combination reserve plan" giving the Federal Reserve System powers to require two kinds of additional bank reserves. One would be the power to require higher reserves against deposits. Banks would be permitted to count certain Government securities as part of the required reserves. The other would be the power to require a special reserve of, say, 50 percent of the amount by which a bank increased its loans. These powers should be flexible enough to be adapted to various situations calling for different reserve percentages. The power of the Board to control reserves should be extended to cover all commercial banks.

2. Specific credit controls. Specific credit controls on consumers' durable goods and housing should by all means be continued. They can be made more rigorous if need be, but this is not now recommended. Legislation should be sought to extend the control of mortgage credit to loans on old houses (started before August 3, 1950). Such credit can not now be restricted. Margin requirements should be raised for future contracts on commodity exchanges. Authority to regulate credit for this purpose has already been recommended to Congress. It is sometimes urged that other kinds of loans be made subject to selective credit controls. However, specialists who have studied the matter are doubtful if there are any other important classes of loans for which selective credit controls would likely be successful.

3. Mandatory ceilings on bank loans. Plans should be placed in readiness for the imposition, if necessary, of mandatory ceilings on

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bank loans under the emergency powers of the President. Such mandatory ceilings would be viewed by bankers and businessmen as very drastic and could interfere with the defense effort. Accordingly, they should not be used unless a resumption of bank credit expansion with serious inflationary consequences occurs, over which other measures are not successful. In my judgment, such mandatory ceilings should not be imposed at the present time.

Respectfully submitted,

s/ Roy Blough  
Roy Blough