

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON 25, D. C.

February 2, 1950

MEMORANDUM

To: The President

From: The Council of Economic Advisers

Subject: Analysis of proposal that "Treasury actions relative to ...transactions in the public debt shall be made consistent with the policies of the Federal Reserve," contained in Report of Subcommittee on Monetary, Credit and Fiscal Policies (Senator Douglas, Chairman) of the Joint Committee on the Economic Report, issued on January 23, 1950 as Senate Document No. 129.

While the Report of the Subcommittee on Monetary, Credit and Fiscal Policies deals with a variety of matters, the larger part of the Report is devoted to a general discussion which reaches a climax in the proposal that "Treasury actions relative to ...transactions in the public debt shall be made consistent with the policies of the Federal Reserve," and that a Joint Resolution be adopted declaring that this is the will of Congress.

The Council of Economic Advisers dissents vigorously from this proposal. We set forth below the reasons for this dissent, as transmitted to the Subcommittee in response to its request.

C. Questions Relating to Report of Subcommittee on Monetary, Credit, and Fiscal Policies

The views of the Council relating to monetary, credit, and fiscal policies were presented to the Subcommittee (Hearings, pp. 533-538), but not in the detailed manner in which we are now requested to comment upon the report of the Subcommittee. There is no disagreement upon the point that these policies as a group have very great importance in determining the success of the Nation in attaining the objectives of the Employment Act of 1946. The Council is glad to express its full agreement with most of the conclusions reached by the Subcommittee in the broad study which it has completed with such remarkable speed. They mark a very real advance in the recognition of the vital role which Government programs must play in our complex economy if it is to be maintained on a high level.

We shall discuss the several recommendations of the Subcommittee, other than those which call only for a specific study, in the order in which they are presented in the report, under appropriate Roman numerals.

I. II. III. Monetary, Credit, and Fiscal Policies

The larger part of the report of the Subcommittee is devoted to a general discussion of monetary, credit, and fiscal policies and to the relations of the Treasury and Federal Reserve Board, leading to recommendations I, II, and III, which reach a climax in the proposal that "Treasury actions relative to . . . transactions in the public debt shall be made consistent with the policies of the Federal Reserve," and that a joint resolution be adopted declaring that this is the will of Congress.

The Subcommittee has not been led to this portentous proposal because there is now any controversy between the Treasury and the Federal Reserve Board. The Secretary of the Treasury and the Chairman of the Board have both told the Subcommittee that the policies in which each of them has an important interest have been worked out through successful cooperation and that they have every expectation that they will be worked out in the future in the same way. Neither of them wishes to raise the question of dominant authority and each of them objects to being pushed into a controversy which they believe is unnecessary. As a principle of good administration, it is true that a division of authority with respect to a matter of this importance is unwise. As a matter of practical working policy, the Secretary and the Chairman are probably right in proposing the continuance of the present successful relationship when an effort to change it would surely evoke the sharpest controversy in the field of debt management where quiet and confidence are supremely important. We therefore refrain from a detailed discussion of the question whether final authority to determine administrative action of the broad economic significance which the Subcommittee attributes to

credit and fiscal policies should be vested in the Chief Executive chosen by and responsible to the people or should be lodged in an administrative board responsible only to a legislative body which is not organized in a manner which permits it to supervise continuing and flexible administrative action.

Debt-management policy. The proposal of the Subcommittee results from its conclusion that the debt-management policy followed by the Treasury and the Federal Reserve Board with repeated public approval of the President is wrong in one important respect and that the decisions of the Treasury should not give primary consideration to continued easy refunding operations at low-interest rates. The Subcommittee believes that the debt-management policy as well as the credit policy should "be guided primarily by considerations relating to their effects on employment, production, purchasing power, and price levels." It recommends that Congress direct this change in policy by joint resolution. This, the Subcommittee says, should be done in order to permit the central bank to attempt to stabilize the economy by a policy of monetary and credit control for the success of which the Subcommittee offers no stronger hope than that

"Our monetary history gives little indication as to how effectively we can expect appropriate and vigorous monetary policies to promote stability, for we have never really tried them." (Report, p. 18)

The only point in issue, aside from the question of final authority, is whether the debt-management policy should be modified to permit long-term, 2½ percent Government bonds to fall below par in periods of inflation. The general policy was described by the President in his Annual Economic Report in 1948, in these words:

"A most important part of our debt-management policy has been the program to support the market for Government securities. During the war period, when it was vitally necessary to maintain a market which would absorb vast issues of securities at low interest rates, the Federal Reserve stabilized the market through its open market operations in buying and selling short-term Government securities at low rates of interest. Now that it is no longer necessary for the Government to increase its debt, short-term interest rates have been permitted to rise. A decline has also been permitted in prices of bonds from the premium prices to which they had risen as a result of market demands in the early postwar period. No bonds, however, have been permitted to fall below par and it is the declared purpose to continue active support of Government bonds for the purpose of maintaining an orderly and stable market at a low level of long-term interest rates." (p. 85)

Relation of debt-management to monetary policy. The President in discussion the problem in his several Economic Reports and the Council of Economic Advisers in their reports have always recognized that the present policy "does not permit the Federal Reserve to make effective use of the traditional method of limiting inflationary movements in the economy by requiring banks to borrow in order to obtain additional reserves and by raising the discount rate charged on such borrowings." After making this statement in his Economic Report in January 1948, the President continued:

"In the recent congressional hearings there have been proposals to solve this dilemma by abandoning the support policy and freeing the Federal Reserve banks to bring about an anti-inflationary contraction of credit by increasing the discount rate, as was done in 1920. No such changes in policy should be considered. The financial world should rest easy that the investment market will not be subjected to the demoralization which swept over it in 1920 when the unsupported market for Government bonds fell about 20 percent below par.

"Affirmation of a policy of supporting the Government bond market as a continuing program of the Government requires the use of other and less dangerous methods to restrain inflationary bank credit. Voluntary but effective restraint by the banks of inflationary bank credit expansion may prove adequate to the problem. If it does not, more direct action by the Federal Reserve banks will be required. Such actions as may be taken will not involve withdrawing support from the Government bond market." (pp. 85-86)

In his Economic Report in January 1949, the President again affirmed his purpose to continue his debt-management policy, saying:

"The public debt will continue to be managed in a manner that will make a maximum contribution to the stability of the economy. An important factor in this program will continue to be the maintenance of stability in the Government bond market.

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"Only during the last few years have we had experience in dealing with the problems of managing a public debt of the size the country now bears. The policy of supporting the price of long-term Government bonds at the $2\frac{1}{2}$ percent yield level has been eminently successful." (p. 11)

The Council also discussed the debt-management policy and the problem of Federal Reserve power to influence credit conditions in its Annual Economic Review, forwarded to the Congress by the President with

his Economic Report of 1949, and set out its reasons for believing that it would be a serious error to change the policy and to adopt that which is now proposed by the Subcommittee (pp. 42-43). Earlier, in its own Annual Report to the President in December 1948 (pp. 27-28), in a discussion of the difficulties flowing from the need to adjust each economic policy to the conflicting requirements of others, the Council used the debt-management policy as contrasted with Federal Reserve credit control as an example. We said:

"Inflation is dangerous, and it is fed by our cheap-money policy. But it would be reckless to modify that policy by changes which might create uneasiness about the national credit and disorder in financial markets at a time when the nation must support a vast public debt."

These statements were made by the President and by the Council when they were frankly worried by an inflationary movement which they felt was creating serious danger to the economy. The issue is now raised by the Subcommittee when it sees no inflationary threat, and when the prices of Government bonds are well above the peg point of par, and may be expected to remain there unless the proposed reversal of the debt-management policy by Congressional resolution should itself create such doubt and uneasiness among the holders of Government bonds that we would face a wave of liquidation. Our apprehension on this score was expressed when we appeared before the Subcommittee. (Hearings, p. 537)

Purpose and result of debt-management policy. On page 26 of its report, the Subcommittee summarizes the five reasons advanced by Treasury and Federal Reserve officials for supporting the price of Government bonds even in periods of inflation. We think these reasons are valid and so cogent that they require that debt-management policy must be dominant and that we must look for other ways to restrain dangerous inflation rather than subordinate the debt-management policy to traditional central bank operations. The five reasons are largely included within the single point that the present policy maintains confidence in the public credit and makes it possible at all times for the Treasury to find buyers at low interest rates for new securities issued to refund our enormous public debt. The Subcommittee neither accepts, rejects, nor qualifies any of the five reasons, but of this one it says it "looms important to the Treasury." We believe that it is important in reality and not merely in appearance. We do not have a complacent attitude towards the problems of managing and refunding a 250-billion-dollar debt which has to be rolled over at the rate of 50 billion dollars each year.

Despite the drumfire of criticism which has been directed at the debt-management policy from certain financial quarters, the judgment of the President that it has been "eminently successful" is wholly justified by the record of the past five years. Our economy was unshaken by an immediate postwar slump which many now overlook, misled by the

fact that slow demobilization withheld millions of our young men from the labor market. It brought a decline of more than 60 percent in production of durable goods, a substantial decrease in nondurable production, and an increase in unemployment even when millions of war workers were withdrawing from the labor force. The policy made available abundant and cheap credit to business when it then endeavored to carry its share of the responsibility in the race with inflation by increasing productive capacity. It contributed to the conditions under which the expected flood of liquidation of savings bonds did not materialize, and sales of savings bonds have continued in large volume. It preserved a solid credit position for the Government when the great economic question arose whether the end of inflation would become the beginning of economic collapse. It has even added to the prosperity of some custodians of funds who disdain it but who would have wholly inadequate outlets for the swollen deposits created by the war if they did not know that they can safely invest in Government bonds because the market price will be supported.

Central bank controls. This is the record of the policy which the Subcommittee would now abandon. What is the record of the proposed substitute policy of flexible monetary and credit control by the Federal Reserve System, when we look to its service in establishing economic stability? The Subcommittee speaks of the desirable characteristics of central bank operations, and it is entirely justified in praising them for flexibility and because they are indirect and do not entail positive action by Government which limits the freedom of businessmen. But when it comes to considering their effectiveness in attaining the objectives of the Employment Act, the Subcommittee only says that we can draw no conclusions from experience because we have never really tried to use these policies to affect general economic conditions.

We do not read history that way. For 35 years, Federal Reserve discount rates have been shifted up and down. For 25 years the System has carried on open-market operations. Changes in reserve requirements have been one of the tools of control for more than a decade, and have furnished experience which persuaded the Council of Economic Advisers to support the judgment of the Federal Reserve Board that broader power to change reserve requirements would permit some effective anti-inflationary action by the central bank notwithstanding the debt-management policy. Experience has furnished very valuable guides to the way central bank power may be used to influence economic conditions, and in our opinion the lesson it teaches is that we must learn much more before the central bank can act with such finesse and with such confidence of the specific results of its action that we should consider the subordination to it of the policies of debt-management.

Repeatedly, in its discussion of this problem, the report of the Subcommittee speaks of the need for "vigorous" use of central bank power. We assume that it is meant that history furnishes no guide to action because central bank operations have never been vigorous enough.

If this also means that the writers of the report look to the Federal Reserve Board to interpret the proposed Congressional directive as an instruction to use its powers more vigorously in a future inflation than they were used in the past, the joint resolution would indeed threaten untold damage to Treasury operations. Before this war, the Board has only twice been called upon to consider action in a period of important inflation. In 1920, it ran the discount rate up to 7 percent. In 1929, it pushed the rate up until it reached 6 percent. The debate still goes on, whether the high discount rates caused the ensuing catastrophes or whether the economic collapse was in each instance due to forces which not even 7 percent and 6 percent discount rates could quell. But certainly the Reserve Board is not open to the criticism that it has not used its powers vigorously. If that record shows that even more violent effort would be necessary in order to make central bank operations effective to curb an inflationary movement, we believe the conclusion should be that these particular anti-inflationary devices are altogether too dangerous to justify giving to them the first place in the arsenal of weapons to gain economic stability, as the Subcommittee proposes in Recommendation I.

Fiscal policy. The admirable discussion by the Subcommittee shows, we believe, that fiscal policy is a far more powerful instrument of economic control of strong economic movements than is credit policy if the latter is confined within prudent limits. The effectiveness of fiscal policy will be greatly increased by the correlation thereto of policies relating to money and credit.

We are in general agreement with the views expressed by the Subcommittee about fiscal policy, and about the desirability of a tax structure which will yield a surplus in periods of high business activity, while leading to a deficit in periods of recession, when expenditures by the Government in excess of the amounts collected in taxes will furnish valuable support to the economy.

We are dubious, however, whether it will soon be possible to devise, as has been proposed in some quarters, a tax program which will so accurately match the requirements of our dynamic economy or will so well reflect the requirements of many patterns of inflation and deflation that once enacted it may be left unchanged except as programs of Government action are themselves expanded or contracted. We therefore agree with the views of the Subcommittee that the problem of flexibility in fiscal operations requires further exploration.

Formula Flexibility. One fiscal policy which was pressed upon the Subcommittee, but which it has not recommended, carries to an extreme the idea of "formula flexibility." Under it some preordained fiscal change, such as a decrease of 15 percent in income taxes, would go into effect whenever a certain degree of change took place in some prescribed economic index, say in the volume of unemployment, or the index of wholesale prices, or the index of industrial production. If one of the economic indicators suggested to the Subcommittee were selected as the one to sound the alarm, it would probably have been sounding off by the end of last June, and vigorous anti-deflationary action, such as reducing taxes or increasing Government spending, would automatically have come into effect. But the Council of Economic Advisers, even though we knew and said that conditions would become even worse in July, advised the President that there were factors outside of the statistical indexes which in our opinion meant a reversal of the business trend before the end of August, and we advised him to hold firm on taxes and to hold off on any program to increase Government spending. We now know, of course, that the formula plan would have rushed us into the wrong course of action last summer. We do not believe it should ever be a substitute for careful study of all of the conditions affecting the economy, and the making of plans which then appear to be appropriate to the particular kind of difficulties which require attention and which cannot be described in advance.

The Value of Cheap Credit. The difference in our position from that of the Subcommittee arises in part from a somewhat different view of the desirability of low interest rates. In the report of the Subcommittee it is said, and repeated, that low interest rates are generally beneficial, but it is proposed to yield that principle in periods of inflation and to use central bank operations to induce an increase in the cost of money.

Our view is that low interest rates are always desirable. In periods of inflation they have the undesirable collateral consequence of contributing to inflationary forces, but even then they have the economic advantage of facilitating the expansion of productive capacity which is the best road to stability. Where we differ with the Subcommittee is that we would not abandon the advantages of cheap money and use central bank operations to cause an anti-inflationary increase in interest rates. We would retain the advantages of cheap money and adopt other measures to curb the inflationary forces. In extreme cases, as in 1947-48, we would tighten the availability of credit by pressure upon bank reserves under the plan proposed by the Federal Reserve Board at that time, but would hold the resulting trend to higher interest rates with narrow limits.

Regulation of Instalment Credit. Another point not discussed by the Subcommittee is the regulation of instalment credit. The President has recommended that the authority of the Federal Reserve Board to regulate instalment credit be renewed, and the Council has already presented to