

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 15, 1948

To Governor Eccles

Subject: _____

From Woodlief Thomas

The attached speech by Under Secretary Wiggins is called to your attention. This is a particularly excellent statement of the interest rate problem, and I understand was given a lot of careful thought in preparation.

W.T.

Attachment

TREASURY DEPARTMENT

Washington

(Address by A. L. M. Wiggins, Under Secretary
of the Treasury, before the Academy of
Political Science at the Hotel Astor,
New York City, April 1, 1948.)

FOR RELEASE, MORNING NEWSPAPERS,
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FISCAL POLICY AND DEBT MANAGEMENT

My discussion tonight will be devoted primarily to debt management as a part of fiscal policy. Overall fiscal policy is concerned with the desirable amount and sources of Government revenue and the amount and uses of expenditures of the Federal Government, on the basis not only of financial but of economic considerations as well.

However, in actual practice, the amount of receipts is often determined as much by a consideration of what it is feasible to collect as it is by a broad consideration of consumer and business incomes and the amount of goods available for purchase. The total amount of the Federal government's expenditures is often determined by other than economic considerations. Our huge war expenditures were made in order to win the war and not because the economy needed them; and this is also true of the proposed expenditures for the European Recovery Program.

It was not deemed feasible nor desirable for total receipts during the war years to equal total expenditures. On the other hand, when national income and production are high, employment full, and inflationary pressures strong, economic considerations should control, so as to produce a budget surplus that may be applied toward economic stability and debt reduction.

The determination of the total amounts and the balance of receipts and expenditures of the Federal government that is most conducive to a healthy domestic economy should be the basic consideration of fiscal policy in peacetime.

The condition of the American economy since VJ-Day indicated a fiscal policy of seeking to keep expenditures as low as compatible with the discharge of our domestic and international obligations and of seeking to keep receipts as high as is consistent with a vigorously functioning private enterprise economy and a reasonable untaxed minimum standard of living for persons in the lower income brackets. These objectives continue to call for the maintenance of the present aggregate level of Federal tax revenues.

We would be blind to the stern realities of the hour if we failed to recognize that rapidly changing world events are generating new variables and new problems which will have a profound effect on our entire national economy and on fiscal policy. However, the limits of my time do not permit a discussion of tax policy nor questions of expenditures as basic

elements in the determination of fiscal policies. I shall limit my discussion to the area of public debt management.

The number one constant in the equation of debt management is a present federal debt in excess of \$250 billion. The importance of this debt is not merely its size but its proportion to the total of all debt, the impact of its management on all interest rates, the cost of servicing the debt, and proper provision for its retirement.

In the 1920's, the public debt, both Federal and State and local, amounted to a little over \$30 billion and was less than 20% of the total public and private debt. Today, the total public debt, Federal and local, is about \$270 billion and constitutes some 60 percent of the total of all debt. In the 1920's, Government securities constituted about 12 percent of the total assets of member banks; while today they constitute about 50 percent of total assets. In the 1920's, the rate of interest on the public debt was largely influenced by current financial and business conditions and the rate on private debt; whereas today, the size and the proportion of the Federal debt to the total of all debt makes it the dominating factor in determining interest rates on private debt and the return on investments. In the 1920's, the public debt was only about $\frac{3}{8}$ ths of a year's gross national product; whereas, in 1947, the public debt exceeded the gross national product for the year.

These figures and comparisons are unmistakable evidence of the importance of public debt management and of the compelling necessity for such management to be directed not merely to the financial considerations of Government itself, as important as they may be, but to the effect of such management on our entire economy. No matter how jealous we may be of the freedoms of private enterprise, nor how abhorrent to our concept of such freedom that control and management by central government may be, the hard facts are that the management of our large public debt is such a dominant factor in the financial and economic life of the Nation that it is imperative that firm control of debt management be exercised by the Federal government. This must continue as long as the public debt continues at its present relative size and proportions. However, financial and business leadership should be constantly alert and fully cooperative in seeing that the exercise of that power is, at all times, directed toward the broad objective of the national welfare.

In February, 1946, at the highest point, the total Federal debt, direct and guaranteed, was \$280 billions. Cash balances of the Treasury amounted to \$26 billions. The wartime interest pattern of the debt ranged from $\frac{3}{8}$ ths of one percent on 90-day Treasury bills to $2\frac{1}{2}$ % on long term Treasury bonds. The distribution of the debt was \$117 billions held by the commercial banking system, \$65 billion held by individuals, \$28 billion held in Government trust accounts, and \$70 billion held by other investors. For the remaining months of that fiscal year, to June 30th, 1946, there was a further deficit in the Federal budget of over \$1 $\frac{1}{2}$ billion. There was a growing inflationary pressure in our economy.

With these factors, the correct policy of debt management was clear. It was to utilize the excess cash balance beyond budget needs for the

retirement of the debt. The proper place for such retirement was in the commercial banking field. This policy was followed, with the result that by the end of December, 1946, when cash balances had been brought down to a peacetime working level, the total debt had been reduced by over \$20 billion, of which \$19 billion were taken out of the commercial banking system.

We then moved into the second phase of postwar debt management. From January 1, 1947, through June 30, 1947, there was a budget surplus of approximately \$3/4 billion. This represented the reduction of the public debt which it was possible to achieve during this six-month period from an excess of receipts over expenditures. However, during this same period, it was possible to reduce the holdings of the commercial banking system by \$6 billion through the application of this surplus, through the use of the proceeds from the sale of Savings Bonds to the public, and through the use of the excess of the cash operating surplus over the budget surplus. The inflationary pressures had increased during this period and, therefore, the economic objective of an anti-inflationary debt management policy was paramount.

For the fiscal year ending June 30th, 1948, there is an indicated budget surplus of \$7.5 billion. This surplus has been, and is being, used for debt retirement. The Treasury also will receive about \$1½ billion from the net sales of savings bonds and from other sources, making a total of approximately \$9 billion which will be available for the retirement of the marketable debt. During this period, inflationary pressures have continued high. Therefore, in the interest of stabilizing the economy, the use of these funds has been directed toward a reduction of bank held debt, with particular emphasis on the retirement of debt held by the Federal Reserve banks.

Offsetting the impact of this program to a considerable extent has been the non-bank selling of Government securities to the Federal Reserve banks and the inflow of gold. These factors have diminished the full anti-inflationary effect of the debt management policy this year. However, this policy has been of substantial effect on the credit structure, particularly on long term interest rates of private and municipal credits, and in encouraging a greater degree of caution in the lending field.

The present budgetary surplus as of the end of March is greater than the net surplus indicated on June 30th next. However, an excess of expenditures in the fourth quarter of the current fiscal year above receipts will reduce this amount to the \$7.5 billion indicated in the budget estimates. The deficit for this three-month period can be more than offset, however, with withdrawals from the Government's war loan deposits in commercial banks now approximating \$2 billion. These withdrawals, together with cash receipts from the sale of savings bonds and net receipts from trust funds, will be available for debt management purposes and will be used to continue the pressure on the money markets.

Throughout the current fiscal year, recognition has been given to the wartime artificiality of the low rates on short term Government securities. The task was to remove the rigidities of these artificial wartime rates

without serious disturbance to the money markets. Through the cooperation of the Treasury and the Federal Reserve System, the rates on 90-day bills were permitted to move up, beginning with the issue of July 10, 1947. Through the issue of 7/8th percent certificates on August 1st, 1947, for an eleven month maturity, an adjustment of the certificate rate was begun. These adjustments have continued until the 90-day bill rate is now approximately 1% and the one-year certificate rate is 1-1/8ths percent. The effect of these adjustments in rates has been consistent with the overall debt management policy of the past year.

I have indicated that the budget surplus has been the most potent weapon in debt management for the anti-inflationary objective. This leads to a brief discussion of the outlook for the fiscal year ending June 30th, 1949. We start with the President's budget estimate of a surplus for fiscal '49 of \$4.8 billion. In view of world conditions, we would be unrealistic if we failed to recognize the possibility that this surplus may be considerably reduced through increased expenditures. Furthermore, a tax bill has passed the Congress which, if it becomes law, will reduce the total revenues of the Federal government by more than 10 percent. Under this legislation, revenues during the fiscal year ending June 30, 1948, will be reduced by only about \$600 million; but revenues for the fiscal year ending June 30, 1949, will be reduced by about \$5 billion. Adding to this \$500 million, which will be paid out in additional tax refunds, the proposed tax reduction, based on present budget estimates, would convert the expected surplus of \$4.8 billion into a deficit of \$700 million.

Even on the earlier budget estimates, without consideration of reduced receipts that will result from the proposed tax reduction and without any consideration of increased expenditures beyond original budget estimates for military and economic preparedness, there is indicated no further budget surplus between April 1st and December 31st, 1948. The next period of substantial surplus will be in the first quarter of calendar 1949.

For the full fiscal year 1949, with the currently proposed tax reduction and without any net increase in expenditures, there will be a rise in the public debt of \$700 million, and the only funds available for debt management will be the cash receipts from trust funds and the receipts from sales of Savings Bonds in excess of the budget deficit. If, therefore, inflationary pressures continue through fiscal 1949, and if debt management policy is to be continued with an anti-inflationary objective, the ammunition will be severely limited. It is, therefore, highly important in the year ahead that a maximum effort should be devoted to the sale of Savings Bonds to non-bank holders, so as to provide the greatest possible amount of funds to be used in maintaining reasonable pressure on the credit situation.

Recognizing the strategic value of the sale of Savings Bonds to individuals as a dual purpose weapon against inflation that will divert cash from the spending stream and, at the same time, provide funds which may be used in retiring bank reserves and deposits of commercial banks, the Treasury Department is instituting a new and accelerated Security Savings Bond Campaign, beginning April 15th. Enthusiastic support for the program by industrial concerns, labor organizations, bankers, retailers, insurance companies, the entire advertising industry, and many others, assures an all-out effort.

I have used the President's budget estimates as the basis of all the figures I have given. Here and there, questions have been raised as to whether these estimates, in some cases, may be too low or too high. The answer is that all estimates of the future are necessarily estimates; they cannot be proven facts. They are as scientifically prepared as is possible, by as competent group of technicians as can be assembled, and are based upon all known facts and the judgment of those in the best position to form a sound judgment in the financial field, in the business field, and in Government. What the national income will be, what the personal incomes for the nation will total, what the national gross product will be between July 1st, 1948, and June 30th, 1949, is not a slide rule determination on January 1st, 1948. Yet a determination had to be made at that time of a base on which to estimate Government revenues for the period six to eighteen months in advance. With a Government budget equal to about 20% of total personal incomes and with the Government revenues determined largely by the total of such incomes, any variation in the base necessarily affects the actual revenue receipts. With many new factors continuously arising that affect the base, the surprise is not in how much the difference is between actual receipts and estimates but how little.

Revenue estimates for the fiscal year 1949 are based on personal incomes of \$200 billion for that period. This is \$3 billion more than the total for the calendar year 1947 and is \$11 billion less than the rate at which such income payments ran in the month of January, 1948. I am fully convinced that the base of \$200 billion is as realistic and as uncolored by desires or objectives as reasonable men, using all available material and the most scientific technique, can determine.

On the expenditure side, costs that are products of war and defense constitute 79% of the President's budget. There are few areas in this group where expenditures may be reduced, but, on the other hand, there appear to be potentials in which substantial increases may become the price of self preservation. In the other areas of the cost of Government, the American people have shown little disposition to deny themselves services that multiply the cost of Government. There are some areas in which economies may be, and are being, effected, but, so long as the American people demand of the Federal government vast operations and services, subsidies and guarantees, substantial reductions in the cost of Government cannot be had.

It has been suggested that, in order to improve the budget picture for fiscal 1949, the sum of \$3 billion for the foreign recovery program be earmarked and charged against the 1948 budget and credited to the 1949 budget. The result is merely a bookkeeping transaction that would not affect the time of receipt by the Government of a dollar income nor the time of payment of a dollar of expenditure. From the standpoint of debt management, there would be no effect at all.

In the field of interest rates, there is but a limited area in which debt management policy can operate. Present rates on long term Government bonds are practically at the coupon level of $2\frac{1}{2}\%$. During the months of March, April and May, 1947, there was an incipient boom in the bond market with heavy pressures on the long term rate. It was recognized, in the interest of our national economy, that it was undesirable for long

term money to become worth less and less. There was a demand for the issuance of new Government securities to meet investment demand. In order to meet this situation, the Treasury Department, over a period of six months, sold long term bonds from some of its investment accounts to a net amount of \$1.5 billion. In September, 1947, the Treasury Department offered a non-market G-type bond to institutional investors under a limited formula, resulting in sales of approximately \$1 billion. The effect of these operations was to take the pressure off the market and create the conditions under which prices declined and interest rates moved up. Thus was averted the boom market in long term securities.

Following this period, the market pressures reversed themselves and there developed instead an increasing downward pressure on prices and upward pressure on rates. The $2\frac{1}{2}\%$ long term rate was then stabilized through purchases in the market by the Treasury and the Federal Reserve banks. At present, there appears to be a relative equilibrium in the long term market.

It should be well recognized that there is no question of the financial adequacy of the Federal Reserve System and the Treasury to maintain the market and the rate and to buy all of the securities that may be required for that purpose. The total amount of marketable Government bonds with a final maturity date of ten years or more presently outstanding is only \$64 billion out of the total debt of more than \$250 billion.

There are several considerations that argue for the maintenance of the long term $2\frac{1}{2}\%$ rate on Government securities.

Whether this rate is the correct one in terms of long-range worth of long term money or not, it was the rate used in financing the war. That rate, and the market for securities based on that rate, and the liability of institutions that have acquired those assets based on that rate, have been integrated into the financial structure of both public and private institutions throughout the nation. Commercial bank holdings of Government securities are about seven times their capital funds; the holdings of Government securities by mutual savings banks are about six times their reserves. The holdings of Government securities by life insurance companies equal more than five times their capital funds. The average maturity of Government securities held by commercial banks is four years, by mutual savings banks is thirteen years, and by life insurance companies, fifteen years. Any rise in interest rates of Government securities, with a consequent decline in market value, would create a book loss against capital funds of these institutions, multiplied by the ratio of Government bonds to capital assets. A small rise in the interest rate of long term government securities would result in a market decline of all long term securities that would create a book loss on assets held by many such institutions equal to the total of their capital and capital reserves. While such book losses would not be actually sustained, the existence of such market valuation shrinkage in large proportions might threaten the stability of many institutions.

An aggregate of \$46 billion savings bonds are held by millions of individuals. These securities bear an interest rate to maturity from $2\frac{1}{2}\%$ to 2.9%. These bonds are payable upon presentation and demand. A

rise in interest rates would be a wholesale invitation for cashing these bonds and would undermine the confidence of the owners in their original investment.

The interest cost to Government on the public debt is \$5.2 billion per year, or \$100 million per week. This item represents 14% of the Federal budget for the fiscal year 1948. Unless there is a substantial reduction in the debt, the total interest cost will continue to rise. There are two reasons for this. One involves savings bonds. The interest rate on E Savings Bonds, if held to maturity, is 2.9 percent, but the interest charge on these bonds is carried in the budget on the basis of the actual accrual each year. The bracket rates for accrual are graduated and they run up to 4.76 percent. This top rate will be reached on the largest blocks of savings bonds outstanding during the next two or three fiscal years. Second, the continued accumulation of trust funds is invested, under statutory requirements, at an interest cost to the Government up to 4%. To the extent that these funds are used to retire short term, low rate securities, the interest cost on the total debt will rise. It is of considerable importance to the taxpayer that the interest cost of the debt be held to a minimum.

With interest rates on the Government debt the dominant factor in influencing all interest rates, any rise in long term rates on Government securities would disturb private business in its long term planning.

No one can predict today what the financing needs of Government may be in the years ahead. To destroy the integrity of the long term rate with which World War Two was financed would multiply the difficulties in any large scale financing that might be needed in the years ahead. Nor should we overlook the fact that, with the present debt, more than \$50 billion must be refunded each year.

It has been argued that long term interest rates should be allowed to seek their "natural" level. What is sometimes meant by the natural level is the determination made by the investment and money markets. But this use of the term "natural" adds little to the discussion, as the determinations made by the money market are, for the most part, merely reflections of the underlying credit policies of the monetary authorities.

However, monetary authorities are not omnipotent. In the long run, there is a real natural rate of interest, and a departure from this rate will collect its own toll. The natural rate of interest in this sense is that rate which is high enough to hold down the amount of capital formation to the currently accruing savings of the economy, yet low enough to permit the savings made at a high level of employment to be fully invested.

A too-low rate of interest will, in the long run, encourage more capital formation than can be financed by the current savings of the community. The difference will then be made up by an expansion of bank credit with a consequent upward pressure on prices sufficient to compress consumption enough to release the necessary resources.

On the other hand, a too-high interest rate will not permit as much capital formation as the real savings of the community would make

possible. As a consequence, the community will not secure the benefits of all the investments which it could otherwise have, and the labor and capital which would have gone into creating these investments will be unemployed.

It is necessary, therefore, that the monetary authorities recognize the long run economic limitations upon their powers.

It should be fairly recognized that if selling pressures by holders of long term bonds are offset by no substantial demand except that provided by the Federal Reserve System and the Treasury, the maintenance of the $2\frac{1}{2}\%$ long term rate will provide no flexibility for the use of long term rates as an important factor in credit control. This brings us back to the big constant in the equation, the size of the public debt, the cost of carrying it, its widespread ownership among millions of individual owners, and its preponderant proportion in the assets of commercial banks, savings banks, trust funds, insurance companies, and other institutions. These considerations must continue to control the determinations of public debt management policy.

In the short term interest field, there is some greater latitude. In that area, financial and economic considerations permit a reasonable adjustment of that rate up or down as the needs develop. It is a delicate mechanism with vast potentials and should be used with great prudence and keen understanding of the effect of every move.

In conclusion, I revert to basic considerations of fiscal policy as they relate to receipts and expenditures. Broad economic considerations should have first place. It is inconceivable that we would take the risk of placing on top of the inflationary pressures growing out of the financing of the war new inflationary pressures that will grow out of deficit financing. The dangers are too great. The alternatives are clear. We must either make up any difference between receipts and expenditures through further taxation or resort to the straight-jacket of rigid controls of our economy. Even with such controls, sound fiscal policy dictates that any deficits be financed through mobilizing the savings of the country, and particularly of individuals, insofar as that is possible. If resort must be had to the banks, the borrowing should be through short term, low yield obligations, such as bills and certificates, which would be appropriate both from the standpoint of the cost to the Government and their place in bank portfolios.

The task ahead in the administration of a sound and effective fiscal policy is not an easy one. To meet the current and the new situations that may develop, we shall need skill and wisdom. More than that, we shall need restraint on the part of the business and banking community, on the part of labor, on the part of Government, and on the part of the consuming public. And all of us will need and should seek Divine guidance.

In our efforts to provide economic stability at home and abroad and to utilize our resources for the high purposes of promoting world peace and world prosperity, a common sacrifice lies ahead to protect this Nation from any weakening of its economy and to guarantee that our great strength, which is the hope of mankind, shall be preserved.