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The so-called controversy — the mis-called feud — between the Treasury and the Federal Reserve System must be utterly baffling to the general public. As a writer in Fortune Magazine put it, it seems like a battle between two adding machines. Yet, next to defense, it is by far the most important question we face today. No armed strength we can muster will preserve our institutions if we allow them to be undermined by inflation.

What do we mean by inflation? To every housewife who goes to market it is painfully apparent in the rising cost of living. To every school-teacher, to every Government worker, in the Federal Government, in the States, in the cities, to millions living on retirement funds and countless millions more who are counting on their savings, to every individual who depends for existence on a fixed income it conjures up a nightmare of fear that the dwindling purchasing power of the dollar will reach a starvation level. To the churches, the universities, to the millions investing in insurance, it is a living threat to their security. And what about the pensions which Congress has voted for our armed forces — for our soldiers, sailors and marines who have been injured or crippled on the fighting fronts? What about the pensions for which labor has fought so hard? Are these pensions going to be just a mirage?

Every historian and every economist knows that inflation has been the great destroyer of the vast middle classes and of Governments. It has paved the way for dictatorship and overthrow of democratic institutions. It is a destroyer as evil as war itself. In the eyes of those who want to destroy democracy and the capitalistic institution, it is the cheap way of achieving their collapse. It costs the enemy nothing in lives or treasure. It is really the supreme folly for a nation to arm against threat of invasion from without and yet let this insidious invader bring ruin from within.

The first victims of inflation are those least able to defend themselves but even the shrewd, the speculator, the initiated who think they know how to hedge against its ravages, can be engulfed in the ultimate economic havoc. Surely after all these years of debate and exhortation no one is ignorant about its evils.

Yet the causes of inflation still seem to be but dimly comprehended, perhaps because economists talk about it in terms understood only by other economists, or perhaps it is because the words we use -- money, credit, bank deposits -- seem more mystifying than they are.

If one visualizes a pair of scales on which the amount of money available to buy goods on the one side is balanced against the amount of goods available for sale on the other side, it is perhaps possible to get a picture of what the economists mean when they talk about monetary stability. Perhaps the picture of what is meant by inflation becomes more clear if we imagine too much money demand on one side of the scales in relation to our capacity to produce goods available for sale on the other side. In that case the value of the money goes down, the price of the goods goes up. Conversely, if the amount of money demand on one side of the scales is too small in relation to our capacity to produce the goods for sale on the other side then the value of the money goes up and the price of the goods goes down. That is what we call deflation.

All that is simple enough. Obviously, the main purpose of Government must be to do all in its power to promote as ample a supply of goods as possible and to prevent an unbalance in money demand in either direction. What we face today with production larger than ever is still too much money in relation to the available goods.

What do we do about it? There is quite universal agreement that we should reduce the amount of money demand through taxation, for one thing. That, of course, is vitally necessary. What is not so well understood is that money demand is not limited to purchasing power arising out of current income. Money demand can come from three other sources. First, money in hand, cash and bank deposits earned in the past and not spent. If these are too large they will become active and upset the balance. Second, past savings invested in liquid assets. If these are cashed and the money spent they can inaugurate an almost indefinite spiral of inflation. Third, new money created through bank credit expansion. When these three additional causes of money demand go really berserk the stability of our society is endangered. All of them interact on each other and all of them impinge on the functioning of our banking system.

Basically, the source of our money supply is the banking system. And here again, while the economists know about it and can talk to each other in terms that are mutually understood, public understanding is limited. Most of us who have not had to delve into the subject are likely to suppose that the banker lends to other people the money that we deposit in his bank. That is not the case if we look at the banking system as a whole. The outstanding fact which is so little comprehended, even among bankers who are supposed to know about such things, is that the banking system creates money. They don't do it by having printing presses in their windows where you can see one-dollar, five-dollar, and ten-dollar bills turned out by the bale, but they do it just as

effectively by writing on their books a credit to this borrower or that which can be turned into currency or coin, if one wishes, but usually is passed from hand to hand by bank checks. Indeed, nearly all of the business of this nation is carried on through bank checks. The deposits in our banks constitute the overwhelming bulk of our money supply.

Still greater obscurity surrounds the subject of bank reserves and the relation of reserves to the creation of deposit money. And I do not propose to attempt to elucidate the complexity of this matter here and now. It is of the greatest importance, however, to know that the main source of the banking system's ability to create money is derived from these reserves. To oversimplify the matter, though the statement is broadly correct, banks can lend, roughly, about six dollars for every dollar of reserves that are made available to them, or to put the matter in reverse, they need obtain only one dollar additional reserve for each six dollars that they add to our supply of deposit money.

Now this means that reserve dollars are not just ordinary dollars. They have aptly been called "high-powered dollars". Why? Because they can be multiplied into some six times their amount. Now all of this is entirely right and proper and quite characteristic of banking systems in all modern and civilized nations.

On the other hand, let me say in passing that I don't want to be understood as endorsing a lot of things the bankers do. They pass resolutions against inflation but when it comes to supporting any public policy, or action, or law, that will stop them from contributing to inflation, they say, oh no, they can't do it. It is socialistic, or

it is undemocratic, or it is against States' rights, or it is something else that is most abhorrent. I am rather out of patience with the bankers at the moment, not individual bankers, but most organized banking.

But to get back to my theme. We have done a great many things here and there in the name of fighting inflation. We have frozen prices, or attempted to do so by issuing orders that they stay put, and we have frozen wages, or attempted to do so by the same means. I think it is pretty serious when we say to the working man that he may not ask for his labor what employers are able and willing to pay. The fact that we have adopted these heroic measures and that the country accepted them indicates how gravely it regards this menace of inflation.

Almost everybody in the country is conscious of something affecting his daily life and his pocketbook which he is told is for his own good to prevent inflation. One remarkable and most heartening thing about the American people is that they will endure, of course with accompanying complaints, very heavy burdens to defend the dollar -- and the heaviest of all burdens -- to defend their shores. But they want to know and they are entitled to know why their daily lives are being regulated by price controls, and wage controls, and rationing and all the rest of the accouterments of a regimented State, especially when the end and aim of all their efforts is to avoid just that kind of infringement upon their individual freedoms and liberties. It is dishonest if we ignore the most important factor of all in inflation, i.e., the money supply, and act as though it had very little or nothing to do with our problem.

The public has a remarkable understanding and acceptance and patience with blundering so long as confidence exists in the country's leadership. That includes this Congress. And the Congress has done a good job so far on taxation and in authorizing measures, often with great misgivings, that others sincerely believe will help to fight inflation. Nevertheless, I think the country as a whole senses the fact -- certainly they have been told -- that many of these measures do not get at the causes of inflation at all. They deal with the effects and try for a time to suppress them. I think the country is possibly ahead of the Congress in willingness to submit to still heavier taxation.

But the one great gap in general understanding is that this is not enough. The great gap in our defense is in the field of credit, that is, in the banking system itself. We have drained off, or are planning to drain off, through taxation, surplus money income, on one side of the scales but we have left the credit spigot wide open so that as fast as, or faster than, these taxes drain off the money or purchasing power, the credit spigot pours more credit dollars -- and they are the same thing -- back onto the scales.

To put it another way, it doesn't do much good to tax money out of our pockets -- to bring the scales back in balance -- if they are going to be over-weighted again by this open spigot pouring out credit dollars.

Then what must be done to shut this spigot down -- or shut it off until the scales are in better balance? And they are going to get

more and more out of balance as the available goods on one side dwindles because materials and manpower are being diverted to defense -- unless the spigot is shut off. We don't need more credit dollars today. We need less. It is often overlooked that the volume of money already created is more than ample to take care of all of the business, both civilian and defense business, now in prospect. To create more and more credit would be to pile inflation on inflation.

But how do we manage the spigot? We can require that people put up more cash for automobiles, household appliances, houses, or, for that matter, shares of stock -- and all of these things have already been done, and even tighter terms may be needed. Those so-called selective controls apply directly to borrowers and only indirectly to the lenders. What needs to be done at the same time is to curb the lender so that he will not lend someone else the dollars that formerly went into consumer credit. Well, for one thing, we can require the banker to carry more cash in his reserves -- that limits him somewhat -- and that, too, has been done virtually to the limit allowed by present laws.

There is another, even more direct way to curb the banker's appetite for more and more loans, and hence more and more inflationary creation of dollars. And this brings me to the core of the argument, or difference of opinion, or whatever you wish to call it, between the Treasury and the Federal Reserve System.

I must digress a moment to say that the Federal Reserve System came into being under the wise guidance of Woodrow Wilson and Carter Glass of Virginia. Save for those who have had to make a study of it, it seems



mysterious and remote from our daily lives. It is, in words that may be equally obscure, the American version of a central bank. And what, asks the average man, is a central bank? Again I shall not delve into the intricacies of central banking. Central banks are, in most countries, ancient institutions, but whether new or old they are vital to the business and economic life of a modern country. If the Congress, which was the creator of this form of American central banking, decided to abolish it tomorrow, another institution would have to be created in its place to perform the broad functions it performs.

Its major purpose and reason for being is, in simple words, to exert its powers and influence to keep the scales in balance -- to see to it that the country has enough money to carry on all its activities, in war and in peace, while at the same time striving to prevent creation of too much money in a boom or too little in a slump. It is a sort of money reservoir to provide what we used to call an elastic currency adjusted at all times to the needs of the community. And here I want to make it quite plain that when I speak of the needs of the community I do not mean the needs of the Treasury of the United States. There are some people who get confused on this point, who tend to identify the Treasury with the whole United States.

It can, within limits laid down by the law, increase or decrease the banker's reserves and thus provide him with fewer, or more, reserve dollars on which to build his loans and investments. It can do this by providing more or less reserves through its discount and open market operations or by changes in so-called reserve requirements.

Today the banker can get reserves, at will, by selling some of the Government securities he holds. He can sell them with perfect confidence that the Federal Reserve will buy them, if necessary, at a pegged price, possibly at a premium. When the Federal Reserve buys them, however, they pay for them with reserve dollars. They create new reserve dollars that feed the fires of inflation. It is equally true if businesses, or insurance companies decide to sell some of the Government bonds they hold and the Federal Reserve buys, the result is that reserve dollars are created in the banking system. It isn't necessary to follow the mechanical or technical operations involved in central reserve banking to grasp the all-important fact that the credit spigot that is fueling this inflation simply cannot be turned down or turned off as long as this source of new reserve dollars -- high-powered dollars -- remains wide open.

And what has this to do with the Treasury-Federal Reserve differences of opinion? It has everything to do with it. For the past decade the Federal Reserve System has stood in the market place -- the open market place -- as the residual buyer of Government securities. Residual buyer? Well, that simply means that if there are no other buyers, the Federal Reserve stands there and buys. It has a portfolio, or what is called an open market account, in which it puts the securities it thus has to buy. When the Federal Reserve Act was passed it was thought that they would only buy for this portfolio during depressions, on occasions when money was short, and that they would sell from it in times like these. In other words, that they would act as a balance wheel to counteract inflation and deflation, not to augment it. Yet today, after years of nearly continuous

inflation, there are upwards of \$20 billion in that portfolio or account, more than the entire national debt was in the late twenties. And today every security the Federal Reserve Banks buy furnishes reserve dollars -- high-powered dollars -- to the bankers on which they can build more and more loans. Now this is the royal road to inflation. It is the source of most of the inflation -- the higher cost of living -- which the country has already experienced in the past year. In fact central bank financing of this character has been the cause of the most disastrous inflations in history.

Then, one may ask, why on earth do the people who run this central bank stand there and deliberately feed inflation? I can't give a single or a simple answer to that. For one thing, it has to be understood that the people who run the central bank do not want any such thing to happen -- they don't like to or want to buy the securities. The only reason they do is because nobody else will. And why won't anybody else buy these securities which the central bank buys? Because possible purchasers think they have more profitable ways of using their money. The reason insurance companies, corporations, banks sell their holdings of Government securities is because they have more profitable uses for their money. In an inflationary period such as we are in there are always more profitable ways of using money than investing it in bonds that pay only a small rate of interest. In a depression it is just the opposite. But in the past year billions of Government securities have been sold, many of which the central bank has had to buy. Had to buy? Not exactly. The Federal Reserve

has not been directed by Congress to buy. There has been no important revision of the Federal Reserve Act since 1935 -- when the Federal debt was less than 30 billions.

Then why did they think they had to buy?

Today with a Federal debt of more than \$250 billions -- by far the largest segment of the entire debt of the country -- many people feel it is essential to maintain orderly conditions and a ready market in Government securities. There is a fair consensus on that. The central bank rightly attends to it as part of its function of contributing to healthy credit conditions. The difficulty arises -- and the differences of opinion -- from the fact that the Federal Reserve has been buying and continues to buy at a fixed price well above par for the long-term Government securities and at only narrowly changing prices for shorter term Government securities. If it did not buy at a fixed price, that is if it waited until prices fell to a point where true investors felt they had a bargain and would make the purchases, the obvious result would be that the prices of Government bonds would go down. If this happened the interest yield on them would go up. Investors instead of getting only 2-1/2 per cent or less might get 3 per cent.

Now I happen to think that there are innumerable investors, insurance companies, churches, universities, and other institutions, that would think 3 per cent was a fair return, a living wage which would enable them to carry on and pay their way and keep on hiring their ministers, and their professors. But when the return on their money is a good deal

less when prices are rising, and the cost of their operations is increasing, it is natural for them to sell some of their Government securities in order to put their money into higher yielding investments that will give them a living wage.

Then why doesn't the Federal Reserve let the prices go down a little and the interest yield up so that these true investors will buy and hold these securities instead of dumping them in the market place where they are like so much gasoline feeding the inflationary fire? Well, it is true of treasuries all over the world and it is the natural and proper concern of treasuries to want to finance the Government at as low a cost as they can. But the logical end of that policy is to ask, "Why pay any interest at all?" "Why not just have the central bank create the money for nothing?" No sanely managed treasury wants to go that far. Certainly our Treasury is not proposing any such course. But they have been insisting, and they are still insisting, on keeping the rates fixed. They point out that the cost of the public debt is already a large item in the budget and they, and various others, say that it is more important to prevent that cost from going up than it is to permit minor fluctuations in interest yields which, under present-day conditions, would not deter either the borrower or the lender.

So far as it goes their argument seems plausible. But it misses the point. The people who run the Federal Reserve believe, and I think they are right, that even a relatively small increase in the yield of Government securities would lessen the pressure and attract true investors.

They feel, and I agree, that the present return to investors who buy Government bonds is not realistic and that even if it cost the Government a good deal more to carry the debt, it would be worth it ten times over, or more, because it would hold down the cost of defense and the cost of living.

I want to explain right here that what I am talking about is the so-called marketable bonds, that is the kind of securities that are bought and sold in the open market. The E, F, and G Savings, or Defense Bonds, are not sold in the open market. You can cash them at values written into the contract at any time you wish. But unless you keep them until they are due and payable you take a penalty in the form of loss of interest. The E Bonds are the ones which are held by the great bulk of small investors throughout the land. They are very different from the Liberty Bonds of World War I which were bought and sold in the open market. What I am talking about here are the kinds of present-day Government securities which are bought and sold in the open market and are mostly held by the very large, and for the most part, sophisticated investors. These sophisticated investors, if they sell the marketable bonds today, not only get the full interest the Treasury originally promised to pay on these securities but, in the case of long-term bonds, they can sell them well above par or at what the bond brokers call a premium, and the Federal Reserve stands there to pay out high-powered reserve dollars to maintain that premium. It does not make sense to me for the Government to penalize the little investor and pay a premium to the big one.

The more one looks at it, the area of controversy, or difference of opinion, between the Treasury and the Federal Reserve over interest rates does not seem to be of epic dimensions except in its broader implications. It would seem that there can be, as indeed there must be, a meeting of minds and I venture to predict that there will be on a basis that will avoid extremes. I would say that the extremists are those who on the one hand would suspend all central bank operations in the buying of Government securities and let the market go wherever it will. Ideally that is all very well but practically it is out of the question and no one is seriously proposing it who holds a responsible job. Nor would those who run the Federal Reserve favor or permit panic conditions to develop in the Government bond market or conditions that would throw banks or other institutions into insolvency. On the other extreme, are those who advocate a rigid, iron-clad, inflexible pattern of pegged prices for Government securities. If such pegging were continued long, there would be no sense at all in the Government's issuing a variety of short and long-term securities with different interest payments according to their maturity. Any such rigid pegging would logically call for just one issue at whatever interest rate the Government chose to pay.

But the real significance of the difference of opinion cannot be correctly stated in terms of interest rates. The Federal Reserve people have made it emphatically clear that they do not care what the interest rate is so long as real investors will buy and hold Government securities.

What they want is to be freed from support operations which continue week in and week out, month in and month out, to feed high-powered reserve dollars into the market where inflationary pressures are rampant and where bank loans alone have gone up by 10 billion dollars since Korea. That is the whole objective of their determination to avoid being caught again in a harness of rigidly pegged rates. If one-half of one per cent, or even less, would lead the public to buy and hold Government securities, they would be more than satisfied. Of that I am certain.

There is a point between these two extremes where a reconciliation can and must be effected. The Federal Reserve is less extreme than either the Treasury on the one side or the critics of the Federal Reserve on the other. They occupy a sort of middle ground. My own views were expressed in the Report of the Subcommittee on Monetary, Credit, and Fiscal Policy of the Joint Committee on the Economic Report. I had the honor to be Chairman of that Subcommittee and Senator Flanders, together with Representatives Buchanan and Wolcott, joined with me in this statement:

"We recommend that an appropriate, flexible, and vigorous monetary policy, employed in coordination with fiscal and other policies, should be one of the principal methods used to achieve the purposes of the Employment Act. Timely flexibility toward easy credit at some times and credit restriction at other times is an essential characteristic of a monetary policy that will promote economic stability rather than instability. The vigorous use of a restrictive monetary policy as an anti-inflation measure has been inhibited since the war by considerations relating to holding down the yields and supporting the prices of United States Government securities. As a long-run matter, we favor interest rates as low as they can be without inducing inflation, for low interest rates stimulate capital investment. But we believe that the advantages of avoiding inflation are so great and that a restrictive monetary policy can



contribute so much to this end that the freedom of the Federal Reserve to restrict credit and raise interest rates for general stabilization purposes should be restored even if the cost should prove to be a significant increase in service charges on the Federal debt and a greater inconvenience to the Treasury in its sale of securities for new financing and refunding purposes."

I don't want to overstress or underemphasize the importance of making some adjustments in Government interest rates, which have a persuasive effect on all other rates, that will attract and hold the savings of the public. Within the admitted limitations of a so-called flexible policy, a great deal can be accomplished to shut off this spigot of too much money bidding for a diminishing supply of goods. That is the essence of inflation. The middle course I have in mind would be for the benefit of everybody in the United States and not for the benefit of any group or class.

One sometimes hears it said that this agitation about interest rates just reflects the perpetual pressure of greedy bankers for higher returns and hence more earnings. Such an allegation hardly squares with the conspicuous silence of the banking community, as such, in backing up those of us who favor more realistic and more flexible rates. It hardly squares with the frenzied resistance of organized banking to any additional or supplemental device for curbing their appetite for more and more loans. Perhaps the ultimate in the fury of attack was reached recently when the head of the American Bankers Association denounced as socialistic an increase in bank reserve requirements. And by the same token the height of suspicion seems to have been reached in some talk I

have heard emanating from banking circles that the Federal Reserve System's advocacy of somewhat higher interest rates is just a smoke screen to enable them to get Congress to clap on some other kind of curbs that will shut off the spigot of credit.

Another argument that pops up is to the effect that because the Federal Reserve ever since the beginning of World War II has been pegging Government securities except for some minor changes in short-term interest rates last year, there is no reason for it to change now, suddenly at this late date. Such an argument ignores the economic history of our times. When we entered World War II the events at Pearl Harbor froze us into the very low rates of interest then prevailing. For that was a time of great slack in employment and production. We had to embark overnight on a huge war expenditure and gigantic deficit. It was thought that we could not finance huge deficits on rising interest rates for Government bonds. When the war ended there were wide expectations of an immediate slump and when the postwar boom developed it was generally assumed that it would wear itself out within a reasonably short time. In retrospect, it is unfortunate that the Federal Reserve did not break out of its rigid shackles long before now. They reported to Congress repeatedly the dilemma they faced. They argued unsuccessfully with the Treasury for greater freedom of action. I think they should have fought even harder than they did.

But that is water over the dam. We are now in a period, and have been in a period for some years, of a balanced cash budget. So it is not the Federal Government and its running a deficit that is causing inflation.

The inflation is coming almost entirely from private deficit financing, from liquidation of existing assets frequently at a premium, and from too easy access to bank credit. The whole core and meaning of the argument for a higher rate now is to reduce as far as possible this incentive to dispose of liquid assets and to reduce the too easy access to bank credit which results in the creation of more and more money. Interest rates are a mere reflection of and not the end and aim of such a policy. That policy is to defend the dollar, to preserve its buying power, and thus to maintain confidence in our dollar and in our securities.

You can't fool the public long by artificiality. Confidence in the dollar and in Government securities is founded on public willingness to buy and hold such securities. It can only be undermined by central bank financing that eats away the value of the dollar. I have heard it said that all of this is old-world economics and that, in time, as there are fewer and fewer civilian goods available, people will not know what to do with their money and they will have to invest it in Government securities at present, or even lower, levels.

That is a weak reed to lean upon when bank credit is growing daily and adding more and more dollars to the money supply. Moreover, we are facing a defense period of indefinite length. We are facing rapidly mounting defense expenditures. Unless further taxes are enacted to cover these costs, we will be in for another period of deficit financing before long and again, as happened after Pearl Harbor, we will be faced with the problem of how to handle it.

That is why this controversy needs to be settled and settled quickly. Even if savings accumulate, they will not flow into Government securities unless basic confidence exists that our finances are in good order and that the value of the dollar will not diminish further. Otherwise, these savings will ferret out hedges against inflation. They will go into the black markets that are hard enough to control in wartime and far more difficult to deal with if we are to have long years of a defense effort.

Too many of the public think they were fooled once because the dollars they invested buy so little today. The fact is that the enormous store of liquid assets, of ready money, which the public holds today will not be so liquid if Government securities are not made the equivalent of cash, as they are under rigidly pegged rates. The fact is that much can be done to shut off the spigot by more freedom of action for the central banking authorities in their buying and selling of Government securities. This is a lesson that has been learned in other nations and learned the hard way in all too many cases. The fact is that there is no sure way to maintain public confidence in Government securities and in the credit of the United States Government other than to strive for a genuine, not an artificial, market for the obligations of the Government.

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