THE UNIVERSITY OF CHICAGO
CHICAGO 37 · ILLINOIS
DEPARTMENT OF ECONOMICS

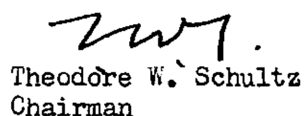
January 30, 1951

Mr. Marriner S. Eccles
c/o Mr. S. R. Carpenter
Secretary of the Open Market Committee
Board of Governors of the Federal Reserve System
Washington, 25, D. C.

Dear Mr. Eccles:

Permit me to transmit to you the enclosed statement on "... Monetary Policy" prepared and signed by members of the Department of Economics.

Very truly yours,



Theodore W. Schultz
Chairman

TWS:rm

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February 7, 1951.

Dear Mr. Schultz:

I appreciate your thoughtfulness in sending me the statement on "The Failure of the Present Monetary Policy" prepared and signed by members of the Department of Economics of the University of Chicago, in your letter of January 30. I have read it and I want to say that it is the best statement I have read on the subject.

There is only one point in the statement which I think you might clarify or improve, i.e., the part on page four wherein you say "This weapon has not been used effectively throughout the last ten years because the Treasury and the Federal Reserve System between them have been unwilling to let one particular price, the interest yield on government bonds, rise more than fractionally." The situation just prior to the war and during the entire war period up to the end of 1945 was one of very heavy deficit financing, requiring large purchases of government securities and the maintenance of a stable pattern of rates in order to assure the success of such financing. I did not approve of the long-term market issues which were put out during that period because of the easy money situation which existed at the beginning of the defense program and the low rate structure with which the Federal Reserve got stuck. As a practical matter I don't believe that substantial deficit financing can be successfully carried out on a basis of increasing interest rates; that is why it is so important that everything possible be done to avoid deficit financing and that the present interest rates be permitted to adjust to the market conditions at the earliest possible date, rather than be maintained by the Federal Reserve.

I have taken the liberty of using the statement extensively, and have sent it out to the members of the Senate and House Banking and Currency Committees, and of the Joint Committee on the Economic Report, a few other members of Congress, members of the Federal Advisory Committee, and a few friends — under a letter similar to the copy I am enclosing.

I want to commend you and your colleagues. Keep up the good work.

Sincerely yours,

M. S. Eccles.

Mr. Theodore W. Schultz,
Chairman, Department of Economics,
The University of Chicago,
Chicago 37, Illinois.

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C O P Y

THE FAILURE OF THE PRESENT MONETARY POLICY

Our purpose in preparing this statement is to show that the present monetary policy of the Federal Reserve is highly inflationary, that the monetary actions of the Federal Reserve since Korea have permitted the marked price rise which has already occurred, and that the Federal Reserve, presumably under the influence of the Treasury, is pursuing an ill-conceived policy that will interfere with effective mobilization of our economic strength even though taxes are increased enough to keep the federal budget in balance.

Prices are rising at an alarming rate. This rise is widely attributed to the armament effort, to the efforts of business firms as they get ready for military contracts, and to speculative purchases by businessmen and consumers in anticipation of further price rises. This explanation neglects the critical role being played by a misconceived monetary policy in permitting these armament and private efforts to produce a price rise. As a result of the monetary failure, the government is now committed to drastic measures in its attempt to control prices and wages which do not strike at the root causes of inflation and which impair the general efficiency of the economy and, also, affect adversely the armament effort.

Actually the production of armament is as yet a mere trickle. The recent price rises cannot, therefore, be attributed to expenditures on these. Neither can they be attributed to other expenditures by the federal government. During the second six months of 1950, the federal government took in substantially more than it paid out. The federal budget was, therefore, if anything, a deflationary rather than an inflationary force during this period. True, as armament expenditures rise, this situation will change unless new

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taxes are levied to meet the increased expenditures. Such additional taxes should be levied. But the recent price rises cannot be attributed to failure by Congress to enact adequate taxes. On the contrary, the willingness of Congress to impose new taxes has been the brightest spot in our economic policy during the last six months.

The expectation has been that there would be substantial armament expenditures in the future, that a wide variety of goods would be unavailable, and that there would occur future rises in prices. The expectation has given a strong incentive to businesses and individuals to buy now. The repeated threats by government of wage and price ceilings have further promoted price rises by serving notice on any groups that can exercise control over prices or wages to increase them before it is too late. But neither force could have produced a price rise together with full employment and a high level of output unless businesses and individuals had been able to get funds with which to finance additional purchases. Anticipations of future price rises could have been prevented from producing a price rise by a vigorous monetary policy designed to make credit tight, to prevent an increase in the quantity of money, or if necessary, to decrease the quantity of money in order to offset a rise in the rate of use of money

Instead of following such a policy, our monetary authorities have done nearly the reverse. They have provided additional reserves to the banking system, thereby making it possible for banks to expand both their loans and their deposits at an extraordinary rapid rate. The loans have provided the financial means for speculative purchases; the deposits have provided the circulating medium for the larger money volume of transactions.

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The consequences are written clearly and dramatically in the statistical record since Korea. From May 31 to the end of 1950, bank loans rose by nearly $10 billion or nearly 20 per cent. Adjusted demand deposits, the most active component of the money supply, rose by over $7 billion, or over 8 per cent. Currency outside banks rose only slightly, by about $0.5 billion, so that the total circulating medium rose by 7 per cent. This increase in the money supply was made possible primarily by Federal Reserve purchases of government securities. Federal Reserve holdings of government securities rose by almost $3.5 billion, or 20 per cent. Almost half of this increase was offset by a gold outflow, but nearly two billion was added to member bank reserve balances by the security purchases and other Federal Reserve operations. The resultant 12 per cent increase in reserves was more than enough to support the 8 per cent increase in demand deposits, so that excess reserves were actually more than twice as large at the end of 1950 as they had been seven months earlier.

With a rise of over 8 per cent in demand deposits, it is little wonder that personal income rose about 10 per cent, wholesale prices about 11 per cent, cost of living by nearly 6 per cent. It is no accident that these figures are so nearly of the same magnitude. This is about as clear a case of purely monetary inflation as one can find.

These are admittedly highly technical matters, which is one of the main reasons why, as professional economists, we feel it incumbent on us to call them to the attention of the public. They clearly are technical matters of the gravest importance. The price rise of the last six months could almost certainly have been largely or wholly avoided by effective monetary

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action. Indeed, prices would probably today be little above their level in May if the Federal Reserve System had kept its holdings of government securities unchanged instead of adding to them by $3.5 billion.

The Federal Reserve System has had ample legal power to prevent the recent inflation. Its Board of Governors are an able and public spirited body of men. Their failure to stop the inflation can be charged neither to impotence nor to ignorance nor to malice. Why then have they failed to use the means at their disposal?

The failure to tighten bank reserves since Korea is a consistent part of the financial history of the last decade. One cost of effective use of monetary measures to stem inflation is a rise in the interest rate on the government debt. The major weapon available to the Federal Reserve System is control over its holdings of government securities. Sales of securities produce a flow of money into the Federal Reserve System and out of currency in circulation and out of bank reserves. This action reduces the availability of credit to the public. This weapon has not been used effectively throughout the last ten years because the Treasury and the Federal Reserve System between them have been unwilling to let one particular price, the interest yield on government bonds, rise more than fractionally. They have preferred to hold this one price down even at the cost of facilitating a rise in all other prices. It is long past time that this short-sighted policy was abandoned.

These remarks are clearly of more than historical interest. The problems we have been facing during the last six months are unfortunately likely to plague us for a long time. A sound economic policy for this period should rest on two pillars: monetary policy and fiscal policy. It

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should use monetary policy to prevent the civilian sphere from adding fuel to inflation; it should use fiscal policies to offset the inflationary pressure of government spending. The need for fiscal policy, specifically, heavier taxation to match heavier expenditures, is fortunately by now widely recognized. The need for, or even the possibility of, using monetary policy is hardly recognized at all. Nor can we accept the dictum of the Council of Economic Advisers that "because of the needs of debt management, . . . general credit policy cannot be expected to be a major anti-inflationary instrument during the coming period of intensive mobilization." The prices at which the citizens of this country can buy goods and services are much more important than the price at which the government can borrow money.

The so-called "needs of debt management" have been magnified out of all proportion to their actual importance in economic policy. A determined policy to stop inflation will have numerous consequences, one of the least important of which would be a rise in the interest rate on government debt, a rise that would probably be moderate. But even from the narrow point of view of "debt management," the policy being followed by the Treasury is, to say the least, short-sighted. The nearly $35 billion of Series E bonds outstanding can be redeemed at the will of their holders. Further price rises that continue to reduce the real value of these bonds are almost certain to produce sooner or later a flood of redemptions of outstanding bonds, to say nothing about the effect of further price rises on the willingness of the public to purchase additional savings bonds. This outcome would raise far greater difficulties for "debt management" than a rise in interest rates.

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Monetary measures to keep down the supply of money have the great advantage that they operate impersonally and generally, affecting all alike. They do not interfere with the details of day-to-day operation, require no great administrative staff to enforce them, do not interfere with, but rather add to, the incentives to produce efficiently and economically. By preventing an expansion of credit, they assure that credit obtained to finance armament production is at the expense of credit for other purposes instead of in addition to such credit. In this way, they make the financial operations consistent with the physical operations. The physical resources for armament production must largely be obtained by diversion from other uses; they can more easily be so obtained if the financial resources are diverted as well.

Monetary policy cannot serve two masters at once. It cannot at one and the same time buttress a strong fiscal policy in preventing inflation and be dominated by the present misconceived cheap money policy of the Treasury. The necessity of making a clean-cut choice between these two objectives has been obscured by brave talk and rear-guard actions by the Federal Reserve -- the raising of reserve requirements, moral suasion of the banking fraternity, selective controls on installment and stock market credit and the like. These are all doomed to failure so long as the Federal Reserve System stands ready to buy unlimited amounts of government bonds at essentially fixed prices.

Our national security demands a major armament effort. This armament effort is bound to create inflationary pressure. We cannot afford to add to this inflationary pressure by an inflationary monetary policy. The Federal Reserve System should at once announce that it will conduct its

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operations with an eye single to their effects on the supply of money and credit and on the level of prices. It should at once begin to sell government securities to whatever amount is necessary to bring about a contraction in the currently swollen credit base. And it should persevere in this policy to the point that the inflation is checked even though one of its incidental effects is a rise in the interest rate on government securities.

Signed:

Milton Friedman
Lloyd A. Metzler

Frederick H. Harbison
Lloyd W. Mints

D. Gale Johnson
Theodore W. Schultz

H. G. Lewis

of the
Department of Economics
University of Chicago

(February 1, 1951)

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Statistics and Sources

1. Federal Government Cash Budget

	1950, second half (In billions of dollars)
Cash receipts	21.9
Cash payments	19.95
	1.95

Source: One half the annual rates given in Table 9, Annual Economic Review by the Council of Economic Advisers in The Economic Report of the President, January, 1951, p. 160 (hereafter referred to as Annual Economic Review).

2. Money and Credit Data, banks other than Federal Reserve Banks.

	End of May, 1950	End of December 1950
	(In billions of dollars)	
Demand deposits adjusted	85.0	92.1
Currency outside banks	24.7	25.2
Total circulating medium	109.7	117.3
Time deposits	59.5	58.9
Total privately held money supply	169.2	176.2
Loans (all banks)	51.2	60.8

Source: Annual Economic Review, Table A-28, p. 198, for all items except loans. May loans, Federal Reserve Bulletin, December, 1950, p. 1641; December loans, increase to November 29, from Federal Reserve Bulletin, January, 1951, p. 55; increase from November 29 to December 31 estimated on basis of increase for commercial banks shown in Annual Economic Review, p. 197.

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3. Operations of Federal Reserve System

	May 31, 1950	December 31, 1950
	(In millions of dollars)	
U. S. Government securities	17,389	20,778
Total credit outstanding	17,935	22,216
Gold stock	24,231	22,706
Member bank reserve balances:		
Total	15,814	17,681
Excess reserves	526	1,174

Source: Federal Reserve Bulletin, January, 1951, pp. 43-4

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Mr. Theodore W. Schultz,
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