

TO: MEMBERS OF CONGRESS, EDITORS,
BANKERS, AND ALL CITIZENS
INTERESTED IN SOUND FINANCIAL
POLICY.

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The Squabble

All this shooting between the Treasury Department and the Federal Reserve Board over whether we are going to have "cheap" money—that is, the rate that Government bonds will command—or higher rates as advocated by the Reserve governors—leaves the average layman with a cold feeling. He just doesn't understand what all the argument is about. We don't blame the taxpayer!

He's caught in a political whirlpool that has no place in an economic program dedicated to the nation's welfare. Even the boys downtown (the denizens of Wall Street who find it difficult to make ends meet) can only remark that many in Washington can't see the forest for the trees.

The tussle between the Treasury and "Fed" has been going on long enough. Unless Congress steps in and stops this farce, we are in for another round.

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Those who have not specialized in monetary theory are likely to find it a bit difficult to comprehend just what the controversy between the Secretary of the Treasury and the Federal Reserve Board is all about. In an endeavor to aid the average reader to understand the principal questions involved, Dr. Willford I. King, an economist who has long concerned himself with such problems, has prepared the accompanying analysis. We believe you may be interested in seeing what he finds to be the primary basis of the conflict.

Sincerely yours,



Sumner Gerard, Trustee

COMMITTEE FOR CONSTITUTIONAL GOVERNMENT, INC.

FEDERAL DEBT POLICY AND INFLATION

DEMAND DEPOSITS

In our United States, barter plays but a minor role in trade -- money or money substitutes being employed to pay for most goods that change hands. Pennies, nickels, silver, or paper money are commonly used to cover small purchases, but, when larger amounts are involved, the buyer usually settles by giving to the seller a check which transfers to the seller part of the buyer's checking account. The funds in these checking accounts are referred to in banking parlance as "demand deposits."

However, many a person gets a "demand deposit" without depositing in the bank any money, but instead by giving to the banker his note. In other words, demand deposits largely originate through borrowing from the banks. The more the volume of borrowing the greater is the volume of demand deposits in the nation. And, when debts are paid off, the volume of demand deposits shrinks.

CREDIT AND SPENDING POWER

The spending of the individual who does not go into debt is limited by his income plus his past savings. This same principle holds for all individuals taken together, and also for government. Furthermore, if

either an individual or government borrows from another individual, the gain in the spending power of the borrower is exactly offset by the loss in the spending power of the lender.

But the case is very different indeed when either the individual or the government borrows from a bank. Such borrowing increases the total ability to spend, for, when the bank lends, it exchanges its credit for the credit of the borrower. The latter is not freely spendable. By contrast the bank's credit is generally acceptable in payment of debts and therefore serves the same purpose as money; in other words, it furnishes part of the nation's supply of circulating medium, and, when created by borrowing, adds to the total of ready spending power in the nation.

CIRCULATING MEDIUM, TRADE, AND THE PRICE LEVEL

Experience shows, moreover, that, when other factors are unchanged, any increase in the spending-power total makes the general price level rise. Economists have found that the relationship between the supply of circulating medium, business volume, and the price level can be expressed by a very simple formula known as the Equation of Exchange. If M = the average number of dollars of pocket-

book money and demand deposits in circulation in the nation during a specified period.

V = the average number of times each dollar is used in the same period to pay for goods; V being therefore, the velocity of monetary circulation.

T = the volume of trade, in other words, the number of units of goods paid for in the given period, (a unit being the quantity selling for \$1. at the base date.)

P = the general price level, in other words the average price per unit paid for goods in general in the given period. Then clearly

M^V = the total number of dollars paid for goods in the given period.

PT = the total number of dollars received for goods in the given period.

Hence

$M^V = PT$ This is the equation of exchange. With the terms defined as stated, it must always hold true.

Evidently it can be transposed into the form

$$P = \frac{M^V}{T}$$

This form makes evident the fact that the price level varies directly with the total amount of circulating medium and with the velocity of circulation; and varies inversely with the volume of trade. Experience shows that V and T have a strong tendency to move up and down together, and that, therefore, P , the general price level, tends to vary directly and proportionately with M , the total quantity of money and demand deposits; in other words inflation of M tends to make the price level rise, and deflation of M tends to make the price level decline.

No practicable method of controlling either V or T has ever been discovered, but, since price fluctuations caused by variations in those two quantities are usually minor, they can be offset by manipulating M . It follows that the only simple and feasible way to control the price level is to regulate the size of M .

BORROWING'S EFFECT ON THE VOLUME OF CIRCULATING MEDIUM AND THE PRICE LEVEL

In the United States, M is made up mainly of demand deposits in banks. Hence, when either private borrowing or governmental borrowing from banks causes demand deposit

volume to increase, prices tend to rise; when either private parties or governmental authorities pay off their bank loans, M tends to shrink, and this brings about falling prices.

Since borrowing from anyone except banks cuts down the buying power of the lenders by the same amount that it increases the buying power of the borrowers, it has very little effect upon the total demand for goods—and hence upon the price level.

At present, the Federal Government owes to individuals and private non-banking concerns some \$113 billions, and to the banks some \$96 billions. The total volume of circulating medium in the United States, in other words M , is around \$120 billions. It follows that the Federal Treasury Department, by shifting debt from individuals to the banks, or vice versa, can influence the price level greatly. Suppose that, for example, it were to sell \$40 billions of non-negotiable bonds to the public and pay off \$40 billions of its indebtedness to the banks. This would reduce M by about one-third, and prices on the average would tend to fall by roughly one-third. On the other hand, by borrowing another \$40 billions from the banks and using the proceeds to buy bonds held by non-bank owners, it could raise the price level approximately one-third. By such shifting of the Federal debt from banks to other holders, or vice versa, the price level can, hypothetically be moved through a range so wide as to submerge completely any counter movements in T or V that might conceivably occur.

FACTORS LIMITING THE TREASURY'S FINANCIAL ACTIONS

Such being the case, why does not the Federal Government always use this method of regulating the price level instead of trying fruitlessly to control prices by multitudinous regulations? The answer is that shifting the Federal debt back and forth between bank and non-bank creditors is by no means a simple process. The banks do not care to accept payment until the Government's notes or bonds which they hold fall due. Furthermore, since the banks virtually manufacture the credit which they extend to Government, they may be glad to lend it for 2% per annum. By contrast private lenders, having to save to buy bonds, may demand 4%. Suppose, therefore, that the Secretary of the Treasury decides to cut the price level one-sixth by selling \$20 billions of savings bonds to the public and paying off

\$20 billions of the Government's bank debt. If he is compelled to pay an extra 2% interest charge in order to market the bonds, this will mean an extra \$400,000,000 of interest charges

be met each year, and, if the budget is to be kept in balance, will call for that sum in additional taxes. Since Congress is always loath to vote more taxes, and since the taxpayers are even more loath to meet the new levies, it is easy to see why the Secretary of the Treasury is anxious to hold down the interest rates paid by the Government on its obligations.

HIGHER INTEREST RATES VERSUS BORROWING FROM BANKS

Partly because of the espousal by Government officials of unsound economic theories, and partly because of the reluctance of the voters and their representatives in Congress to adopt a pay-as-you-go policy, our Government, for a score of years, has had chronic deficits, and has therefore had to borrow more and more. Doubtless, by offering higher interest rates, it could have covered all of its deficits by borrowing from non-bank lenders. But, to have placed in private hands the \$96 billions borrowed from banks would probably have cost the taxpayers between \$1 billion and \$2 billion per annum in additional interest charges. On the other hand, it would have prevented the doubling of the price level which has occurred -- a doubling which has cost the thrifty members of our population not less than \$200 billions measured in dollars of present purchasing power.

When Congressmen, fearing their constituents, fail to levy taxes sufficient to balance the budget, the Secretary of the Treasury must take on the unpleasant task of borrowing the money to pay Government bills when they come due. If interest charges run up, he must borrow still more to cover this additional cost. Under the circumstances, it is not surprising that the present Secretary, John W. Snyder, wanting to borrow as little as possible, insists on keeping interest rates low. To accomplish this end, he asks the Federal Reserve banks to buy any bonds which the Government cannot market at 1%. President Truman supports Mr. Snyder's request.

POSITION OF THE FEDERAL RESERVE BOARD

But the Federal Reserve Board members, knowing that the Federal Reserve Banks cannot

buy Government bonds without creating new demand deposits and thus inflating the currency, demur. They fear that Congress will not carry out the Administration's pay-as-you-go program, and that, as a result, the Treasury will be required to borrow huge sums. If this borrowing is from the banks, M^1 , the supply of circulating medium, will grow rapidly, the price level will shoot upward, and again the thrifty may be robbed of hundreds of billions of their hard-earned savings.

Moreover, the Federal Reserve Board members feel that they have been given by law the responsibility of keeping the nation's economy on a sound basis. They have found that, by putting restrictions on stock-market margins and installment sales, and by cutting the lending power of member banks by raising their reserve requirements, by reducing their credit balances in the Federal Reserve Banks, or both, the volume of member-bank loans, and therefore of the resulting demand deposits, can be reduced materially. Every such reduction cuts down the size of M^1 , or at least prevents its expansion.

They also know that another way of preventing inflation is to sell some of the bonds in their portfolios, thus retiring from circulation the money received and decreasing M^1 . But, if they are forced to buy from the Treasury the bonds which it cannot market elsewhere, their bond portfolio will increase -- not diminish -- and their efforts to stabilize the price level will be nullified.

Now we see why public-spirited citizens like John W. Snyder, Thomas B. McCabe and Marriner S. Eccles differ so radically on the subject of the maximum interest rates which the Government ought to pay on its bonds.

WHY NOT UTILIZE THE WIDESPREAD DESIRE TO TAKE A CHANCE?

Some years ago, former Congressman Samuel B. Pettengill, distinguished writer and publicist, suggested a very novel fund-raising program which if adopted, might enable the Secretary of the Treasury to enlarge greatly his sales of savings bonds without raising the interest rates thereon. A meritorious feature of the proposed plan is that it would stimulate the less thrifty members of the population to accumulate savings, by appealing to a widespread human trait -- the penchant for taking a chance -- a trait which, under present

conditions, leads mainly to want and misery. Here is an adaptation of Pettengill's original plan, given merely in outline:

1. The Secretary of the Treasury would be authorized by law to sell at \$5 each a series of 4,000,000 numbered lottery tickets. Each ticket would have a coupon attached. Four of the coupons would be exchangeable for a \$25 non-negotiable savings bond payable twelve years hence to the registered owner or to his heirs. The Secretary of the Treasury would take \$4.50 of the sale price of each ticket to pay for the bond, and would turn the remaining 50¢ over to the lottery for prize money.
2. As soon as 4,000,000 tickets were sold, a widely advertised drawing would be held announcing the distribution of \$2,000,000 in non-taxable prizes. The first prize might be set at \$250,000. This would leave \$1,750,000 to be distributed in a number of smaller prizes large enough to attract attention in communities throughout the nation.
3. Then 4,000,000 more tickets would be sold and another drawing would be held. And so on.
4. Presumably, this plan might induce many individuals to save 90% of the

hundreds of millions of dollars they now foolishly gamble away to their own and their families' detriment. The effect of this plan would be, first, to help the Secretary of the Treasury raise large sums at low interest rates from new private sources and, second, to induce thrift which would be a great benefit to all who participated.

THE OUTLOOK

Unfortunately, public prejudice against any legal approval of gambling may prevent adequate consideration of Mr. Pettengill's unique proposal. If so, the conflict between the ideas of Secretary Snyder and the Federal Reserve Board may continue, and time alone will tell which will win public support, and what will be the final outcome.

If the Government can approximately balance its budget, and if Mr. Snyder can actually market at 2½% enough savings bonds to make up any temporary deficit, he can claim the laurels. But if instead, he cannot sell to the public the required amount of such bonds but instead forces them upon the Federal Reserve Banks, inflation will result, prices will climb, and the Federal Reserve Board members can thereafter greet Mr. Snyder with an avid "I told you so!" And thrifty Americans will pay the piper!

You can help bring about better understanding of the problem confronting our national government and the Congress in preventing inflation, if you will distribute this statement to interested individuals. Write for 3 free copies, postpaid anywhere; 12 for \$1; 40 or more, 5¢ each. Ask for "FEDERAL DEBT POLICY AND INFLATION."

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