Draft

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Dear Senator Douglas:

In connection with my testimony presented on November 22 before the Subcommittee on Monetary, Credit, and Fiscal Problems of the Joint Committee on the Economic Report, I indicated that I had not attempted to include in my statement some other important matters which may be of interest to the Committee in its deliberations. You very kindly granted me the privilege of filing a supplementary statement should that appear desirable. Later in the course of my testimony you asked if it would serve a useful purpose if Congress were to instruct the Treasury further as to the policies to be followed in debt management where they are dependent upon the monetary policies of the Federal Reserve System. You also stated that you would appreciate it if you could get some suggested standards of an instruction that might be given to the Treasury by Congress with reference to Treasury relations with the Federal Reserve.

Since presenting my testimony I have given a great deal of thought to this problem, and I should like to take advantage of the privilege of making a supplementary statement which you extended to me at the hearing. The following is an expression of my views on this matter.

A very fundamental dilemma confronts the Federal Reserve System in the discharge of the responsibilities placed on it by Congress. The System has by statute the task of influencing the supply, availability, and cost of money and credit. In peácetime, the objective is to do this in such a way that monetary policy will make the maximum possible contribution to sustained progress toward goals of high employment and rising standards of living. Federal Reserve System powers for carrying out this responsibility are at present basically adequate. But the System has not, in fact, been free to use its powers under circumstances when a restrictive monetary policy is highly essential in the public interest. It has been precluded from doing so in the postwar period because of the large volume of Government securities held by institutions and persons who did not view them as permanent investors. Reasons for supporting the market under these conditions I have already discussed.

This policy of rigid support of Government securities should not be continued indefinitely. The circumstances that made it necessary are no longer compelling. But the Federal Reserve would not be able to change these policies as long as it felt bound to support debt-management decisions made by the Treasury, unless these were in conformity with the same objectives that guide the Federal Reserve. The Treasury, however, is not responsible to Congress for monetary policy and has a general easy-money bias under almost any and all circumstances. As long as the Federal Reserve policy must be based upon this criterion, it could not pursue a tight money policy to combat inflationary pressures.

Decisions regarding management of the public debt set the framework within which monetary action can be taken. As the size of the debt grew through the period of deficit finance in the 'thirties and particularly over the war period, Treasury needs came to overshadow and finally to dominate completely Federal Reserve monetary and credit policy. When the Treasury decides, as it has in the past, to finance at a low rate pattern during an inflationary period, the Federal Reserve is forced to defend that pattern unless the System is prepared to let Treasury financing fail, which it cannot do. To maintain a low rate pattern in an inflationary period, when there is a strong demand for credit, the System must supply Federal Reserve credit at the will of the market.

Under these conditions it can hardly be said that the Federal Reserve System retains any effective influence in its own right over the supply of money in the country or over the availability and cost of credit, although these are the major duties for which the System has statutory responsibility. Nor can it be said that the discount rate and open market operations of the System are determined by Federal Reserve authorities, except in form. They are predetermined by debt management decisions made by the Treasury. This will be true as long as the System is not in a position to pursue an independent policy, in effect vetoing in the market any program of financing adopted by the Treasury which is inconsistent with System objectives.

The Federal Reserve System was established by Congress primarily for the purpose of determining and carrying out credit and monetary policy in the interest of economic stability and is responsible to Congress for that task. There is a seven-man Board of Governors, including persons with varying backgrounds and points of view, appointed to serve the public interest. The Board is assisted by an experienced and highly qualified staff of experts. There are twelve presidents of the Federal Reserve Banks, each with a staff of specialists, and each Federal Reserve Bank has a Board of Directors composed of leading citizens in its district drawn from professional, business, farming, banking, and other activities. There is also the Federal Advisory Council, composed of a leading banker from each of the twelve districts, established by Congress to advise the Board. All of these supply information and advice and many participate in formulation of monetary policies appropriate to the needs of the economy.

Under present circumstances the talents and efforts of these men are largely wasted. Federal Reserve officials are not in all cases sought out for consultation by the Treasury regarding debt management policies before decisions have been reached. In connection with each financing decision, the System has made suggestions to the Treasury, but very often these have not been accepted. Decisions are made by the Treasury largely on the basis of its general desire to get money as cheaply as possible.

In a war period or a depression, there is reason for financing a deficit through bank credit -- that is, by creating new money -- and the Federal Reserve System has supported such financing at low rates by supplying the Federal Reserve Bank credit needed to accomplish it. In the early postwar period some support was necessary for the reasons I have indicated, but it should not have been as inflexible as it was. But the country is entering a year in which the outlook is for high employment and economic activity. We also anticipate, however, a Government cash deficit of over 5 billion dollars. It would be inexcusable to finance this deficit by creating new money at low rates of interest should inflationary pressures resurge. But if the Treasury continues to insist on cheap credit, and if the Federal Reserve is expected to maintain market conditions such as to provide it, we shall have to pump new money out into the economy even though it may be in the interest of economic stability to take the opposite action. If we must prostitute Federal Reserve credit to make an easy credit market for the Treasury, we cannot avoid creating cheap money for everybody. All monetary and credit restraints are gone under such conditions; the Federal Reserve is simply an engine of inflation.

With respect to the problem of how future monetary and credit policies are to be established, it seems to me Congress must choose among the following general alternatives:

(1) Congress can permit the present arrangement to continue. The Treasury can be allowed to control in effect the open market and other credit authority as it does now by establishing such rates and terms on its securities as it pleases, with the demand that the Federal Reserve support them. It should be recognized that under this course, limitations over the volume of bank credit available both to private and public borrowers, and accordingly limitation over the total volume of money in the country, are largely given up. Credit and monetary restraint may be required from time to time to promote economic stability, but any such restraint would be entirely dependent upon the decision on the part of the Treasury to pay higher interest rates on its newly-issued securities. If this alternative is followed, the Congress should relieve the Federal Reserve System of the responsibilities for credit policies and recognize that in that event the principal purpose of the Federal Reserve System would be to supply additional bank reserves on the demand of any holder of Government securities at rates of interest established by the Treasury.

(2) The Congress could provide the Federal Reserve System with a partial substitute for the open market and discount powers which debt management decisions of the Treasury now render useless

for purposes of credit restraint. Some measure of control over the availability of credit under inflationary circumstances could be regained if the System were given substantial additional authority over basic bank reserve requirements. With such authority, the System could, if necessary, immobilize new bank reserves arising from a return of currency from circulation, gold inflows, and System purchases of securities from nonbank investors and thereby restrict any undesirable expansion of the money supply. In addition, the System would need authority to require banks to hold a special reserve in certain Government securities. This would be essential in case banks should endeavor to enter upon an inflationary credit expansion through the sale of Government securities to the Federal Reserve or in event it was necessary to assist the Government in case of large-scale deficit financing.

(3) Congress, if it wishes credit and monetary policy to be made once again by the Federal Reserve System in accordance with the objectives of the Federal Reserve Act and the Employment Act of 1946, could direct the Treasury to consult with the System in formulation of its debt management decisions in order that these decisions may be compatible with the general framework of credit and monetary policy being followed by the System in the interest of general economic stability. It is obvious, of course, that Government financing needs must be met and the responsibility

of the Federal Reserve to insure successful Treasury financing would continue to be thoroughly recognized. Also the policy of maintaining orderly conditions in the Government securities market would be continued. But essential Treasury financing can be accomplished successfully within the reference of a restrictive credit policy, provided the terms of the securities offered are realistic in relation to market conditions.