


BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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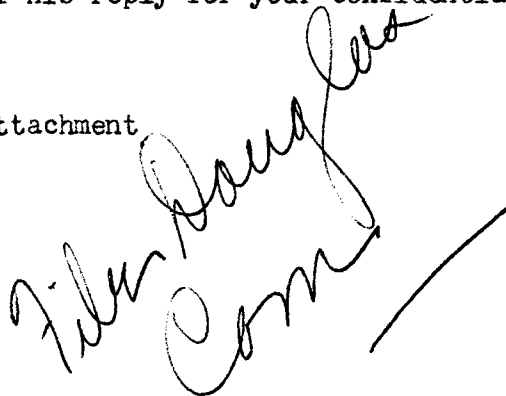
To Governor Eccles

Subject: _____

From Mr. Coleman 

You will recall that Senator Douglas asked Mr. McCabe, at the hearings on December 3, to give him his ideas in regard to a possible directive on Treasury-Federal Reserve responsibilities. Mr. McCabe asked me to send you the attached copy of his reply for your confidential information.

Attachment


William Douglas
Com

December 22, 1949.

CONFIDENTIAL

Honorable Paul H. Douglas,
Chairman, Subcommittee on Monetary,
Credit, and Fiscal Policies,
Senate Office Building,
Washington, D. C.

Dear Senator Douglas:

In the course of my testimony before your Committee, you expressed the opinion that it might be helpful if Congress were to give a definite directive of policy, perhaps one which both the Treasury and the Federal Reserve System might follow so that each would have due regard for the other's responsibilities in arriving at decisions on debt-management and monetary policies.

As you know, the primary declaration of policy, as expressed in the Employment Act of 1946, makes no specific mention of policy to prevent undue inflation. While the language of this basic declaration of Governmental policy puts the emphasis on promoting expansion, you will agree, I am sure, that only a superficial reading of the Act would justify the conclusion that it was intended to perpetuate inflationary pressures. As your comment recognized, the inflationary road leads to ultimate economic collapse and its attendant evils of widespread financial dislocation and unemployment. It is certainly implicit in the Act that what we actually seek as a basic objective of our entire society, whether Governmental or private, is steady economic progress toward constantly improving standards of living. Our purpose is clearly to avoid the extremes of severe inflation or deflation.

That is a fundamental concern, of course, of the Federal Reserve System. Its purpose is to exert as great an influence as is possible through monetary and credit policy toward the common objective of stabilized progress. The more I have thought about the subject since the hearings, the more doubts I have about the advisability of a more explicit directive than now exists, irrespective of where it is placed in the statutes.

I recognize, nevertheless, that it is useful to think in terms of such a directive even though none be embodied in the law.

The discussions concerning it put in focus the central question which is in your mind, as it is in mine; namely, how best to assure that debt-management policy, on the one hand, shall be consistent with monetary policy, on the other, without subordinating either the Treasury or the Federal Reserve System. If you choose to comment on this subject in whatever report you may make, it will, I feel, be helpful in the future in the relationships between the Treasury and the Federal Reserve.

This is a matter of institutional relationships. The question is not peculiar to the United States. It is inherent in the relationships of treasuries and central banks in all of the leading nations of the world. I still believe that the best solution will depend, in the long run, on the abilities, the vision and the leadership of the men who head these institutions, rather than upon some statutory language which, as I have emphasized before, is almost certain to be susceptible of sharply differing interpretations. If it is too precise it may prove more hampering than useful.

Your hearings have had the desirable effect of dramatizing again the vital importance of human relationships, not alone in dealing with the difficult problems which confront the Treasury and the Federal Reserve, but in other areas both in and out of Government. We are all aware, I think, of the difficulty, if not the impossibility, of bringing about merely by legislative enactment, solutions for complex present-day problems. This is true, for example, within the military establishment and in the adjustment of labor-management differences in the industrial field. This is a subject on which I feel deeply, based on my personal experience in industry and in various Governmental capacities.

Not only have these hearings put in much better focus the problems of debt-management and monetary policy, but to my way of thinking they have served to demonstrate that by building on the excellent personal relationships which exist today between the Treasury and the Federal Reserve we will pursue a path that gives far greater assurance of solving our problems in the light of what is best for this country than could be expected from adding to our legislative instructions. Above all, I think you have demonstrated again why it is so essential to seek men of the highest obtainable caliber to discharge Governmental responsibilities. That is why I have placed so much stress upon men, rather than mandates, and upon the need for authorizing a salary level for the Reserve Board that recognizes the importance of its responsibilities and its proper place in the structure of our Government.

The Problem of Specific Directives

Your question to me, which I will try to answer to the best of my ability, is as follows:

"Would it be possible for you within a couple of weeks to give us an opinion in writing as to whether or not you think such a directive could profitably be given and, if so, what you think you would suggest it should be?"

There is no difference of opinion on the part of the Treasury or the Federal Reserve that, on the one hand, monetary and credit policy is the responsibility of the Federal Reserve and that, on the other hand, debt management is the responsibility of the Treasury. It is clear as a matter of law that the Treasury has final authority to determine the types, maturities, and coupon rates of Government securities which are issued either for raising new money or for refunding purposes, while as a matter of law the Federal Reserve has final authority for regulating the availability, cost, and supply of money and credit.

This being the situation, there is nothing in the law to prevent the Federal Reserve and the Treasury from operating at cross purposes. A significant example would be the bringing out by the Treasury of an issue of Government securities bearing a coupon rate so low that the market would not take them unless the Federal Reserve supplied the market with additional funds. To do that, however, would have undesirable economic consequences at a time when the situation called for credit restraint. It is when anti-inflationary measures are in order that the problem envisaged by the Committee becomes most acute.

The crucial problem, for those exploring the possibilities of helping to solve it by means of a Congressional directive, is to devise a directive which will increase the prospect that monetary policy and debt-management policy will be harmonious, that both will contribute to the prevention or restraint of inflation at any time when this may become necessary, and that at such a time no lesser objective (such as keeping down the cost of servicing the public debt) will be permitted to stand in the way.

There are at least three or four different logical starting points for drafting a directive. Starting at these points various alternative drafts have been prepared and studied. The ones which follow seem to me to illustrate possible alternatives. The order of

their arrangement is not intended to indicate a preference on my part for, as I have said, the more I have studied the matter the more I am convinced that the dilemma — the problem of reconciling differences — cannot be satisfactorily resolved by a directive. For convenience of reference I am designating the alternatives as A, B, and C:

Alternative A (amending the Employment Act of 1946) - If it should be desired to put a directive in the Employment Act of 1946, as has been suggested, a way of doing so could be by amending the Declaration of Policy in that Act to read as follows (new matter underscored):

"The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare and so as to avoid or mitigate injurious inflation, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power."

Comment. - To insert in the 1946 Declaration of Policy some reference to avoiding or mitigating "injurious inflation" would make explicit, and therefore undeniable, what is now in the Declaration implicitly, notwithstanding the emphasis on expansionary policy.

Even if one assumes that the Declaration as thus amended would emerge unchanged from the gauntlet of controversy in and out of Congress, its generality, and the limitations with which the new language is surrounded are such as to raise grave doubts of its value for the purpose in hand. Even if such an amended Declaration had been in effect since 1935 I doubt whether it would have caused the policies of either the Treasury or the Federal Reserve to be any different during this period from what they actually were. Either agency could have found elsewhere in the language of the Declaration justification, if necessary, for policies pursued.

Alternative B (a directive with the stress on interest rates) - If it should be desired to give a directive to both the Treasury and the Federal Reserve, and to focus it on the matter of interest rates, one way of doing so could be to enact legislation reading about as follows:

"Pursuant to the general declaration of policy of the Federal Government in the Employment Act of 1946 the Treasury and the Federal Reserve System, in reaching decisions involving policies within the respective responsibilities of the Treasury for debt management and of the Board of Governors and the Federal Open Market Committee for monetary and credit policy, shall take into account the need for having at all times such general levels of interest rates as will be appropriate in the existing economic situation for restraining excessive expansion or contraction of credit and for maintaining sound banking and credit conditions."

Comment. - So far as the Federal Reserve is concerned, this would add nothing to the standards and limitations under which the System has long operated. The substance is in large part expressed, and for the rest clearly implied, in the Federal Reserve Act. However, the rule would explicitly direct the System to give primary consideration to general levels of interest rates which will be appropriate "in the existing economic situation". By implication, the System would be directed not to let its policies be guided by any lesser considerations.

At the same time, it would place the Treasury under legal obligation to observe the same general rule as the Federal Reserve, subordinating the objective of keeping down the cost of servicing the public debt to the broader considerations set forth in the directive.

I think such a directive would not only fail of its purpose but would also have undesirable consequences. With the best will in the world, the Treasury and the Federal Reserve might well differ as to whether, for example, an expansion in the volume of credit would in fact, at any given time, be "an excessive expansion" and as to what general levels of interest rates would be "appropriate in the existing situation." In these circumstances, the directive would not help the two agencies to compose differences. In fact, it might sharpen them, as it would enable each agency to affirm that its own view of any given situation had Congressional backing.

Alternative C (Directive with the stress on economic stability) - If it should be desired to have a directive which in general terms would stress economic stability and attempt to insure the predominance of this objective, one way of doing this would be to have legislation reading about as follows:

"Pursuant to the general declaration of policy of the Federal Government in the Employment Act of 1946, the Board of Governors of the Federal Reserve System and the Federal Open Market Committee, in the exercise of their responsibilities under the Federal Reserve Act to influence the supply, availability, and cost of money and credit, shall be guided primarily by the purpose of contributing to the maintenance of economic stability, and the Treasury of the United States, in the management of the public debt, shall pursue policies which accord with the market structure of interest rates as influenced by the monetary and credit policies adopted by the Federal Reserve authorities in the exercise of those responsibilities."

Comment. - This would reiterate the responsibility of the Federal Reserve for monetary and credit policy. It would explicitly make economic stability the overriding guide for such policy, to which debt management would be expected to conform.

In other words, under such a directive, the Treasury would be instructed not to expect the Federal Reserve to "make the market" for offerings of securities at such terms and rates as the Treasury might determine. On the contrary, the Treasury would be instructed to suit its offerings to market conditions as influenced by monetary and credit policy. This would be an attempt, as I see it, to return to theory as well as practice that prevailed in earlier times when the public debt was not the dominant factor which it is today in the country's debt structure.

It is most difficult for me to comment on a directive of this type so as to convey my real thoughts. In words and in form, it embodies in explicit language the position which we in the Federal Reserve System feel should prevail. It is the end toward which we are working. It is a statesmanlike formulation and I doubt whether the Treasury would take issue with it as an abstract statement of the problem. I cannot, of course, speak for the Secretary of the Treasury, but, in all my contacts with him, I have been impressed by his dedication to the welfare of this country and his desire to do all he can to strengthen the structure of the economy, and the soundness of its banking position. Certainly he is not unconcerned with the dangers of inflation nor, do I feel, would he desire to pass on to his successors a relationship between the Treasury and the Federal Reserve System that left the System less power and less initiative to combat inflationary situations that may arise in the future.

At the same time, I feel deeply that it would be inexpedient to inject language as explicit as is embodied in this directive into

the political arena of Congressional debate, and I would urge you in the strongest terms to refrain. It would be impossible in my judgment to keep the discussion in focus and to emerge with a situation nearer to the ends toward which we are both working. The problem of interest rates, historically, has strong emotional connotations. There is still a considerable body of opinion that questions their validity. I do not have to point out to you the type of controversy that has raged around the problem of usury. It is this emotional background that has conditioned at every turn, during these recent postwar years, the problem of "par support". Were it not for this background, the question of whether or not a given level of support prices was just above or just below parity would never have raised the almost electrical emotional tensions which it did, tensions sufficiently strong to impress every responsible official dealing with the debt, that under the circumstances that prevailed a level of support even slightly below par would release forces out of all proportion to the operational problems at issue, grave as they were.

We are still close to this background. If this problem were raised to a level requiring you and your colleagues in Congress to stand up and vote, they would naturally want to know what they were voting for as well as what they were voting against. The opposition would proclaim that they were asked to vote for high interest rates. I find it very difficult to imagine how we could keep such a discussion in focus. What we are really concerned with is flexibility in the interest rate structure, flexibility over a relatively narrow range. The discussion would tend inevitably to magnify that range to the point where unstable holders of the debt might wonder again whether they should not take cash while the taking was good, and it might well force us to issue clarifying statements that would stand as commitments and come to haunt us when prompt anti-inflationary action were really required.

I hope that you will ponder seriously what I have said. As you know, I have a sympathetic appreciation of your problem.

Concluding Comment

Judging by my own experience, the more one studies various alternatives the more he appreciates the difficulties of framing any new directive or mandate that could be expected in practice to have

Honorable Paul H. Douglas

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a constructive influence. A draft designed to meet one difficulty only seems to run against another, or even to create a new one. None of those here presented, at all events, would have my own recommendation. It would be my hope, however, that by having them before it for consideration, along with any others which may be suggested from one quarter or another, your Committee will be assisted in developing the kind of constructive report which you desire to present.

Sincerely,

Thomas B. McCabe,
Chairman.