

ROLE OF GOVERNMENT
DEBT MANAGEMENT - TREASURY/FEDERAL RESERVE POLICY

by Karl R. Bopp
before the
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Introduction: Need for perspective

- A. Interest in Treasury-Federal Reserve dispute when program was formulated
- B. Treasury-central bank differences not new in periods of defense and war

*Except possibly for quaintness of expression the following quotations describe wartime conditions in other countries and at other times as well as those in England during the Restriction period: *Parliamentary Papers*, 1819, Vol. III. Vansittart usually addressed the Governor and Deputy Governor somewhat as follows: "I beg leave to acquaint you, that it will be an Accommodation to the Public Service, if your Court will consent to exchange the Exchequer Bills dated . . . for a like Amount to be dated . . . I request therefore you will have the goodness to move your Court to consent to such Exchange accordingly." In the case of purchases (as contrasted with exchange) of bills, it was a "great Accommodation to the Public Service" or even a "very great Accommodation." Ordinarily the Court resolved to comply with the Chancellor's letters. Not infrequently, however, they imposed conditions, especially concerning repayment. For example, the Bank became increasingly concerned in 1814. They had agreed to purchase 8 million from May 5 to June 9. They agreed to a further purchase of 2 million on June 16 "on account of the urgent Necessity of Government, under the peculiar Circumstances of the Moment, and

also that so large a Portion of the said Advances is settled to be paid off out of the Instalment of the present Loan." Three weeks later they agreed to purchase another 2 million. "But the chairs to acquaint the First Lord of the Treasury and the Chancellor of the Exchequer, that the Court cannot grant any further Advances; and expect such Arrangements may be made as shall tend to a very considerable Reduction of the present enormous Amount of these Advances." Nevertheless, the request of July 28 for yet another 2 million "was Reluctantly complied with, under the Assurance that every Endeavour will be made to bring the Advances of the Court within reasonable Bounds as soon as possible."

(Footnote 29, p. 269 "Central Banking at the Crossroads", K. R. Bopp Reprinted from *American Economic Review Supplement*, March 1944)

- C. Existence of large debt not the fault of Treasury nor the central bank but of the Government
- D. Deficits and refundings must somehow be financed.
All debt must be held by somebody.
 - 1. Saving part of income
Saver replacing dissaver
 - 2. Create new money, or
 - 3. Activate existing money
- E. Role of debt management secondary to fiscal policy.
Analogue of compensatory fiscal policy is
compensatory debt management policy

I. Debt, Money and Spending

- A. What "monetizing the debt" means
- B. Implications of unlimited monetization at fixed terms
 - 1. Monetary authority loses control over supply of money
 - 2. Self-inflamatory expansion and contraction
 - 3. Relation to money market and private debt

II. Means of Regulating the Relation between Debt and Money

- A. Through varying the degrees of marketability
 - 1. Eligibility for bank investment
 - 2. Non-marketable issues
 - 3. Other variations
- B. Through varying terms in the market
 - 1. Variations in maturities
 - 2. Variations in prices and yields
 - (a) Pegged markets
 - (b) Orderly markets
 - (c) Free markets
- C. Forced saving

III. Recent Treasury-Federal Reserve Policy

- A. Beckoning Frontiers: Public and Personal Recollections of M. S. Eccles
- B. Postwar differences prior to Korean outbreak
- C. Open conflict - August 18, 1950
 - 1. New York rate increased from 1-1/2 to 1-3/4 %
 - 2. Snyder announces 13-month 1-1/4 % refunding note
- D. Joint announcement of full accord - March 3, 1951

IV. Conclusion

Relation of debt management and monetary policies to over-all problem of economic stability and growth

*Sent to Messrs X
Lewis & Clark on 8/6/57*

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Substance of Remarks by Karl R. Bopp,
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June 20, 1951

I have a hunch that this topic is up for discussion because it was a "hot issue" when your committee met to construct a program for this seminar. It is desirable, however, to acquire some perspective before discussing current problems of debt management.

As you know, neither the Treasury nor the Central Bank is responsible for the creation of Government debt. Debt arises when the Government spends more than its income. Although the Treasury and the Central Bank can give advice and make recommendations, it is the past and current decisions of Congress on expenditures and taxation that create the problems of debt management.

It must be obvious also that deficits and maturing issues must some-
how be financed. Another way of saying this is that all of the debt must be held by somebody or other. There are only a limited number of basic sources from which funds may be drawn. The first is through saving and investing part of current income in Government securities. The individual or institution who does this, in effect transfers part of his income for use by the Government. A second method is to purchase Government securities from past money savings. When this is done, money that would otherwise be idle is placed in the spending stream by the Government. Unlike savings from current income it adds to the current spending stream. The third method is purchase of Government securities by banks which adds to the current spending stream by increasing the total money supply.

The major problem of debt management is to adjust terms of new issues to secure funds from the sources that will help stabilize the economy. Such a compensatory debt management policy would be designed to secure funds from current savings in periods of inflationary pressures and from activating existing money or creating new money in periods of depression.

Perspective - that is, taking the longer view - is helpful also in appraising the relationships between Treasuries and Central Banks. It is important, of course, to keep in mind that both these institutions consist of human beings and that one would not expect all of these people to think alike. It may even be true at times that the difference between extreme views in either the Treasury or the Central Bank may be greater than the difference between the "average" or official views of the two institutions as a whole. With this qualification in mind, I think it is fair to state that Central Banks have commonly objected to the relatively easy money policies advocated and pursued by Treasuries during periods of defense and war. I have studied the history of central banking in a number of countries and could cite many illustrations from official sources to support this judgment. I do not want to create the impression that I think Central Banks have always been right when they have disagreed with Treasuries. Disagreements have also arisen in periods of crisis and depression. A number of illustrations could be cited from such periods in which it seems to me the Central Bank was wrong.

I suspect that the difference in judgment of the two institutions arises from the differences in their direct responsibilities. Once the expenditure and revenue programs of the Government have been legislated, the direct responsibility of the Treasury is to see that the financial needs of the Government are met. It is natural for the Treasury to feel a little bit surer if it can rely on the creation "of as much new money as may be needed." A Central

Bank, on the other hand, has direct responsibility for the total quantity of money and its influence on the flow of expenditures. I think that each institution recognizes the direct responsibility of the other. The difference arises from the relative emphasis placed on these two objectives in an over-all program.

Discharge of the mutual responsibility for economic stability involves means of regulating the relation between debt - especially Government debt - and money. Professor Whittlesey already has described the process by which debt may be monetized and demonetized. I shall not repeat that discussion but shall move directly into a consideration of several means by which monetization may be encouraged or discouraged.

The two general ways in which this may be done are through varying the degrees of marketability of securities and through varying terms of marketable issues. Logically there is yet a third method, namely, "forced saving", but this is a method of last resort that I shall not discuss.

The first method of impeding or preventing conversion of debt into money is to limit the marketability of the securities. This method has been used extensively by the Treasury. As you know, many of the long-term bonds issued during the war loan drives were made ineligible for bank investment. Some \$36 billion of currently outstanding issues are of this character. The savings bonds with which we are all familiar are non-marketable issues. At present more than \$57 billion of these are outstanding. Finally, approximately \$14 billion of investment series bonds recently issued in exchange for long-term issues are non-marketable.

Limitations on marketability while very important should not be exaggerated. For example, so long as non-bank investors hold very large amounts of bank eligible issues and additional issues become eligible with the passage of time, the existence of some issues which are not eligible for bank purchase may not limit adequately the monetization of debt. Furthermore, the savings

bonds though not marketable are redeemable at a sacrifice in interest and thus may in effect be monetised.

The second and more conventional method of impeding or preventing conversion of debt into money is through variation in the terms in the market. In any discussion of this problem it is desirable to keep in mind constantly a basic characteristic of any market. Crudely stated, this characteristic is that a central agency can control either the price or the supply in the market; but it cannot control both. The only way in which a central agency can control both is through the additional mechanism of rationing.

With this inherent characteristic of markets in mind, we are in position to discuss the three general types of markets that are commonly mentioned, namely, pegged markets, free markets, and orderly markets.

A pegged market is one in which unlimited amounts may be bought or sold at approximately fixed prices known in advance. To operate such a market, it is obviously necessary that some agency stand ready to take "the other side" of all transactions. For example, if a Central Bank desires to maintain fixed yields on Government securities, it must be prepared to purchase all the securities that other investors will not take at such yields. It pays for such securities with a check drawn on itself, that is, by creating new reserve deposits. It must also be prepared to offer Government securities to the extent that the market wishes to invest in them at the fixed yields. It receives payment for such securities ultimately in the form of reserve deposits. In other words, in the process of maintaining fixed yields the Central Bank loses control over the supply of reserves and money.

Unfortunately, the market outside the Central Bank is likely to be selling securities at the very time when economic stability would be promoted by

purchases, and is apt to be buying securities when economic stability would be promoted by sales. The reason in brief is this: the fixed yield is likely to become cumulatively less attractive with rising prosperity and inflation; it is likely to become cumulatively more attractive in depression. Thus the market outside the Central Bank tends to sell Government securities - and thus promote an expansion of the supply of money - with rising prosperity, and it is likely to purchase Government securities - and thus reduce the supply of money - in depression. Yet the appropriate monetary policy is just the reverse, namely, to limit the supply of money in prosperity and to expand it in periods of depression. Maintenance of fixed yield on Government securities also tends to obscure the risk inherent in private debt and thus to aggravate the problem of dealing with monetary expansion in periods of prosperity.

I can summarize this discussion of pegged markets by saying that unlimited monetization of Government debt at fixed terms tends to produce self-inflamatory expansion and contraction of the economic system.

It is tempting to believe that the way out of the dilemma of fixed markets is a restoration of free markets. We must, however, beware of appealing phrases. On this point I venture two judgments; first, that you men in this room could not agree on an operational definition of a free market, and second, that if you were to agree, the definition would contain "arbitrary" elements. One reason for coming to this conclusion is that the Federal Reserve System now owns more than \$22 billion of Government securities. Obviously some decision has to be made with respect to the disposition of these securities in defining a free market. I have heard it said that a free market will not exist until the Federal Reserve has liquidated its holdings. In answer I ask you to contemplate for a moment what would happen if the Federal Reserve withdrew \$22 billion from the money market. Either other assets of the Reserve Banks would have to

increase by that amount or liabilities would have to be reduced. The two assets that are germane to the discussion are gold and loans. I see no reason to suppose that gold would increase - particularly in the absence of cheap nuclear gold and the fact that less than \$22 billion of gold exists outside the United States.

A corresponding increase in loans might indeed take place, but I see no economic reason for calling a market free when it is controlled by loans and unfree when it is controlled by Government securities. The difference is one of method and not of principle.

We fare no better if we move over to notes and reserve deposits - the two major liability accounts. I see no reason why Federal Reserve notes - the folding money that we carry around in our pockets - should decline as the Fed liquidated Government securities. This leaves us with member bank deposits, which now amount to about \$19 billion. In terms of mere numbers, Government security holdings of the Reserve Banks are sufficient to wipe them out completely. I ask you, however, whether a definition of a free market that involves this possibility has meaning.

I hope I have said enough to demonstrate that such appealing and apparently precise conceptions as a "natural" or "free" market in Government securities become either woody or arbitrary or both upon analysis. One comes to the same conclusion if he analyzes the maturity distribution rather than the total of the System's holdings of Government securities.

We cannot solve our monetary problems once and for all. The problems themselves are constantly changing. We can but do our level best in meeting them. The point at which we have now arrived is neither a pegged nor a free market - however defined. It is what has been called an "orderly" but flexible market.

The purpose of a flexible open-market policy involving flexible, but not erratic, interest rates would be to promote economic stability by influencing

the flow of expenditures through adjustments in the volume, availability, and cost of reserves. The relationship between reserves and the flow of expenditures is not rigid or invariable. For this reason it is not possible to give a precise blueprint for the day-to-day administration of a flexible open-market policy. It is possible, however, to give some implications of such a policy.

Fundamentally, it implies the possibility of movement of both directions - that is, more restrictive as well as less restrictive - as circumstances warrant. This means that there would not be inflexible support at any specified level of prices. It does not, however, mean that the Government securities market would be abandoned to its own fate.

The day-to-day operations of the open-market account are influenced by the securities in the portfolio and also by market forces whose strength varies a great deal. For example, if investors sell securities because of panic or fear, the appropriate action may be for the System to purchase in order to allay that fear. On the other hand, if owners are selling in order to invest or lend elsewhere, the appropriate action may be to permit yields - long-term, short-term, or both - to rise and correspondingly to allow prices of securities to fall.

The System is interested in the volume of reserves not as an end in itself but as a means of influencing the flow of expenditures to promote economic stability. In my judgment, the most important way in which the System can make its contribution to stability is through operations in an orderly and flexible but neither a rigid nor a completely free market for Government securities.