

STRICTLY CONFIDENTIAL

*Second draft
2/7/51
To the Secy.*

I am very happy to have this opportunity of appearing before the Banking and Currency Committee in order to discuss with you the problems involved in the management of the Nation's finances.

The responsibility for the sound conduct of the Nation's finances is a very grave one. Since the earliest days of our history, this responsibility has been placed with the Secretary of the Treasury. But the problems involved are not my problems alone. They are not the problems of the Congress alone. They are the problems of every citizen of this Nation.

Here is the situation as I see it. We have today a public debt amounting to over \$250 billion. Not long ago we were worrying about a debt which might reach \$50 billion. We did not know how the country would be able to stand such a debt. We did not know how it would affect the solvency of the Government. We did not know how it could be managed without disrupting the financial life of the Nation.

But our public debt today is more than five times that figure. It is the most important single factor in our financial structure. It represents one-half of all the debt obligations in the country. Mortgages, state and municipal securities, corporate bonds, other private obligations -- all of them added together only equal the sum total of the present debt of the Government.

Life insurance companies now own over \$13 billion of Federal Government securities -- about one-fifth of their total assets. Mutual savings banks own \$11 billion -- about one-half of their total assets. Nonfinancial corporations own \$20 billion, or nearly 15 percent of their current assets. Individuals own \$67 billion of Federal securities of all kinds -- representing approximately one-third of their total liquid assets of more than \$200 billion.

Commercial banks hold more than \$61 billion -- representing approximately one-half of their earning assets.

Before World War II, the situation was entirely different. Financial institutions and business concerns had much more of their invested funds in private obligations. Only a very small proportion of our individual citizens were owners of the securities of their Government.

After World War II, the public debt was in a predominant position in the financial life of the Nation. The size, the importance, and the wide distribution of the debt are new facts to all of us. They create new problems. They place tremendous new responsibilities on the Secretary of the Treasury who is charged by law with the sound management of the Nation's finances. And under present conditions of international crisis and rising inflationary pressures, both the problems and the responsibilities are enormously increased.

Throughout the postwar period, as I have emphasized, the public debt was the most important single factor in the financial life of the Nation. But it has not been a disruptive factor. The problems involved in managing a public debt of over \$250 billion are unprecedented. But they have been successfully solved. During the postwar period the debt has been managed in such a way as to ease the problems of reconversion and promote our return to peacetime activity at the highest level of production and employment in history.

How was this accomplished? It was accomplished by means of maintaining stability in the market for Federal Government securities and by spreading the debt as widely as possible among the people of the Nation -- at the same time that bank holdings of Federal securities were being reduced.

The Treasury has been eminently successful in achieving these objectives. There has been no more dynamic period in our entire industrial history than

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the past five years. There has been no similar period in which such a large volume of long-range programs for increasing productive capacity and for modernizing existing plant and operations were put into effect. Stability in the financial markets was essential to these programs. But the maintenance of stability did not require absolute inflexibility in interest rates. As the economy itself began to function smoothly at a new high level of activity and trade, more flexibility in the Treasury debt management program was achieved by allowing short-term interest rates to increase gradually. With the outbreak of the crisis in Korea, however, the considerations calling for a high degree of stability in the Government security market once more became all important.

Likewise, the Treasury achieved great success in its program for increasing the proportion of Federal securities in the hands of nonbank investors and reducing bank holdings of Government obligations. In the last half of 1950, the holdings of nonbank owners reached a new postwar peak, while bank holdings, correspondingly, fell to a new low for the postwar period. This shift in ownership is of the greatest significance at the present time, since it acts directly on the money supply by reducing the inflationary potential of bank assets.

These results could not have been achieved if our people had not had full confidence in the ability of the Government to manage the debt without disturbance to the economy. They could not have been achieved if the citizens of the Nation had not had full confidence in Government securities -- and acted on that belief.

Today, with the enormously increased financial requirements of the defense program before us, it is more important than ever before that people hold on

to the Government securities which they now own. It is more important than ever before that they add to these holdings as their funds permit them to do so.

One of the obvious things that has to be done if we want people to hold on to an investment already made is to stabilize the price. During the present emergency, we must eliminate the fear that the owner or prospective buyer of an obligation of the Government is going to be penalized immediately by having the market price of his investment drop. Nobody who has any choice wants to hold on to a commodity that is going down -- that is being priced lower all the time. It doesn't take a financial expert to figure out the direct and immediate consequences of such a price decline on the personal finances of the security owner.

Let us make no mistake about it -- forcing up the interest rates on Federal Government securities means forcing down the price. It means slicing off a part of the investment which every owner of a marketable security has made in the obligations of the Government. It means that owners of demand obligations, such as savings bonds, may decide it is prudent to cash in their bonds -- to get their money out. There is little inducement to hold a fixed income obligation, like savings bonds, when the owners of other Government securities are getting increasingly higher returns.

Let me repeat again -- nobody wants a commodity that is going down in price. It is imperative that we keep the securities of the Federal Government attractive to owners and purchasers. It is imperative, therefore, that we keep the prices of these securities stable. We must avoid

every action which holds the risk of starting a rumor, a belief, or a fear that investment in Federal securities is not a good investment -- now or in the future.

These considerations are urgent at all times. With a Federal debt of over \$250 billion, interwoven throughout the financial fabric of the Nation, there is no period when we can afford to raise doubts as to the wisdom or prudence of an investment in Federal Government securities. Under present circumstances, however, when the money must be forthcoming for a greatly enlarged defense program, the considerations calling for a stable and confident situation throughout the whole broad structure of the public debt are magnified many times.

Because of the uncertainties of the international situation, we cannot foresee the full extent of the financial demands which may be made upon the Government. We know only that they will be very large. The Congress has already acted to increase the revenues of the Government. Further measures for a greatly enlarged revenue program are now being deliberated. I am faced with the fact, however, that our military spending is already rising at a rate which will result in a budget deficit of several billion dollars by the last quarter of this fiscal year. To the extent that additional revenue is not at hand to cover all of the Government's needs, we shall have to borrow. We shall have to increase our already large public debt.

Under any circumstances which we can foresee, there appears to be no possibility for some time to come of reducing the outstanding debt of the Government. This means that maturing obligations which come due must be refunded. Every holder of a maturing issue -- like every holder of a demand obligation, such as savings bonds -- may, of course, obtain cash for his

securities if he so desires. But the money to pay him will, in turn, have to be borrowed from someone else. During the remainder of this calendar year, for example, over \$50 billion of marketable securities alone must be refunded. This in itself is a tremendous financing operation. It cannot be conducted successfully without full confidence of the holders of the maturing obligations and of investors generally in the desirability and the wisdom of continuing their investment in securities of the Government.

These are the considerations which I must weigh if I am to fulfill my responsibilities for the sound conduct of the Nation's finances. In my view, they cannot be overemphasized. Questions and doubts as to the wisdom of investing in securities of the Government would lead to conditions of financial chaos. If these questions and doubts persisted to the point where important numbers of Federal security owners attempted to liquidate their holdings, irreparable harm would be done to the entire financial structure of the Nation.

Faced with these facts, and fully recognizing the public trust which is placed in me as Secretary of the Treasury, I cannot stand back while experiments affecting the public credit are being tried. Such experiments hold the risk of endangering the financial functioning of our Government and disrupting the financial life of the country at the very time when we must move swiftly, confidently, and surely in building up the defenses of our Nation.

The Federal Reserve has been pursuing a course of action during this period of international crisis which involves precisely this risk. The Federal Reserve has carried on a policy which has resulted in lowering substantially the prices of outstanding issues of Government securities. The

stated purpose of this program is to check credit expansion by raising interest rates.

First and foremost, this program -- as I have just said -- is dangerous because it takes the grave risk of upsetting the debt structure of the country; not only the debt structure of the Government itself, but the private debt structure as well. This would involve all of the difficulties which I have discussed.

I ask why we should take such a risk; why we should even consider actions which might impair the credit of the Government of the United States. Even if the expansion of bank credit could be completely stopped by this method, it still does not seem rational or reasonable to use this weapon, knowing, as we do, the risk which it involves. Why -- at a time when it is possible to maintain the Government bond market at a level permitting new issues to be offered at no change in interest rates -- should we use a weapon which lowers the price of the outstanding securities of the Government, seriously unsettles the Government bond market, and raises doubts which, if not quieted, could impair the Government credit?

In the second place, even if bank credit expansion were completely restricted, the battle against inflation would not necessarily have been won in whole or in part. The present inflation is not fed only by bank credit expansion. During the years since the end of World War II, there have, at times, been advances in prices when there has been no expansion in bank credit and currency holdings -- bank credit and currency constitute the money supply of the country. There have been other periods when the price level stood still or declined, although the money supply was expanding.

Why then should we use changes in the interest rate at all to combat inflation?

The stock answer to this question is that, in times of inflationary pressures, we must use all of the weapons at our disposal. It does not seem to me that this theory is appropriate. It cannot be called anything but irresponsible to use measures which have the distinct possibility of doing more harm than they do good.

The discussion up to this point centers around why I would be opposed to the Federal Reserve anti-inflation program, even if it could be demonstrated that this program would check credit expansion. But I am also opposed to the Federal Reserve policy because it has not been proved that it is an effective measure in restraining bank loan expansion and in fighting inflation. The evidence, on the contrary, is all on the other side.

The record of recent months clearly shows that the Federal Reserve actions in increasing interest rates have had no perceptible effect on credit expansion. Total loans of all commercial banks expanded nearly \$8 billion in the last six months of 1950 -- an increase of a magnitude which has never been equalled in this country. We have had other extreme examples of attempts to control bank credit expansion by interest rate increases in the past history of our country. In the 1919-1920 inflationary period, rates on short-term Treasury issues were run up sharply until they reached nearly 6 percent; and the rate on call-money went as high as 30 percent. In 1929, rates on short-term Treasury issues were run up to above 5 percent; and the call-money rate went to 20 percent. Yet, bank credit expansion was not effectively checked until we had the market crashes with which all of us are familiar.

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The demonstrable results of the Federal Reserve actions in raising interest rates are those which affect the stability of the Government security market and confidence in the credit of the United States. The Government security market has been seriously unsettled; and the resulting fear has restrained investors from purchasing or holding on to Government obligations. The actions of the Federal Reserve System also have brought about two failures in Treasury refunding operations. Finally, the confusion and fear with respect to the prices and yields of Government securities may even have weakened the appeal of savings bonds. During the last part of 1950, there was a noticeable decrease in the sales of the larger denomination savings bonds and an increase in redemptions of these denominations, which are ordinarily bought by the more "sophisticated" investors.

These are the controlling factors in my opposition to increases in interest rates on Government securities.

There is, however, another sure effect of the Federal Reserve actions in raising interest rates which I cannot ignore. I refer to the increase in Government expenditures which will be required to pay for the higher interest rates which we are now forced to pay upon new issues of Government securities. The Treasury is often quoted as being only concerned with this one aspect of increased interest rates. I am sure that I have made it quite clear to you today that this is not the case. Nevertheless, it is the Treasury's responsibility to recommend fiscal policy which will use the taxpayers' money wisely. There is never any defense for needless increases in taxes. I am sure that you agree with me that to use the taxpayers' money to pay for further increases in the interest cost of the public debt in an ineffectual attempt to control inflation is absolutely unjustifiable.

I believe it would be helpful to you in understanding the effects of the Federal Reserve's actions in raising interest rates on Government securities, if I spent a few minutes now discussing more specifically what has happened in the Government security market since the invasion of the Republic of Korea.

As soon as I received the news of the Korean crisis, I went over in my mind what this action would mean with respect to the finances of the Government of the United States. It seemed to me that if we were to keep the economy on an even keel during the period ahead -- if we were to prevent the defense effort from producing strong inflationary pressures and otherwise unbalancing the economy -- our first line of defense on the financial front was a stable and confident situation in the market for United States Government securities. You can see from the previous discussion why I reached this conclusion.

Accordingly, on the day following the outbreak of hostilities in Korea -- that is, on Monday, June 26 -- I had the Fiscal Assistant Secretary of the Treasury convey to the Open Market Committee of the Federal Reserve System, my feeling that "everything possible should be done to maintain a basically strong position in the Government bond market during the present period of international disturbance."

On July 17, I wrote at some length to Chairman McCabe of the Board of Governors of the Federal Reserve System, restating my feeling that stability in the Government bond market is of paramount importance because of the disturbed international situation and explaining my reasons in some detail. In this letter, I also stated that it was imperative that every financing operation of the Government be carried through to a successful conclusion.

On many occasions since then -- both publicly and privately, and directly to Chairman McCabe and other officials of the Federal Reserve System -- I have restated my conviction that stability in the Government security market is required.

As I have said, officials of the Federal Reserve System have not agreed with me that the situation calls for stability in the Government bond market. The System has ignored, in its actions, the fact that the Secretary of the Treasury, as chief fiscal officer of the Nation, has grave responsibilities with respect to the management of the outstanding obligations of the Government of the United States. The System has made it clear that, in its opinion, it has complete right to disregard entirely the wishes of the Secretary of the Treasury and of the President in managing the Government security market.

Although discussions of the differences between the viewpoints of the Treasury and the Federal Reserve on stability in the Government security market almost always start with the actions of August 18, the Federal Reserve -- right from the beginning of the outbreak of the conflict in Korea -- acted in a manner which unsettled the Government security market. Despite my requests for a program which would promote confidence in the Government's financial position, the Open Market Committee did not stop its program of weakening the market for Government securities by continuously putting pressure on long-term bonds. In the period from June 27 through August 18, the System sold \$1.1 billion of long bonds in 38 trading days.

My decision to maintain the 1-1/4 percent rate on the two issues of 13-month Treasury notes offered in exchange for the \$13-1/2 billion of Treasury bonds and certificates of indebtedness maturing on September 15

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and October 1 was no surprise to the Federal Reserve. This offering -- which, in accordance with the laws of the United States, had the approval of the President -- was in line with my policy of maintaining stability in the Government security market.

The terms of the issues announced on August 18 were identical with the terms of the issues offered in connection with refunding the certificates of indebtedness which had matured on June 1 and on July 1. Furthermore, the terms of the new issues were in line with the market on the day of the refunding announcement; and met the needs of the market which required a short-term security at that time. Nevertheless, the Federal Reserve, at the opening of trading on Monday, August 21, immediately proceeded to run up the rates on short-term securities -- that is, mark down the prices of these issues -- to levels wholly inconsistent with the rate on the refunding offering of the Treasury.

There has been a great deal of emphasis on the fact that the Federal Reserve had to purchase a large portion of the maturing issues in the September-October refunding operation in order to prevent the Treasury from having to pay off almost the entire maturities in cash. What has never been made clear is that this so-called "support" would not have been required if the Federal Reserve had not changed the market on the first trading day after the financing announcement. The refunding issues were priced in line with the market, as I have said; and the market would have responded to the refunding operation satisfactorily, if the Federal Reserve had not immediately changed the market pattern of yields on outstanding securities. The Open Market Committee accomplished this by lowering the prices at which it sold Government securities from its portfolio, thereby giving purchasers a higher rate of return than they would receive on the new issues offered by the Government.

Obviously, most of the holders of the refunded issues did not choose to exchange them for the new issues. A great many of them did their own refunding through the process of selling the maturing issues to the Federal Reserve System and buying back outstanding issues which were more favorably priced. Most of the remaining holders either sold their securities to the Federal Reserve and retained the cash, or turned in the maturing issues to the Treasury for cash. Less than 6 percent of the refunded issues were exchanged for the new issues by private holders. It is obvious, when one looks at the exchange experience, that the actions of the Federal Reserve in raising interest rates on Government securities made the refunding operation a failure.

I have noted that the September-October refunding was approved by the President before its announcement. When it became apparent that the actions of the Federal Reserve System were threatening to cause a failure in the refunding operation, President Truman -- personally and by letter -- requested Chairman McCabe to see that the actions of the Federal Reserve System were consistent with maintaining confidence in the credit of the United States and stability in the Government security market. The President was assured that this would be done. In the weeks that followed, nevertheless, the Federal Reserve continued to push up rates on Government securities.

While these events were taking place, it was necessary for the Treasury to undertake another refunding offering. The terms of the refunding of \$6 billion of certificates of indebtedness and bonds maturing in December

1950 and January 1951 were announced on November 22. Because of the actions of the Federal Reserve in the intervening period, a higher interest rate had to be offered than in August in order to price the new issue in line with the market. Holders of the December-January maturing issues were, accordingly, offered 5-year Treasury notes drawing interest at the rate of 1-3/4 percent per year. The new issue was in accord with the Federal Reserve recommendation; and Mr. McCabe assured me of the full cooperation of the System in the refunding operation.

The announcement was made on November 22. The following day was Thanksgiving; so that Friday, November 24, was the first trading day after the announcement was made. On that day, the Federal Reserve permitted the market to go off sharply; and further unsettled market psychology by dropping the price on the Victory Loan 2-1/2's by 2/32 during the day. This latter action was of particular significance because this issue is the bellwether of the long-term bond market.

As a result of the continued uncertainty with respect to the price and yield outlook created in the minds of Government security owners, the exchange experience in the December-January refunding operation -- while considerably improved over September-October -- was still far from satisfactory. Only 51 percent of the maturing issues were turned in to the Treasury by private holders for the new issues. Moreover, the cash redemption experience was only slightly better than in September-October. Cash redemptions amounted to 14-1/2 percent of the total of the maturing issues; in the previous operation they had amounted to 17-1/2 percent. This compares with an average on offerings of this type of a little over 5 percent in recent years.

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In addition to unsettling the Government security market by sharp mark-downs in the prices of outstanding Government issues, the Federal Reserve System continuously instigated rumors of further increases of rates on Government securities. This type of thing led to further doubt and confusion as to where the Federal Reserve System intended to take the Government market.

This "planned confusion," as it was called by one market commentator, was supposed to make banks hold on to their Government securities and refrain from expanding loans. What actually happened was entirely different. There was so much confusion and unsettlement in the market that investors were restrained by fear from holding on to Government securities. As a result, the Federal Reserve portfolio of Government securities increased by nearly \$2-1/2 billion between June 30 and December 31 -- the opposite of the effect the Federal Reserve actions were intended to have.

Although there was some pressure on the long end of the Government market, the events which I have just described affected primarily the short- and medium-term issues of Government securities. However, early in January, Mr. McCabe and Mr. Sproul -- President of the Federal Reserve Bank of New York -- outlined to me a program which would involve a complete reorientation of debt management policy. They proposed a program of further increases in interest rates, particularly in the long-term area. They also wanted me to put higher interest rates on savings bonds. It seemed to me, under these circumstances, that the time had come to settle for the duration of the emergency the matter of the rate on long-term Government bonds. Accordingly, I met with the President and Chairman McCabe to discuss the entire defense financing program. At this time it was agreed that market stability was essential and that, therefore,

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the 2-1/2 percent rate on long-term Government bonds should be maintained and that refunding and new-money issues should be financed within the pattern of that rate. This was immediately prior to the speech which I made on January 18, before the New York Board of Trade, announcing this policy.

As you all know, officials of the Federal Reserve System have publicly attacked this policy, despite the fact that Chairman McCabe had agreed to it before its announcement. Particularly Mr. Sproul and Mr. Eccles have strongly criticized the announced program. Moreover, subsequent to the announcement, the Federal Reserve System continued to put pressure on the long-term bond market. On January 29, the Open Market Committee again reduced its buying price on Victory Loan 2-1/2's. It was at this juncture that President Truman asked the Open Market Committee to meet with him, so that he could impress upon the Committee the need for stability in the Government bond market and confidence in the credit of the United States; and request that they govern their actions accordingly. You all know the results of this meeting.

For a full understanding of the program which has been pursued by the Federal Reserve since last June, it is important to note the source of the Federal Reserve's power.

In an act passed during the first session of the first Congress of the United States, the Secretary of the Treasury was given full responsibility for the conduct of the Nation's finances. This responsibility has remained with him since that time. The instruments which enable the Federal Reserve System

to assume this responsibility itself and to dictate the financial policies of the Government have fallen into its hands accidentally. They are the direct result of the great changes in our economy and in our financial life brought about by the increase in the public debt -- with an accompanying increase in the Government security holdings of the Federal Reserve System.

In 1913, when the Federal Reserve System was established, it was given permission by law to carry on transactions in the financial markets. This permission was thought of as an incidental part of its discount functions -- namely, as an incidental part of credit operations carried on between the banks and their own members. There was no thought and no possibility at that time that market operations could influence to any appreciable extent the financial policies of the Government.

For many years, such market transactions as were carried on by the System were conducted by informal groups or committees. In the middle Thirties, however, when the last major revision of the Federal Reserve Act took place, an agency for carrying on market transactions was established by law and was given full statutory authority to conduct all of the open market operations of the System. This agency was designated the Open Market Committee of the Federal Reserve System. It was made up of the seven Governors of the System, together with five of the presidents of the Reserve Banks. At that time -- as in 1913 -- there was no recognition that conditions might develop which would give this Committee the powers it now has to dominate the financial markets and to dictate the financial policies of the Government.

Between 1935 and the present time, the Federal debt has grown from \$33 billion to over \$250 billion. The Government security holdings of the

Federal Reserve System have grown from about \$2-1/2 billion to over \$20 billion. Because the public debt is widely distributed among institutional, business, and individual owners throughout the Nation, the Open Market Committee need use only a small part of its current holdings to change the interest rates and establish any price level it chooses for the marketable securities of the Federal Government. Because of the size of the public debt, this action in turn has the effect of a depth charge. It sets up repercussions which are felt throughout the entire economy.

As I have already emphasized, powers of this magnitude, if exercised without regard to the public interest, hold the possibility of irretrievably damaging the credit of the Government. They hold the possibility of driving nonbank investors out of the Government security market and forcing the Government to finance its needs by increasing resort to the banks -- the most inflationary type of financing which it would be possible to devise. I am certain that the Congress and the Nation will not wish to delay longer in removing the possibility of such a dangerous development during this critical period in the Nation's history.

I hope that I have succeeded today in dispelling the thought that there is any mystery about the steps which we must take if we are to finance our defense needs without harm to the economy. The problem is clear. Our course is plain. Let us now do away with futile theory and conjecture. Let us get on with our great task of building up our defenses by utilizing in full measure the strength, the vitality, and the power for growth of the American economy and the American financial system.