

William McChesney Martin, Jr., Papers

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Series IV, Subseries A

Reports, 1949-1951

Statement of Allan Sproul
President of the Federal Reserve Bank of New York
Before the Senate Banking and Currency Committee
May 11, 1949

You have asked me to testify on Joint Resolution 87 to extend the authority of the Board of Governors of the Federal Reserve System to exercise consumer credit controls until June 30, 1951, and on S. 1775 to provide supplemental reserve requirements for all insured commercial banks. I am in favor of the first of these proposals and, with qualifications, in favor of the second.

The question of whether control of consumer installment credit should be extended is part of a much broader question, namely, what you expect of credit control, as a whole, in terms of its contribution to economic stability at high levels of production and employment. I take it as established American policy that a principal means of Government intervention in the economic processes of the country is the administration of broad credit powers by the Federal Reserve System. By this means a pervasive influence may be brought to bear on our economy, without intrusion upon specific transactions between individuals, which is likely to be the consequence of more detailed physical controls, and which could spell the end of democratic capitalism as we have known it.

When the Federal Reserve System was established thirty five years ago, it was generally believed that this influence could best be brought to bear through overall quantitative credit controls. Such controls exercised by reason of our powers to lend or withhold reserve funds, to or from the banks of the country, and to raise or lower the price of our accommodation were the principal instruments of credit administration. They still are, although we now use open market operations in Government securities and,

at times, changes in reserve requirements, more largely than discounts and rediscounts, to make our policies effective.

Experience has taught us, however, that such quantitative credit controls need to be supplemented by qualitative credit controls in certain areas. A specific example is the experience of the decade of the twenties. We then found that even a vigorous use of general instruments of credit control might not prevent excessive expansion of credit in particular areas, and that this expansion might be dangerous to the whole economy. That experience led to those provisions of the Securities and Exchange Act, which gave the Board of Governors of the Federal Reserve System power to regulate margin requirements on security loans. I do not think you would want to revoke that power. At the present moment, I believe we can all be thankful that there has not been unrestrained speculation in securities during the post war years, and that we do not face the possibility of the liquidation of several billion dollars of credit in that area, at a time when deflationary tendencies are already in the ascendant.

Another specific example is in the field of consumer installment credit, with which you are now concerned. Here I must draw more on theory than on practice, because I do not think the war years were a fair test, and because the experience of the past year, since the power of the Federal Reserve System to control consumer installment credit was revived, is too brief to be entirely convincing.

I think it is generally admitted, however, that instability in our national economy may well be increased by our ability and propensity to purchase consumer durable goods on credit. In times of maximum production and

high employment, such as 1948, an unrestrained expansion of consumer installment credit can and will accentuate inflationary tendencies. It cannot increase production, but it can contribute to a spiral of price and wage increases. And in a period such as we are now going through, a swollen volume of consumer installment credit, which had to be liquidated, might well accentuate deflationary tendencies. With some slackening of business and some reduction of employment, the diversion of a large volume of current income to the repayment of old debts, could dangerously reduce currently available consumer purchasing power. I do not wish to be understood as condemning consumer installment credit, it is a necessary part of our financial machinery. But it operates in an area where special restraint may be necessary. In a sense, it is marginal credit in a particularly volatile part of our economy, and some measure of control over it is desirable.

Fortunately, it seems to me, that control can be exercised in a way which is consistent with our economic and governmental system, and which is administratively practical. The terms of the control can be made clear enough and precise enough to do the job, without interfering too much as between buyer and seller, and without trespassing upon individual determinations as to who is to get credit and who isn't. The concern of such regulation is the aggregate volume of credit in use in this field, as related to the general state of our economy, not the credit worthiness of the individual buyer or borrower nor the trade practices of the individual seller or creditor.

I have cited two specific examples of the need for qualitative credit controls to supplement our quantitative control powers. There is a further general argument for these powers, which may be more persuasive than either of the other two, at least to those who rebel against all special controls.

Our general control powers have been greatly weakened in recent years, by the emergence of a tremendous public debt, and the obstacle which that has placed in the way of a vigorous use of our general control powers. I am not going to argue here the case for our support of the Government security market. I think that support has had the approval of the Congress and the country. Otherwise you would have done something about it. But it has interfered seriously, during the recent past, with the use of the discount rate, open market operations, and even changes in reserve requirements -- which are the ordinary means of quantitative credit control - and it may do so again. If the scope of action open to the Federal Reserve System is to be narrowed by public debt considerations, and if effective credit policy is to be possible, we shall need to have the help of those supplemental instruments of control which are administratively feasible, and not repugnant to our economic system.

I believe the control of consumer installment credit, in the terms of this legislation, is such an instrument. I would prefer, in principle, that the authority granted to the Federal Reserve System to control such credit be made permanent. I recognize, however, that mine may not be the generally accepted view, and I can see advantages in a congressional review of such a new administrative power, at a prescribed time. The limit of two years which you have fixed is, I should say, the minimum to permit administrative development, without the handicap of undesirable reaction, by those controlled, to the possibility of early expiration of the authority.

When I come to S. 1775, relating to reserve requirements, I must repeat what I said about this legislation when it was being considered last year. I am not so clear about it as I am about extension of our powers to

control consumer installment credit. Personally, I believe that as a means of combatting short run or cyclical inflationary or deflationary pressures, increases or decreases in reserve requirements are, at best, pretty clumsy for effective and equitable use. At worst, or so long as the Federal Reserve System continues to bear responsibility for support of the Government security market at something like fixed prices, changes in reserve requirements are pretty futile as an anti-inflationary weapon, and not much better as an anti-deflationary weapon.

On balance, I come out in favor of the continuance of the present authority with respect to supplementing reserve requirements for three reasons. First, I believe that if the power is a clumsy one for the Federal Reserve System to use, it is an even clumsier power for the Congress to use. In other words, I do not think a reduction in present reserve requirements should be brought about by Congressional refusal to extend this authority. It should be brought about, when appropriate, by administrative action. If such action should be taken before June 30th, of course, this argument would fall.

My second reason is that there are occasions when an increase in reserve requirements may be an appropriate method of combatting a long term trend as distinguished from short term or cyclical fluctuations. Such a long term trend might be a renewed large inflow of gold to this country, such as occurred during the thirties when excess reserves of the banks were driven up to several billion dollars. You may remember that, in January 1941, in order to try to meet this situation, the Board of Governors of the Federal Reserve System, the Federal Advisory Council, and the Presidents of the Federal Reserve Banks, jointly urged that statutory reserve requirements for

demand deposits be increased to 26 per cent (central reserve cities), 20 per cent (reserve cities) and 14 per cent (country banks) and 6 per cent for time deposits; and that they further urged that the Federal Open Market Committee be empowered to increase reserve requirements to not more than double these percentages. Admittedly the situation which existed then does not exist now - the member banks do not have several billion dollars of excess reserves, and we do have large holdings of Government securities in the System portfolio which could be sold to offset a gold inflow. But it is not inconceivable that, at some future time, some similar need might arise.

Finally, I have a more fundamental bias toward the continuance of this authority. I again repeat something I said at your hearings last August.

"There may well be reasons, taking the long view, for an increase in the reserve requirements of the commercial banks of the country, and of the limits within which those requirements can be varied by the Federal Reserve System. I am inclined to believe that this could be a progressive step in our monetary-banking organization, especially if there should continue to be a persistent and substantial inflow of gold. With a modern central banking system operating in a highly developed deposit banking system, and with a decreasing reliance upon gold, much of the need for low reserve requirements and consequent economizing in the provision of money by commercial banks has disappeared. In these circumstances there may well be a balance of advantage in higher reserve requirements, as a means of reducing the dangerous expansibility and, at times, destructive contractability of a money supply based on low reserve ratios of commercial banks. There may be too great an element of leverage in our present system to be left at the disposal of 14,000 banks."

This is a long term improvement, not a short term device, however. It suggests a general overhauling of the present antiquated system of assessing reserves, not an immediate credit control program.

My suggestion, therefore, would be that you continue the present powers of the Federal Reserve System, as contemplated in S. 1775, leaving it to

administrative action to bring about whatever reductions in reserve requirements the present business and credit situation seems to require. Such a course can do no present harm, as I see it, may have some future usefulness, and should fit into the longer range consideration of the problem of reserve requirements, which I have advocated. The latter, I urge most strongly. I think it is high time that we shifted the basis of reserve classification from type of city to type of deposit. This is particularly so, if we are now going to bring within the apparatus of nationally fixed reserve requirements, thousands of insured nonmember banks. It would be too bad to perpetuate for long, with them, a reserve classification which was outdated at least as soon as the Federal Reserve System was established thirty five years ago.

When I make this statement, I assume that you are going to include nonmember insured banks in this legislation if you adopt it. It should be made applicable to such banks, not merely to members of the Federal Reserve System, if it is to be capable of having its maximum effect, if it is to be fair to the banks which are members of the System, and if it is to protect the System against unwarranted withdrawals from its voluntary membership. Whenever action is taken under this authority, you may be sure that it is in terms of the national situation and national needs. That means that all insured banks should feel its restraints, when restraint is necessary, and should have the encouragement of its relaxation, when relaxation is in order. That means that whatever temporary sacrifices of earnings and profits its use may entail, should be borne by all of the banks, and by the whole national community, which are the beneficiaries of the action taken. If the insured nonmember banks are now to be permitted to continue to avoid this

small share in national credit policy, I would let the legislation lapse, and await the outcome of the more fundamental study of reserve requirements which I have suggested.

STATEMENT OF CHAIRMAN THOMAS B. McCABE
OF THE
BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM

Before the Senate Banking and Currency Committee, May 11, 1949

In support of:

S. J. Res. 87, extending until June 30, 1951, authority to
regulate consumer instalment credit

- and -

S. 1775, providing authority to require all insured banks to
carry supplemental reserve requirements of 4 per cent
on demand and 1 1/2 per cent on time deposits.



ISSUED BY THE
BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM
WASHINGTON

**STATEMENT OF CHAIRMAN THOMAS B. McCABE OF THE
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
BEFORE THE
SENATE BANKING AND CURRENCY COMMITTEE, MAY 11, 1949**

Mr. Chairman and Members of the Committee:

I deeply appreciate the opportunity to appear before you today on behalf of the Board of Governors of the Federal Reserve System. We share a great responsibility. You as the representatives of the people have laid down the broad monetary and banking policies of the nation. We as your instrumentality are charged with the administration of these policies in such a way as to contribute to the maintenance of a high level of employment, stable values, and a rising standard of living. That is the goal set by the Employment Act of 1946. It is the basic guide for Federal Reserve System policy.

We are emerging from eight years of mounting inflationary pressures. During these eight years the public's total holdings of liquid assets nearly quadrupled. The physical volume of production, as nearly as it can be measured, expanded by only about half again as much as the prewar maximum. It was this great disparity between demand and supply which drove consumers' prices up to 75 per cent above prewar. When I testified before the Joint Committee on the Economic Report in mid-February I said, "Some easing of inflationary pressures has been indicated recently by marked declines in prices of various commodities, principally those that have risen most sharply," and I called attention to the fact that "over-all consumers' incomes and holdings of liquid assets, nevertheless, have continued at high levels and are fairly widely distributed." That is still the case today.

Last August when inflationary pressures were still mounting, you granted us certain supplementary powers to help cope with the situation. After Congress acted at the special session, the Board of Governors put to use the authorities which it had received. Regulation W was reissued establishing down payments and terms on consumer instalment credit more lenient than those that prevailed when the power lapsed the preceding November, but sufficient to exercise a

wholesome restraint on the rapid growth of this volatile credit. At the same time, the Board increased reserve requirements of all member banks by two per cent on demand deposits and by 1½ per cent on time deposits.

Later in the year the economic situation turned. In the interim, however, the Treasury and Federal Reserve System underwent one more severe test of their resolve to maintain stability in the market for Government securities. From September 1 to November 1 bonds in the amount of 3¼ billion dollars were purchased to carry out this policy of stability.

In retrospect, I am certain that our action in support of the Government securities market was the right one. That program was a gigantic operation. In the two years 1947 and 1948, the System's total transactions in Government securities amounted to almost 80 billion dollars. Despite this huge volume of activity, the net change in our total portfolio was relatively small. I am convinced that we could not have abandoned our support position during this period without damaging repercussions on our entire financial mechanism as well as seriously adverse effects on the economy generally.

Since the peak of inflation in November, there has been a significant readjustment in the economic situation. You are familiar with the general features of this readjustment, but I should like to review them briefly.

With the passing of the inflationary crest we acted promptly to relax credit restraints. Four major steps were taken:

1. On March 2, the Board announced a relaxation of the consumer instalment credit regulation.
2. On March 28, the Board reduced margin requirements from 75 to 50 per cent.
3. On April 22, the Board further relaxed Regulation W, making the maximum maturity 24 instead of 21 months across the board, reducing the down payments on all articles of furniture, appliances, etc., covered by the regulation from 15

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to 10 per cent, while retaining the one-third down payment on automobiles. All articles costing less than \$100 were exempted. Previous exemptions had applied to articles costing less than \$50.

4. On April 28, the Board reduced reserve requirements for all member banks, the effect being to release approximately 1¼ billion dollars of required reserves.

It has been of great help to us to have the benefit of close cooperation with this Committee, and with the Banking and Currency Committee of the House.

Before coming to decisions on all matters of policy, the Reserve Board has the inestimable advantage of being able to communicate with and obtain factual information, as well as opinions, from the twelve Federal Reserve Banks and their twenty-four branches throughout the country, on whose boards are more than 250 directors, drawn not only from banking but from the widely diversified industrial, commercial, agricultural, and professional pursuits of the nation. The directors, the officers, and staffs of the Reserve Banks and the Board, the Federal Advisory Council, and the member banks comprise the Reserve System which, as I have often said, is like a vast pyramid, whose breadth and strength is in its base. The Board has constantly available current information, drawn from this great System to supplement the vast mass of factual and statistical data gathered through other governmental sources. Moreover, the System sponsors special studies as occasion demands. In addition, we are always at pains to consult with representative businessmen, the small as well as the larger ones, with trade associations and, in fact, with all who are affected by System operations. We try to weigh carefully their views and to distinguish broad national considerations from those reflecting narrower interests. I mention these myriad sources of information to emphasize that we do not function in a vacuum.

We do not wish to exaggerate the role which monetary and credit policy has played in the period from which we are now emerging. It is fair to say, however, that in the last year of upsurge especially, it exerted some restraining influence. We think we may fairly say that we used the powers which Congress entrusted to us flexibly, and that we have made an earnest effort to take into account every relevant fact and circumstance, including

the hardships or inconveniences imposed on those subject to regulations and requirements.

We can all take satisfaction from the fact that the many banks of the country are on a more secure foundation now than ever before in our history. The bankers themselves, as a result of their voluntary efforts to restrict loans in the face of strong inflationary pressures, deserve a great deal of the credit for this condition. At the same time, we must recognize that our existing banking strength is in part the product of national economic and financial developments since the mid-thirties. Today our commercial banks, with about 50 per cent of their total loans and investments in Government securities largely acquired as a result of war finance, enjoy an exceptional unprecedented liquidity. Their capital accounts, while not yet at a desired level in relation to deposit growth since prewar years, are over 50 per cent greater than before the war, representing in large part a steady plowing back of earnings.

Not only do our many unit banks possess unusual strength, but the Federal Reserve System, as a result of the Banking Act of 1935, is in far better position than ever before to assist member banks, and through them all banks. Its greater experience enhances its ability to meet the credit needs of a time when surpluses rather than scarcities prevail and private enterprise requires encouragements rather than restraints.

In his Economic Report to the Congress last January the President pointed out that the monetary authorities should at all times be in a position to carry out their traditional function of exerting effective restraint upon excessive credit expansion in an inflationary period and conversely of easing credit conditions in a time of deflationary pressures. He asked that Congress provide continuing authority to the Board to require banks to hold supplemental reserves up to the limit we had requested in August, 10 per cent against demand deposits and 4 per cent against time deposits. He stated that this authority should not be confined to member banks, but should be applicable to all insured banks. The President asked that the authority for the regulation of consumer instalment credit be continued in order to exert a stabilizing influence on the economy. The President made these requests after a most careful and exhaustive survey of the situation with the Board and the requests had the unanimous approval of the Board.

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That report was prepared and submitted nearly four months ago, four months in which inflationary pressures have abruptly abated and the economic situation generally has changed in many respects. In view of these developments I come here today with somewhat changed recommendations. We now feel that we will have adequate powers for the period immediately ahead if the Congress will extend the two temporarily granted authorities voted by the special session last August and make the authority to increase reserve requirements applicable to all insured commercial banks.

Elbow room is essential to an institution such as the Federal Reserve System performing central banking functions. Congress has made the System responsible for the maintenance of sound credit conditions in this country in the interest of high-level economic stability. To carry out that responsibility we must always be in a position to operate flexibly, counteracting trends as they set in, either toward inflation or deflation. We must take into account how much latitude exists to move in either direction from the position that seems correct for the near future. Viewed in this perspective, the present powers of the Federal Reserve System are ample for our needs during a downward trend. Our powers in the other direction, however, are limited. So long as we have the huge Federal debt to support we cannot count on use either of the discount rate or operations in the open market to exert the same degree of influence that they did before the war. To an extent hitherto not contemplated, we are forced to place greater reliance on reserve requirements as a defense against inflationary trends. We are at the moment, however, very close to the limits of that power.

We come before you, therefore, to ask you to maintain what we regard as the minimum operating leeway that is needed in view of our responsibilities. We do not plan to use those powers now. In fact, reserve requirements may be further reduced if present trends continue. But we do want the powers in case an emergency situation should arise. The basic concept underlying the Federal Reserve System is that it should have at all times residual power to deal flexibly with changing situations, not that it should come to Congress whenever an emergency exists. Looking backward at the situation, I feel it would have been better for the economy if we had been in a position earlier

to restrain consumer instalment credit expansion and to increase reserve requirements.

You understand, I am sure, that the ability of the Federal Reserve System to influence credit developments is always subject to limitations, even when our residual authorities give us much greater elbow room than we have at present. In large part these limitations arise out of the complex organization of finance in a highly developed country such as ours. In part they reflect the many different types of financial activities that are carried on within the Government itself.

As members of this Committee realize, the existence of our huge public debt and the need to assure orderly conditions in the Government bond market have greatly complicated the problems faced by the System in adapting policies to adjust the supply of money and credit to the needs of a stable, high-employment economy. At the present time our commercial banks hold about 60 billion dollars of marketable Government debt securities. Non-bank public investors hold an additional 70 billion. Whenever any security which is a part of this 130 billion is bought by the Federal Reserve there is an increase in bank reserves, and the reserve so created then becomes the potential basis of a multiple credit expansion.

Of course, the Federal Reserve is not always involved. There may be a balance of buyers and sellers in the market and orderly conditions may exist without Federal Reserve participation. But if there are more sellers than buyers at any time, the Federal Reserve must enter the market. It thereby makes reserves available to the banking system regardless of whether such reserves are needed for the stability of the economy. If the money supply (deposits plus currency) is already ample in relation to the goods and services for which it can be exchanged, the further increase through bank credit expansion on the basis of the new bank reserves serves mainly to exert inflationary pressures. The initiative in all such operations rests with the market and not with the Federal Reserve. Thus the System cannot always control the availability of bank reserves. It should accordingly be equipped to vary the required amount of reserves so as to neutralize the indirect effects of its Government security transactions.

I come now to our most controversial request. The nature of the problem compels us to plead that the authority in respect to supplemental re-

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serves be made applicable to all insured commercial banks, rather than only to members of the Federal Reserve System. Failure to include all such banks will seriously impair the effectiveness of national monetary policy in a critical period. It will work to the detriment of our whole banking structure at a time when the situation calls for consistency and uniformity in national monetary policy. No category of commercial banking should be exempt to that call.

We are not suggesting that the nonmember insured commercial banks carry the same reserves as the member banks. In normal periods they would be unaffected by this legislation. We are proposing only that to the extent *supplemental or increased* reserves may be required under the provisions of this act the percentage amounts would be the same for both member and nonmember insured commercial banks. Under our proposal this would mean at the very maximum an increase over existing State requirements of no more than 4 per cent on demand deposits and 1½ per cent on time deposits.

With a huge public debt it would be wholly unrealistic to have no means of steadying or supporting the market. We have that means in the Federal Open Market Committee. Without it no one could be sure of a ready market or of the rates that might prevail.

The vital point to bear in mind is that this function and operation is a protection for all banks of the country—not merely member banks. All commercial banks have in their portfolios relatively large amounts of Government securities. Every bank, member or nonmember, can have confidence in its ability to find a market if necessary for those securities without exposure to the risks that would prevail if there were no residual purchaser. It should be emphasized as strongly as possible that nonmember banks have benefited and profited from all of these operations and actions, yet they have not had to bear their proportionate share of the burden. That is why we say it is only fair and equitable to ask all insured banks to shoulder their proportionate share of a load which is imposed for the benefit of the entire banking community and for the country.

As I have sometimes put it, to be a member in the Federal Reserve System is like being a contributing member to a local volunteer fire company. So long as enough neighbors contribute, the protection will be adequate. In case of a conflagration,

however, noncontributors also receive help. This is inequitable, but it is humane and necessary to prevent spreading of the danger to the whole community. Nevertheless in the existence and majority support of the institution there is great security for all.

We are not asking that nonmember insured commercial banks be required to become members or to become subject to all of the other requirements and obligations which member banks have to meet. Membership of State banks in the Federal Reserve System is voluntary and our membership will be endangered if the competitive relationship is too glaring.

We are aware, as you are, that there is strong opposition to the proposal to include nonmember insured banks under the supplemental reserve authority. It will be said that it is simply the attempt of another Government agency to grasp for more power; that it trespasses upon States' rights; and that it is a step toward ultimate destruction of the dual banking system.

I can only assure you that the Board does not seek power for the sake of power; in fact, we would prefer, as a matter of personal choice and convenience, to have less formidable responsibilities. At best, the administration of regulatory powers is a headache. Certainly we would be remiss if we failed to explain to the best of our ability the situation as we see it and the way in which we feel the responsibilities entailed can best be met.

I do not feel there is a relevant objection on the score of States' rights. Insured banks are all under the aegis of Federal legislation and for many years member and nonmember banks alike have been subject to Federal law providing for stock market margin requirements.

The dual banking system, which I have long upheld and will continue to support vigorously, is not jeopardized by this proposal. It is specifically drawn to leave with the State bank supervisory officials full discretion and authority to apply and enforce. It seems to me the test must be national needs and not groundless fears that State chartering and supervision are threatened. Clearly they are not. Moreover, we contend that what we propose will fortify and strengthen the dual banking system by arming all banking in this country against a danger that would undermine private banking.

A few States have cooperated to the fullest extent

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possible under their laws to parallel or approach the reserve requirements of the System. It would be desirable, of course, if there were greater uniformity and effectiveness under State reserve requirements, combined with a disposition by all State authorities to pursue policies of parallel action. We cannot safely hope, however, for separate and parallel action by most of the States.

In addition to authority with respect to bank reserves, we request you to continue authority to regulate consumer instalment credit.

As you know, this type of credit is associated particularly with the sale of what are known as consumer durable goods, including automobiles, refrigerators, radio and television sets, washing machines, furniture, and similar articles which have become so much a part of our American standard of living that very large sections of our economy depend on their production and sale. Because the prospective buyer of these articles can exercise so much latitude in both the selection and time of his purchase, sales are subject to wide fluctuation. The credit related directly or indirectly to their ownership is consequently extremely volatile.

The development of consumer instalment financing has come largely during the period since World War I. By the mid-twenties, consumer instalment credit outstanding probably did not exceed a billion and a quarter dollars. Today the figure is nearly 8.5 billion. Since the mid-twenties fluctuations in credit volume have been wide, swelling consumer spending power in expansion periods and reducing it during contractions. Because instalment credit has become so important a factor in the main distribution of durable goods, its wide swings have contributed to instability in the production and marketing of these goods. We are fully cognizant of the usefulness of these credits to the durable goods industries, to consumers, and to the entire economy, and we earnestly desire to see this usefulness continued and extended. We are naturally apprehensive, however, lest this credit grow too fast under the pressure of unsound credit practices and terms and thus at some point contribute to serious instability of markets and purchasing power. We believe that a further period of trial under more normal conditions for the regulation of this credit can well serve the public interest.

Appropriate regulation of instalment credit can be especially helpful during times when more pur-

chasing power serves only to bid up prices. In periods when production and demand approach a balance, such regulation can be relaxed considerably. This the Board has done twice recently in respect to its present authority, and the Board will have no hesitancy in suspending any part or all of the regulation should conditions make such action desirable. The important thing is that the power be at hand to exercise restraint when necessary to maintain sound credit conditions.

Regulation W is of course not in itself the answer to the problem of instability which our high standard of living presents. The problem is far more fundamental. But we are convinced that proper regulation of this volatile type of credit, in conjunction with other credit restraints, constitutes a substantial contribution to stability.

In summary, then, we are suggesting extension of the authorities which you delegated to us last summer but with the application of the reserve requirement authority equally to the nonmember insured banks as well as to the member banks. We are suggesting the extension of these authorities in the hope that the Congress will in the meantime survey the entire framework and functioning of our financial system and of the role of banking and Government therein. It is evident from the resolutions which members of this Committee have sponsored to create a National Monetary Commission that you are well aware of the need for a thorough and painstaking study of this whole complicated and difficult subject. We hope that you will press ahead to authorize such a review and reappraisal in all its ramifications of the function of the entire banking system and its role in contributing to national economic stability through the financing of individuals, business enterprise, and Government.

We in the Federal Reserve System are naturally concerned over the areas of controversy that surround the System's functioning and responsibilities as a central banking, monetary, regulatory, and supervisory authority. We trust that Congress will review its delegation of authority and responsibility to the System to be sure that they are commensurate with each other and with the objectives established by Congress. Such a review would include consideration: (1) of the System's open-market powers and their relation to Federal financing and the administration of the public debt; (2) of the use of selective credit controls such as

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those over security loans and consumer instalment loans and of the proper sphere for the application of such types of control; (3) of the distribution of regulatory and supervisory power among the various Government agencies; (4) of the need for some mechanism of policy coordination on the domestic financial front as we have available through the N.A.C. on the international financial front; (5) of the objectives of central banking and supervisory policies; and (6) of the relation of the Federal Reserve System as a central banking organization to the banks of the nation, both member and nonmember.

In any such review the role and function of reserves will inevitably receive prominent consideration. As you know, the System has been conducting extensive studies of this subject and believes that a more scientific formula for establishing reserves can be determined by the Congress. I feel confident that solutions to these problems can be found without impairment of our long established institutions, or encroachment upon either State or national prerogatives. Indeed, it is imperative to find solutions that avoid, on the one hand, extremes of centralization which would threaten the dual banking system, or, on the other hand, jeopardize the effectiveness of national policy by disunity, discrimination, and divided counsels.

I hope the Committee will include in its review of our financial system an inquiry into the adequacy of our supply of equity capital. I do not need to remind members of this Committee of the fundamental, vital importance of this subject. This nation grew great and strong on the enterprise of its citizens. It used to be possible for a man with a good idea to get capital together, start a business, and market that idea. It is still possible, but it is

becoming much more difficult to do so, and I tell you, as a businessman, that when our alert and up and coming young men of ideas are unable to get the venture capital to start and grow, then the American way of life is on its way out.

In conclusion, I would like to give the Committee my ideas on the present business situation. Naturally I am optimistic about the future of American business, and although many of my business friends are pessimistic about the present situation, I feel strongly that we are in a healthy readjustment period. There must of necessity have been a transition from inflationary prices to more normal ones and a transition from the concept of mass production to one of merchandised production. I feel strongly that we have let our merchandising skills get rusty in the past eight years. The pressure was on production. First we were engaged in all-out production of the materials and machines of war. Then came these past three lush years when pent-up demand beat on the doors of our factories for almost every type of consumer article. There was no need to exercise merchandising skills. The more urgent deferred demands of consumers have now been satisfied and most goods are in plentiful supply. When sales are a little disappointing, as compared to the abnormal years, there seems to be an inclination to look for excuses rather than get down to fundamentals of product price and quality, and consumer services. It is primarily by that constant improvement in quality, accompanied by lower prices, that our competitive system has functioned so phenomenally in improving the American standard of living. I, for one, am glad to see the return of the competitive conditions which are so vital a factor in our enterprise system.

RES

INTERNATIONAL MONETARY FUND

Research Department

Interest Rates and the Inflation Problem
(With Special Reference to the United States)

Prepared by E. M. Bernstein

1. Introduction

The recent controversy between the U.S. Treasury and the Federal Reserve System has called attention to the problem of credit policy in a period of great inflationary pressure.

The Federal Reserve System is concerned to see that the money supply is not further expanded. It would do this by stopping the purchases of government securities by the Federal Reserve Banks in order to support the prevailing structure of government security prices. Such a policy would mean that prices of government securities would decline, the yields would increase, and new issues of government securities would have to bear higher interest rates. But the Federal Reserve System would not have accumulated additional bonds and the money supply would not, on that account, have increased.

The Treasury takes the view that the consequences of such a policy would be to raise interest rates without, in fact, contributing to a solution of the inflation problem. The point is made that fractional changes in interest rates cannot reduce private investment. On the other hand, the ultimate cost to the Treasury in interest charges is said to be large and the need to finance the higher interest payments would lead to a larger budgetary deficit. This in itself may add to the inflationary forces.

This paper discusses the relation between interest rates, the supply of loan funds, and the volume of investment; and it considers the need to prevent the growth of excessive liquidity which may affect the inflationary environment of the future.

2. Interest rates and investment

The essence of inflation is a demand for goods and services for consumption, investment and government purposes which exceeds the supply at the prevailing level of prices and distribution of money incomes. The purpose of anti-inflation measures is to eliminate the excess demand without raising prices and compelling a redistribution of money incomes. For convenience in analysis, it will be assumed that government demand for defense and civilian purposes has been set directly at the proper level and that the restriction of demand for consumption is being induced in other ways than through the interest rate. The problem, then, is whether a change in interest rates can help to reduce the demand for investment and in this way reduce the current inflationary pressure.

When a business man is considering whether to undertake certain investment in fixed capital his decision must be made by weighing several elements. He must consider the prospective receipts which depend on volume of sales and the price; and then he must compare these receipts with the prospective out-of-pocket expenses during the useful life of the investment. From this he determines the gross investment yield, the excess of prospective receipts over prospective expenses other than those involved in the investment itself. If this gross investment yield exceeds the gross investment cost, which is defined as interest plus depreciation, the investment is profitable.

Naturally allowance must be made for uncertainties, and this means that some critical excess of prospective gross investment yield over gross investment cost (varying from time to time) is necessary before investment will be undertaken.

A rise in the rate of interest increases the gross investment cost, although less than is sometimes assumed. For this reason, the operation of the interest rate in restricting marginal investment is probably never very great except for some very long-lived projects. Obviously, the influence of the interest rate on investment is very much diminished in a period of prospective inflation when the outlook for a large sales volume at high prices is especially bright.

Table 1. Gross Annual Investment Cost
(Interest and depreciation)*

Interest Rate (Per Cent)	Five-Year Life	Ten-Year Life	Twenty-Year Life
2	21.22	11.13	6.12
3	21.84	11.72	6.72
4	22.46	12.33	7.36
5	23.10	12.95	8.02
6	23.74	13.59	8.72

* As per cent of price of capital equipment; depreciation on a sinking-fund basis.

Even if interest rates are not a major factor in determining the average volume of investment over a period, they may be very important in influencing the time distribution of investment through the period. Having decided that a given investment will yield more than its cost, the business man wishes to maximize the excess of yield over cost. If the interest rate is higher now than it is expected to be, say two years from now, then a

business-man may be induced to put off a proposed investment until the rate has fallen. Thus, for example, if funds for a given investment can be borrowed now at 3 per cent but may be borrowed two years from now at 2-1/2 per cent, the aggregate saving by putting off the investment for two years would be the difference between the present value of a 3 per cent and a 2-1/2 per cent security, both selling to yield 2-1/2 per cent. For a 20-year security, this is a large sum, amounting to nearly 8 per cent; even for a 10-year security it amounts to 4.4 per cent. The relationship between short-term and long-term rates and the possibility of interim short-term financing while waiting for the long rate to fall can moderate this effect.

Table 2. Present Value of 3 Per Cent Bond at Various Yields

<u>Yield</u>	<u>5-year maturity</u>	<u>10-year maturity</u>	<u>20-year maturity</u>
2	104.74	109.02	116.42
2-1/2	102.34	104.40	107.83
3	100.00	100.00	100.00
3-1/2	97.72	95.81	92.85
4	95.51	91.82	86.32

While this relationship of present to prospective interest rates can ordinarily be a powerful factor in determining the timing of investment, there are two reasons why it would have no significant effect under present conditions, even if there were assurance that the interest rate will be lower two years from now. The first is that with the expected inflation of demand, the profits prospects for the next two years are so great as to offset the extra cost of 8 per cent involved in financing 20-year investment now at the higher rate rather than later at the lower rate. The second is that with the expected rise in wages, materials, etc., the cost of acquiring

investment goods is expected to be so much higher in the future as to more than offset any saving in interest costs. The conclusion, therefore, is that a rise in interest rates cannot be expected to curb to any significant extent the demand for long-period investment under present inflationary conditions and prospects.

Nor can a rise in the interest rate be expected to curb to any extent the demand for investment in accumulating inventories. The demand for inventories is related to the extra facility they provide in production or (in the case of finished goods) in sales. Far more important, however, in determining whether inventories will be kept abnormally large or small is the expectation as to ease of availability of goods and the prospective level of prices. While a rise in the rate of interest could under certain conditions affect the demand for inventories, it is most unlikely to have this effect in a period of prospective shortages and rising prices.

So far as concerns the demand for investment under present conditions, it is difficult to see how it can be curtailed by a higher rate of interest. It is possible, however, that the supply of loan funds would be curtailed by a rise in the rate of interest on government bonds and that this would curtail investment because of a lack of finance.

3. Supply of loan funds

The big sources of funds to finance investment are the undistributed earnings of business (including liquid reserves accumulated in this way) borrowing from the public, and bank loans.

The amount of retained earnings available for investment cannot be affected by a rise in interest rates. That must be determined primarily by

profits, taxes, and policy on the distribution of earnings. Some earnings of the past have been held as reserves in the form of government bonds. Conceivably, at a lower price there might be some inclination to delay in selling such bonds to finance additional investment. This is not likely, however, to be a restraining influence on the use of liquid reserves for investment at the present. Over a longer period, retained earnings will probably be greater than investment from such retained earnings, if opportunities for investment are limited by direct controls, availability of real resources, etc.

The bond market will not necessarily become a less satisfactory source of finance for investment because of a rise in the yield on government securities. It will, of course, be necessary for the yield on industrial bonds to rise with the yield on government securities. The rise may, however, be less on industrial bonds than on governments. There has been a steady reduction in the spread between governments and high grade industrial bonds. Before the war, the difference in yield was between .8 and .9 per cent. It is now between .3 and .35 per cent. With the prospect of even higher earnings in industry, the spread may be further narrowed. The basic question is whether the absorption of more government bonds by the market (i.e., other than commercial banks) will result in some reduction of funds made available for acquiring new flotations of other issues.

Suppose, for example, that banks (and insurance companies) sell government bonds and that the Federal Reserve Banks withdraw support at the present level of bond prices. The bonds sold by the banks will be purchased by the public (the magnitude of the transactions is neglected for the moment). Having reduced their liquidity, the purchasers of bonds will presumably absorb less of new industrial issues, although the reduction may be quite small.

There is, however, another factor to be considered and that is the attitude of issuing houses. The manner in which new securities are issued makes issuing houses very hesitant about bringing out new issues on a falling market or the threat of a falling market. For this reason, there may be a tendency to hold off new issues until the bond market appears to have been stabilized, not only in the general level of yields on governments but in the differentials between governments and industrials at any higher level of yields. This uncertainty will be less significant for new issues of governments.

The sale of bonds by banks provides them with additional loan funds. Given the level of bank reserves and reserve requirements, the sale of bonds by banks is likely to accompany an expansion of business loans. If banks sell governments and they are absorbed by the public, the net increase in the supply of loan funds will be determined by the amount they sell less any reduction in the absorption of new private issues by the market, which is not assumed to be large. The hesitation in bringing out new issues of industrial bonds is presumed to be a temporary phenomenon although not of negligible importance on that account. The expansion of loan funds will not be significantly reduced, therefore, by a rise in the yields of governments, if banks decide to sell government bonds even if the market absorbs them.

The effect of withdrawal of Federal Reserve support and the consequent rise in interest rates will, however, prevent a larger increase in the supply of loan funds. When the Federal Reserve Banks buy the bonds sold by the banks (or insurance companies) the reserves of the commercial banks are increased. As the banks make business loans, their excess reserves decline, but their actual reserves are not depleted except as the loans give rise to

a demand for cash. Thus, with the purchase of bonds by the Federal Reserve Banks the banking system is able to expand loans much more than with the sale of an equal amount to the public. This may not be apparent in the statistical series of bond sales and business loans by banks because other factors (e.g., the flow of gold and changes in foreign deposits at the Federal Reserve Banks) may offset the effect on bank reserves of increased Federal Reserve holdings of securities.

Table 3. Gold Stock, Reserve Bank Holdings of Government Bonds and Loans of Commercial Banks

<u>Year End</u>	<u>Gold Stock</u>	<u>Reserve Holdings of Gov't Securities</u>	<u>Bank Holdings of Gov't Securities</u>	<u>Bank Loans</u>
1946	20.7	23.4	74.7	33.1
1947	22.9	22.6	69.2	40.2
1948	24.4	23.3	62.6	44.3
1949	24.6	18.8	67.3	45.3
1950	22.7	20.3	61.7*	54.0*

* November 1950.

Source: IFS

The effect on the available supply of loans caused by higher yields on government bonds depends on the behavior of the commercial banks. Assuming that the commercial banks sell government bonds, despite their higher yields, but that the Federal Reserve Banks do not buy these bonds, the supply of loan funds for investment will nevertheless increase, but they will increase by somewhat less than the amount of bonds sold by the banks. The principal effect will be to limit the increase in the supply of loanable funds and this will result from the action of the Federal Reserve Banks in not acquiring more government bonds. With a given degree of liquidity (cash holdings of the public), a rise in interest rates is not likely to be very restrictive on the supply of loan funds under present conditions.

If a rise in yields on government bonds is to be effective in preventing an increase in the supply of loanable funds it must be by inducing commercial banks not to sell their holdings in order to increase their business loans.

4. Behavior of the banks

In general, with some minor interruptions and one major interruption, commercial banks sold U.S. government securities steadily in the postwar period in order to secure funds to expand business loans. Such a re-arrangement of bank portfolios was obviously a part of the process of balancing assets in different forms which individuals, business firms and banks had to undertake as a consequence of the large increase in private wealth (concentrated in the form of government securities) which took place during the war. With the higher return from loans to business firms and individuals than from government securities, the banks allowed the proportion of their total assets held in the form of securities to decline as the demand for loans increased. Suppose that medium-term, taxable government bonds, eligible for purchase by commercial banks were now allowed to decline on sales by banks until the yield rose by 1/2 per cent. Would bank sales decline sharply or even stop with the new price? This question is extremely difficult to answer, for data are scarce and the environment is uncertain.

On the face of it, the experience of 1946-1950 would lead to the view that banks will not be deterred from selling bonds by a rise in yield on the order of 1/2 per cent. Between January 1950 and November 1950, commercial bank holdings of government securities declined by \$6.5 billion while the yield on medium term government bonds rose from 1.29 to 1.62 per cent. In

fact, the yield on medium-term bonds of the type held by banks has been rising steadily since 1946, except for the one major interruption between October 1948 and August 1949, without impeding the steady but gradual reduction of bank portfolios.

Table 4. Bank Holdings of Government Securities and
Medium-Term Government Bond Yield
(1947-1950)

<u>Date</u>	<u>Holdings</u>	<u>Yield</u>
1947 Jan.	74.4	1.27
Apr.	72.0	1.24
July	70.6	1.26
Oct.	70.5	1.37
1948 Jan.	69.2	1.46
Apr.	66.3	1.48
July	65.3	1.48
Oct.	63.3	1.63
1949 Jan.	63.0	1.50
Apr.	61.9	1.48
July	64.5	1.23
Oct.	67.7	1.25
1950 Jan.	68.2	1.29
Apr.	65.6	1.39
July	65.0	1.41
Oct.	62.5	1.62

Source: IFB.

Chart

The explanation of this behavior is a willingness on the part of the banks to sell government securities whenever there are profitable business loans to be made and to buy government securities when such loans are not available. They have not been deterred in this almost predictable process

by an average yield that has risen (in the postwar period) from less than 1.1 per cent to 1.65 per cent. The process has run through successive stages—sales by the banks, a rise in yields, temporary support by the Federal Reserve System, and a further rise in yields as sales pressure increases. The driving force in the sale of government securities by the banks has been the desire to make more profitable loans at better rates of interest. In this process, the banks have not hitherto been deterred from selling securities on a falling market. The capital loss on a 3-year maturity, if the yield should go from 1-1/2 per cent is only 1.45 and on a 6-year maturity only 2.80. This is a sum that could be made good within a 2-year period by a modest differential between rates on loans and the yield on government bonds. There is no doubt, of course, that rates on loans to business rise with the yield on government bonds.

The first impression, therefore, would seem to be that banks will not be induced to refrain from selling government bonds by an increase of 1/2 per cent in the yield. The attitude would be different if there were a general view among bankers that the low price of government bonds is temporary and that a higher price will be restored in two or three years and that the demand for business loans will turn down in two or three years. The first circumstance would induce banks to buy securities in the hope of benefiting from the rise in the market. The second circumstance would make banks hesitate to sell securities on a bad market in order to expand business loans for a limited period. The "ideal" behavior for a bank under these circumstances would be to hold securities but to raise the rate of interest on loans to business. ✓

✓ If there were assurance that the price of bank eligible bonds would rise by 3 per cent in two years, banks would require a minimum increase of 1-1/2 per cent per annum in the differential between bond yields and loans to business.

Clearly, these are not circumstances in which banks can feel that if the yield on government bonds rises now, it will fall again in the next two or three years or that the demand for business loans will decline in the next two or three years. Nevertheless, it is not certain, despite their pattern of behavior in the recent past, that banks will go on selling securities to raise the funds to make loans. The banks, like other holders of wealth, distribute their assets among various types of wealth with a view not only to earnings but to liquidity. Before the war, the amount of securities (governments and municipals) in bank portfolios was about equal to the amount of loans. The ratio is now about 4:3. As the ratio approaches the prewar ratio of 1:1, the banks may be less eager to continue to sell securities in order to make loans, even if the yields on government securities are not higher. And as they approach this ratio of 1:1, banks may be more sensitive to the yield on government bonds in deciding between holding governments and expanding loans, than they have hitherto been in the postwar years.

If the banks are not deterred from selling government bonds by a rise in yields, what then is achieved by the withdrawal of Federal Reserve support from the bond market? There is the fact that the lending capacity of the banks will be less if the bonds are purchased by the public than if they are purchased by the Federal Reserve Banks. But even this may not reduce very much the volume of investment in a country where cash holdings are large in absolute amount and the liquidity (cash relative to national income) greater than in the last 1930's. Apart from this positive but limited effect in restraining present investment, the major basis for a Federal Reserve policy directed toward preventing an increase in the money supply is the relationship of increased liquidity now to the inflation problems of the near future.

5. The problem of liquidity

Monetary policy cannot be concerned simply with the immediate effects without regard to the environment that is being created now and in which the problems of the future will have to be met. The Federal Reserve authorities appear properly to be concerned with the growing liquidity of the country. Even with the most effective price and wage controls, the continued growth in liquidity is a menace to stability. The growth of the money supply with a fixed rate of interest will induce a bidding up in the prices of other assets (real estate, stocks) until at their higher prices they are equally attractive with the holding of cash and government securities. The profits, even book profits, on such capital assets affect the private wealth of the public and the attitude of the public toward spending and saving out of current income. They are an inducement to bid up the resources used in construction and investment when direct controls and other restraints are later removed.

It is impossible to argue that the United States can be indifferent to the rate at which the money supply is growing. The effect of the money supply on inflation is not automatic or timeless, as is sometimes supposed; but it nevertheless has a positive role. The country may be prepared to accept a slowly and steadily growing ratio of money supply to income and private wealth. But if the ratio grows too rapidly, it will in time be brought to the level appropriate to the level of income and private wealth by a sharp rise in income caused by and accompanied by a consumption and investment boom. The degree of inflation the United States will have this year and next year may depend in small part on interest and credit policy. The degree of inflation

the United States will have three years from now may depend in much larger part on the interest and credit policy of today.

A policy of permitting steady growth in the money supply may be justifiable when the prospects are fairly clear that the demand for consumption and investment will not fully employ the productive resources of the country. That was the case in the 1930's. The prospect today is for a period of uncertain duration during which defense needs will be so great as to require some diminution in the amount of output available for consumption and investment. And even if the period of preparation for defense is brought to an end by a general settlement, the experience of 1946-48 indicates that this will be followed by a period of abnormal consumption and investment demand that will bring renewed pressure on the economy.

There is no need to exaggerate the role of the money supply in the American economy. It is probably not ordinarily a causal factor of great significance in the inflation pressure. But the high degree of liquidity permits the causal forces to manifest themselves in increased consumption and investment even when the money supply does not respond to these inflationary forces. That is surely a large part of the explanation of the bidding up of prices and costs during 1950. The rise in prices and costs has reduced somewhat the liquidity and the capacity of the public to continue the pressure of excess demand. It may be possible, if liquidity can be kept down, to recapture in part the limiting effect of the money supply on the sudden desire of the public to splash in consumption and investment with each fear of impending shortages or rising prices.

The postponement of certain types of investment and consumer expenditure during the period of defense production will in any case result in an accumulation of potential demand that will begin to express itself when the present restraints are removed. The effect of this accumulated demand will be more concentrated and the resulting rise in prices much greater if liquidity is built up in the intervening years. The experience of the United States in 1946, shows how rapidly prices can rise in such an environment, even when current output is large and ordinarily sufficient to satisfy the demand for consumption and investment at a very high level of income. The experience of many European countries in the postwar years shows that even rigorous price controls cannot prevent the creeping up of prices and costs in an environment of excess liquidity.

The attitude that little can be accomplished in the United States to restrain inflation through credit policy is partly a consequence of emphasis on present inflation problems with inadequate regard for future inflation problems. And it is partly a consequence of the fact that the credit policies of the past have made it more difficult to use credit policy now to deal with the immediate inflation problems. The difficulties of dealing with the present inflation problems through credit control arise from the conjuncture of widespread expectations of rising prices and costs and a high degree of liquidity. Under such conditions, interest rates cannot prevent excessive investment and the availability of bank credit is not essential to the financing of a sudden increase in investment (and consumption). But these expectations need not last and the degree of liquidity can be gradually reduced. The policies to minimize inflation in the present and in the future are being formulated and credit control can do much to make these policies effective.

6. A comprehensive anti-inflation policy

One side of anti-inflation policy is to destroy the expectations of steadily rising prices and costs. This is intended to be accomplished through price and wage controls. There is an unwarranted attitude of skepticism regarding the efficacy of such a policy. To the extent that this skepticism is based on fear that the administration of the controls will give way to pressure, it may or may not prove justified. To the extent that this skepticism is based on the feeling that price and wage controls cannot work, it is wholly unjustified. Such controls are economically sound, they can be made to work, and they have been reasonably effective. A study of the economic aspects of price control, with special reference to the United States, is being prepared.

Clearly the effectiveness of price controls will be greatly enhanced if they are supported by other policies that reduce the pressure of excess demand. There is, in general, a tendency to over-estimate the pressures that will emerge in the next few years. The increase in output at constant prices will probably be greater than is commonly predicted. With the projected arms program, the reduction in the aggregate supply of consumer goods (excluding residential construction) in 1951 and 1952, compared with 1950, may be quite small. Controls on construction and on the allocation of certain materials will keep down investment. With new taxes and the high marginal relationship of increment of all taxes to increments of income, the budget position will be relatively strong. Institutional and personal savings (with the limited supply of durable consumer goods) will increase and will become available for investment x in government securities.

In brief, economic conditions in the next two or three years are not likely to confront the United States with an insuperable inflation problem. But these conditions can create a very difficult inflation problem for the future. To the extent that the problem arises out of the accumulation of needs for investment and consumption, it cannot be entirely avoided. To the extent that the problem arises out of the accumulation of private wealth in liquid form, it can be partly avoided through the fiscal and credit policies of today. Liquidity can be kept down by a policy that would minimize and preferably avoid any increase in Federal Reserve holdings of government securities. At present, this would involve letting the prices of government securities go down under the pressure of sales by commercial banks and others. The Federal Reserve Banks would, of course, moderate the market to assure continuity and a proper relationship among various issues.

The continuation of uncertainty as to future policy increases the difficulty of maintaining the present yield on government bonds without substantial support from the Federal Reserve Banks. A considerable amount of securities is probably now being sold with the intention of purchasing again when prices have dropped. In one way or another, this uncertainty should be ended. There is a good deal of reason to believe that the government bond market will become stronger in the near future. If this view is widely held by banks, insurance companies and large investors, then a withdrawal of Federal Reserve support now, but with assurance that an orderly market will be maintained at a lower level of prices, may encourage banks and other institutional investors to maintain and even to add to their holdings of government securities.

There is a strong feeling, at least among some segments of the public, that adequate measures are not being taken to deal with the inflation problem unless the growth in money supply is halted. There is a sound basis for this view. The Treasury has been represented as more concerned with keeping down interest costs than with dealing with inflation; and the Treasury has been represented as trying to maintain unchanged a pattern of interest rates that was established for widely different conditions. As a matter of fact, there has been more resiliency in Treasury interest rate policy than is generally recognized, as the following tables and charts will show. But this is the time to adapt interest rate policy to the needs of the next few years. And this need not involve a sharp change in the structure of interest rates or the interest cost of the public debt.

Table 5. Yields on Various Treasury Securities, 1946-50*

	<u>1946</u>	<u>1947</u>	<u>1948</u>	<u>1949</u>	<u>1950</u>
Bills	.381	.382	1.014	1.176	1.187
Bonds medium-term	1.11	1.26	1.52	1.35	1.45
Bonds long-term	2.19	2.25	2.44	2.31	2.32

* Annual averages.

Sources: Treasury Bulletin and IFS.

Chart

7. Adaptation of credit policy

Some popular discussions of the controversy between the Treasury and the Federal Reserve have left the impression that the Treasury has been adamant in refusing to consider any change in the pattern of interest rates despite the far-reaching changes in economic outlook and economic policy

during the past year. This extreme statement is not in accord with the facts. To a very significant extent the rates on government securities have responded to market conditions. Within the past year, the average yield on Treasury bills has gone up from 1.10 per cent in January 1950 to 1.37 per cent in December 1950; on 5-year Treasury notes the issue rate has gone from 1-1/2 per cent in February 1950 to 1-3/4 per cent in December 1950. Thus, the Treasury itself has been offering higher rates on its new borrowing. The yield in the market on medium-term bonds (three-year) has been allowed to go from 1.27 per cent in January 1950 to 1.65 per cent in December 1950; and on long-term bonds from 2.20 per cent in January 1950 to 2.38 per cent in December 1950.

And yet, despite this responsiveness of government security yields to market conditions in 1950, the average computed interest rate on the public debt was lower in November 1950 than in July 1949. While on short-term securities, the yield in December 1950 was slightly above, the yield on long-term bonds was slightly below the levels of October 1948. Although some further rise in yields, at least to a level slightly above that of October 1948, should be part of a credit policy adapted to the needs of the next few years, it is by no means the whole or even the major part of such a policy. Nor should it be assumed that within a well-adapted credit policy, the rise in yields or in the interest cost of the public debt must be large. Above all, there is no reason to be unduly pessimistic on what can now be accomplished through credit policy to prevent the building up of excess liquidity.

One phase of a new credit policy would be a moderate rise in yields on outstanding securities. An understanding should be established between the

Treasury and the Reserve Board to assure an orderly market at all times and to provide support for government securities at critical levels, even if this should mean some enlargement in Reserve Bank portfolios. The essential aspect of a credit policy related to the interest rate is not so much the absolute level of yields as the relation of present to expected future yields. A rise in present yields is not an alterable step; there can be and may be a fall in yields two or three years from now. The market should be made aware of this. At the same time, modifications would be made to encourage the holding of government securities by the public and the banks. Among such modifications might be the following:

- (a) A new 25-to 35-year bond with a 2-3/4 per cent coupon rate, especially designed for insurance companies;
- (b) An administrative regulation making bonds within 12 years of maturity eligible for purchase by banks during 1951;
- (c) Readjustment of Reserve Bank portfolios to enable the public and the banks to shift to types of security that will induce them to maintain their holdings.

While some rise in yields and an adjustment in the yield pattern should be used for holding down liquidity, there is no reason to confine the program to yield incentives. The Federal Reserve needs further authority to increase reserve requirements in one form or another with a proviso permitting incremental holdings of government securities to be used as part of the supplementary reserve. There will be difficulty in devising an effective plan because of the great differences between individual banks; but there is no doubt that with good will an equitable plan can be devised.

The objective of credit policy should be to hold down liquidity. This means a definite attempt to avoid increasing Federal Reserve credit except, perhaps, to the extent necessary to offset a reduction in U.S. gold holdings and an increase in foreign balances at the Federal Reserve Banks. Such a policy is an essential part of an anti-inflation program for the present and, even more, for the near future. An imaginative credit program would rouse public support; and the environment for making credit policy effective is more favorable than is sometimes supposed.

Subject: Inflation and Interest Rates on Government Securities

I do not believe it is useful to discuss the problem of interest rates except in terms of the two major problems facing us under present conditions. On the one hand, we must make available to the Government the goods and services needed to carry out our mobilization program, and these goods and services will reduce the amount available for civilian purposes. At the same time, we are endeavoring to avoid an inflationary rise in prices and wages for reasons which it is unnecessary to elaborate.

The Treasury is directly concerned with both of these two great problems. We must find the funds which the Government requires to finance its greatly expanded needs for men, materials, equipment and all the manifold activities connected with the defense program. This is our financing problem, which we must deal with through taxes and through appropriate issues of government securities. The Treasury is equally concerned with the second front, that of controlling the inflationary pressures in the economy created by the defense program. To this end the Treasury has submitted to the Congress programs for increases of taxes which, when adopted, will effectively contribute to reducing the inflationary pressure, as well as finding the necessary funds. We are equally concerned, in our borrowing operations with both aspects of the problems before us. We must borrow the funds which we need, and we wish to do so with the minimum of inflationary results from our borrowing.

Broadly speaking, we face the inflationary situation before us primarily because of growing shortages of civilian goods. The public

knows that we are going to have these shortages, and there is always a tendency for prices to rise and for inflationary movements to get under way whenever it is anticipated that a government must undertake a large scale defense program. Inflationary pressure is inevitable and has always been present in such a situation. We have to do our best to deal with and control those inflationary pressures.

Inflation means over-spending. It means that everyone is trying to acquire more goods or services than he can acquire at present prices. It is this tendency to over-spend which brings about inflation. Hence, it is basically necessary to find ways and means of avoiding or preventing this over-spending.

How is this over-spending made possible? From what sources does it spring? Broadly speaking, it can come in three ways. First, people can stop saving the normal proportion of their current income and try to spend this amount. Second, they can go further, and draw upon their past savings in the form of bank deposits, savings bonds, and similar holdings. Third, they can borrow against their credit or against capital assets, or sell their capital assets.

In the United States our people were saving at an annual rate of approximately \$15 billions per annum in the first quarter of 1950. If they stopped this saving and spent that money, this could add ^{more than} \$2 billion a month to the spending throughout the country and put an inflationary pressure on prices if additional goods were not being produced to meet the increased rate of expenditure. In fact, the supply of goods was tending

to be restricted as the government went forward with its defense program. In the second place, there was outstanding at the time of Korea, a very large volume of liquid savings in the hands of the public, amounting to about \$200 billion. Drawing upon these savings may be made at any time and constitutes a continuous potential inflationary pressure of very large magnitude. In fact, during the third quarter of 1950 the rate of personal consumption expenditure by the public grew to \$198 billion per annum, as compared with \$182 billion per annum in the first quarter of the year. The rate of savings, by comparison, fell off from \$15 billion in the first quarter to \$6 billion in the third quarter, despite the higher incomes resulting from the inflationary rises in wages, farm prices and other incomes during the period.

The third source of funds for over-spending is borrowing or realization of capital assets. Most typical, perhaps, of the two classes are loans from banks and sales of securities on security exchanges. A great deal of attention has been given to the effect on the inflationary picture of the upward trend in bank loans. These loans in fact rose by about \$ billion in the third quarter of the year. There can be little or no question that the full purchasing power provided by many of these loans has contributed to over-spending. What is important to remember is that this is only one source from which funds have been obtained for over-spending. It is not the largest or the most significant source. It would be difficult to prove that expenditures which have been made during this period would have been impossible if these loans had not been made. Nevertheless it is certainly true that there might have been a slightly smaller amount

of what I have called over-spending if there had been no expansion in bank loans during this period. Personally, I believe that even if there had been an absolute freeze on the total outstanding loans of every bank in this country during recent months, so that there could have been no net expansion in bank loans by the banks, that we would ^{merely} have seen a heavier rate of drawing on private savings, some greater liquidation of securities and other capital assets, so that there might have been only a very limited and perhaps hardly noticeable diminution of the upward pressure of wages and prices caused by over-spending.

I do not say the above in order to imply that the bank loan problem should not be dealt with, even though I am convinced the present situation would not be appreciably different even if it had been dealt with very drastically. Although it may be a relatively small element in the entire picture of the inflationary pressures, it clearly requires attention. What I do wish to emphasize is that it must not be given disproportionate attention in terms of all the efforts which we must make to deal with the inflationary problem.

Those efforts take two general forms, which tend to be called the direct and indirect anti-inflationary programs. The direct approach is exemplified by price and wage ceilings. By imposing these ceilings, we are trying to stabilize incomes and we are trying to decrease the speculative pressures resulting from anticipation of future increases in prices. We are trying to maintain the general level of the cost of living, so that our workers will be satisfied that their real incomes are stabilized. These are the direct controls and they are very important because they touch directly at the foundations of an inflationary movement. The real basis

for nearly every inflationary movement is anticipation of higher prices and higher incomes. Our efforts have to be directed toward dealing with that basic factor. The direct measures are also of great help in preventing the tendency for the movements of prices and wages to interact on each other in a sort of upward spiral, one following the other and no tendency to settled readjustment being apparent.

We must remember that all these measures are taken against the background of a situation in which many items are going to be in short supply, and have to be in short supply if we are to carry out our defense effort satisfactorily. We do not want any more shortages than necessary. But we do want the necessary shortages, because they mean we are getting the job done. We must not, however, let these necessary shortages become distorted into widespread and general inflationary pressures, with people vainly attempting to get the goods which are not going to be there by continually bidding-up prices and then asking for higher wages, when they find that prices have gone up.

One of the important series of direct controls consists of the restrictions which have been imposed on consumer credit and on real estate credit. These have a direct impact in dampening down over-spending in these two important areas, and help to release goods, labor, materials, and other resources for the production of more necessary items. They have been, in a sense, forerunners of the commodity allocation arrangements which we are having to introduce, and they assist in the enforcement of those allocation programs.

In addition to these direct controls, we have undertaken to act against the inflationary menace by the so-called indirect controls. These are measures which do not deal specifically with particular prices, incomes,

or categories of credit, but apply more generally to the objective of reducing over-spending. They are of three general types: first, we increase taxes to reduce the amount that people can spend out of current income; second, we intensify our efforts to ask them to make ^a contribution to our national survival by saving and lending their money to the government at reasonable rates; third, we try to reduce reserves of the banking system, so that it will have less potential power to expand credit.

I am sure you will agree that we have vigorously and conscientiously pursued the policy of increasing our taxes. The inflation which we have had to date has not been due to any significant budget deficit, and in fact we have been taking in more money than we have been paying out thus far. But we do not have in prospect a continuation of this happy situation. We will have to increase our taxes ~~x~~ so as to pay as we go to the utmost extent. But, unfortunately, we would have to go much further than this to avoid any possibility of over-spending. We would have to tax our people heavily enough to meet all the expenses of our defense effort, and also to take away most of their saving, if we relied solely on the tax measures.

Instead of this, we are endeavoring in every possible way to supplement our tax policy with a vigorous effort to ask people to save and provide their savings to the government. Let us be quite frank. The success of our anti-inflationary measures in general contribute to the success of our saving campaign, and our savings campaign contributes to the success of our anti-inflationary program in general. In a situation like the present everything works together. The better we do in any direction, the better we shall do in all directions, and vice versa. It is a gigantic campaign like a military campaign, in which every part of the operation must contribute

its share to the campaign. And likewise, the better everyone does, the easier it is for everyone in the campaign.

It is in the third sector of the anti-inflationary campaign that we have run into difficulties. There is a conflict between the objective of reducing the potential power of the banking system to extend credit and the objective of maintaining a stable market for government securities which form such an important part of our financial structure at the present time. There is some difference of opinion as to how this conflict should be resolved. The difficulty arises because the banking system now holds a large volume of government securities purchased at par or better, which are the assets which it holds against the deposits of the public. The savings of the public, in effect, are invested in these government bonds indirectly through the banking system. The banks have not hesitated to sell these government securities to the Reserve System and make additional loans on the basis of the reserves thus established. One way of dealing with this problem of expanding loans by the banks would be, it is argued, to allow the price of government bonds to fall so that banks would not sell them to make loans of inflationary character. That is to say, if the Federal Reserve System should no longer be prepared to buy the bonds at or above par, the banks would not sell them to the Reserve System because they would take a loss, and hence would be reluctant to establish the reserves necessary to make the additional loans. Against this point of view, it is the Treasury opinion that there are other ^{more effective} ways of limiting the expansion of loans by the banking system, and that this particular method has the serious disadvantage of hampering the efforts of our government to raise the necessary funds through tapping the savings of the public. It hampers

this operation in two ways. First, it increases the cost to the Treasury of borrowing money, and makes the Treasury pay to the banks and other financial institutions larger amounts in the form of interest on the public debt, thus adding to the overall expenditures of the government and the over-all deficit to be financed by appropriations and taxes. Secondly, by disturbing the confidence of depositors, insurance policy holders, and other savers, it may accelerate a flight from government securities into commodities and other forms of wealth.

The Treasury believes that, at this critical juncture, the overall fiscal advantages of maintaining the level of interest rates is more important to the country, than the limited contribution which would be made to the bank loan problem by allowing interest rates to rise fractionally and the prices of government to fall. There are a number of reasons why we do not feel that, under prevailing circumstances, a rise in bank loans would be effectively prevented by unsettling the government bond market. The banks today can replenish their cash reserves and go on making loans, without needing to sell any long-term government securities to the Federal Reserve System. They have in their portfolios short term bills and notes some of which mature every day, week or month. To make new loans all that is necessary is that they fail to renew some of the maturing short term securities which they now hold. It is for this reason that we do not believe that banks will forego opportunities to make profitable loans even if their long term government securities are made unmarketable except at a loss. The fact that in recent months they have preferred to sell long-term government securities rather than let the short-term holdings run down as

a means of replenishing their reserves, I believe is to a substantial extent due to the desire to reduce their portfolios because of the threat that prices of these securities might be allowed to decline.

It would not, in my opinion, have been easy to stop the loans that the banks have been ^{making} during the past few months by any of the indirect measures which affect primarily the prices and the interest rates on government securities. I strongly suspect, as I have indicated before, that nothing short of a definite ceiling on the loans permitted to any bank, in the form of a quota for total loans fixed by the Federal Reserve Board would really have achieved the result of preventing an expansion in bank loans during recent months.

While I remain rather skeptical as to the effect of indirect measures in holding down the level of bank loans when the bank's customers are vigorously demanding credit, there are other ways of applying indirect pressure to the level of bank loans without at the same time incurring the risks of unsettling the government security market or adding to the cost of the defense effort and the size of the budget. These might take several forms: a general increase in reserve requirements, the addition of special emergency reserve requirements during the emergency period, and an extension of selective controls on credit in the form of directives to the banking system. Though I do not place any ways near as great emphasis on the significance of bank credit in the total inflationary picture as some others do, I fully agree that no objection should be made to any attempt to deal with this aspect of the inflationary problem unless it involves dangers to other objectives we have before us. Consequently, I would

support the adoption of legislation authorizing the Board of Governors of the Federal Reserve System to increase reserve requirements above present levels. I would also endorse the proposals which the Board of Governors has made at previous dates, as a special emergency period device only, the requirement of a special reserve, over and above regular reserves, to be held in the form of eligible securities of a short time character. I believe this should be a special emergency measure rather than a permanent authority.

In the third place, I would be glad to see the powers of the Federal Reserve System extended to enable them to provide limits as to the amount of business inventories as well as consumer credit, which may be financed for a given borrower. I would also be glad to see them given powers to direct the banking system to refuse credits for particular types of activities. In fact, I am prepared to accede to any request of the Federal Reserve System for powers to control bank loans directly, so long as these powers are not exercised in such a way as to make more difficult the problem this country faces in financing this gigantic effort of national survival and maintaining a steady and confident market for the billions of government securities which ~~it~~ must eventually be placed with the public and with the financial system, at rates which are reasonable but which do not add unnecessarily to the heavy burden of expenditures which we must write into our forthcoming budgets.

Subject: Credit Control and Debt Management

The crux of the credit control problem in this inflationary period is to find some means of holding down the total volume of commercial bank and related credit to the desired volume.

Credit control is the direct responsibility of the Federal Reserve System. Some members of the Board of Governors, at least, now propose to tackle the problem of controlling the volume in large part through the use of the device of allowing the yield on both short-term and long-term government issues to increase and thereby decrease the incentive for commercial banks to shift from governments to commercial loans. The use of the device is technically possible because the Federal Reserve is today in a position through its open market operations to determine the price and yield on the entire government issue.

In times of stable economic activity the Federal Reserve policy might be able to exert an important deterrent effect on the expansion of bank credit. The inherent weakness of the approach today rests on the fact that, under existing circumstances, the type of yield increases which would seriously impede the sale of government securities or notes by commercial banks are probably so great as to be impracticable. The type of fractional increases that would be feasible without running a serious risk of dealing a severe blow to public confidence in the United States credit--and the type which the System apparently has in mind--are not likely to deter the commercial banks from extending further loans as long as the general business situation remains so favorable.

Unless it can be shown conclusively that the withdrawal of the peg in the long-term rate will contribute more in the way of checking the monetary inflation than it will cost in the form of an extra debt burden and unstabilizing effect on the public credit, there would seem to be a public policy presumption in favor of the use of alternative methods of bringing the volume of commercial credit under control.

The most obvious, direct, and perhaps the most effective way would be to freeze the volume of outstanding loans at existing levels and allow increase in the volume only upon specific approval of the Federal Reserve System, or the State Banking Commissions in the case of State banks. A combination of direct quantitative credit control, together with an intensified use of various selective credit control devices such as Regulation W, would unquestionably be more salutary in checking the use in the volume of commercial credit than any practicable combination of open-market and rediscount operations.

The same result of checking a rise in the volume of commercial credit could be achieved indirectly by freezing the entire present commercial bank holdings of Government securities (thus making further increase in cash reserves entirely dependent upon new cash inflows) and requiring a 100 per cent reserve against all new deposits. If the banks were obliged to maintain their government holdings at existing levels and had to establish a 100 percent reserve of cash or government securities against new deposits the volume of bank credit would be effectively frozen.

The above solution is obviously so extreme as to be outside the realm of practicable possibility short of the gravest national emergency. There are, however, variants of the technique of completely freezing commercial bank holdings of government securities that are worthy of careful

consideration as alternatives to fractional increases in yields brought about through Federal Reserve open market operations. The simplest is the device of a special reserve requirement that would require the commercial banks to hold, over and above their regular reserves, a specified percentage of special reserves in the form of short-term government securities or additional cash reserves at their option. The percentage could obviously be set at a figure that would require the commercial banks to maintain short-term Government holdings at existing levels, or even increase the level, for an indefinite period.

The special reserve requirement would force the banks to sell long-term governments to the Federal Reserve System rather than to sell short-terms or allow the short-terms to run out in order to acquire new reserves. While it is clear that this action would not seriously interfere with the power of the banks to establish new reserves at their option, it would equally ^{be} clear that it would be at least as, and probably much more, effective than a deliberate increase in the yield on short-term government issues.

The direct alternative to the Federal Reserve approach of partially freezing the long-term government holdings of commercial banks by permitting a yield increase is an increase in general reserve requirement which would compel the banks to dispose of some government issues to the System in order to establish new reserves. If the assumption is correct that the Federal Reserve System would not propose interest rate yields to increase to the point where the deterrent effect on the banks would be decisive, a modest increase in reserve requirements would have the same partial immobilizing effect.

The choice of approach in the field of controlling the volume of commercial bank lending would seem, in the last analysis, to revolve around the government estimate of the overall situation which will confront this country during the next decade. A fairly persuasive argument can be made for the use of the orthodox, indirect approach of fractional interest rate and rediscount rate adjustments if one is convinced that this country is nearing a new period of stable economic activity and budgetary balance. If, on the other hand, one is convinced that the outlook for the next decade is that of continuing budgetary deficits and an upward price trend, it would appear to be more appropriate to peg the yield on both short-term and long-term government issues and deal with the problem of the volume of credit by a combination of direct restrictions on the volume of loans outstanding and measures which will effectively freeze the entire government portfolio, now and subsequently acquired, of the commercial banking system.

Any appraisal of future policy in the credit control field should bear in mind the fact that, once the banking system acquired large holdings of governments it automatically rendered itself largely immune to any indirect pressure from the central-banking system and largely free to expand the volume of commercial credit at will. If United States public policy requires that the present power of the banking system to expand commercial credit at its own volition be curtailed or abrogated, it would appear essential that the problem be attacked at its source. There appears to be no prospect in the foreseeable future that commercial bank holdings of governments will fall below present levels. It would not appear wise

lightly to give up the objective of keeping the debt service charge down and the price of governments stable merely to permit the Reserve System to experiment with an indirect weapon which, within the limits that it can prudently be used, now appears completely outmoded as an effective deterrent to credit expansion.

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FEDERAL RESERVE OPEN MARKET OPERATIONS, INCREASED RESERVE REQUIREMENTS, DIRECT
LOAN CEILINGS AND BANK LOAN EXPANSION

The Federal Reserve proposals are designed, fundamentally, to bring about a curtailment of further commercial bank loan expansion via the indirect route of limiting the commercial banks' powers to expand their reserves through sales of Government securities to the System. In evaluating the merits of the proposals, therefore, we should try to reach a judgment on the following questions:

(a) Just how important a contributing factor to the post-Korean inflation has commercial bank loan expansion been?

(b) Under existing circumstances will the methods proposed by the Reserve System effectively deter further commercial bank loan expansion?

(c) Are there alternative methods available to the System which will be equally, or more, effective in bringing to a halt the commercial bank loan expansion?

(d) Are any of the alternative methods less injurious to the public debt management requirements than the Federal Reserve interest rate proposals?

There would seem to be no doubt that bank loan expansion has been a major contributing factor to the recent monetary inflation. Since last July, bank loans have risen by 8+ billion, from 52 billion to 60 (?) billion. This 12 percent expansion in the level of bank credit outstanding compares with the _____ percent rise in the general price level, over the same period. In view of these basic statistics, which are readily available and already generally known to the interested portions of the general public, the financial committees and Congress, I think that it would be a mistake to

attempt to minimize publicly the inflationary impact of the recent bank loan expansion. If any issue in this field is really open to debate, it is the issue of whether or not the recent bank loan expansion has now largely run its course and will soon come to a halt as a result of the impact of the various price and allocation controls and commodity shortages. A convincing affirmative answer to this question, would at least enable Treasury spokesmen to maintain that there was no need for adopting the Federal Reserve proposals because the problem with which they were concerned had resolved itself. If, however, a convincing case cannot be made for the proposition that the bank loan expansion phase is now nearly at an end, I think the Treasury should accept the premise that bank loan expansion is a significant contributing factor to the current inflation and that some agreed program will have to be adopted to bring bank credit under more effective control. This would narrow the issue to the choice of methods to be used and there would seem to be a presumption in favor of those methods, other things being equal, that would have the least injurious fiscal consequences.

Whether or not fractional interest rate adjustments, such as those apparently contemplated by the Federal Reserve, would effectively deter further commercial bank loan expansion, turns on the intensity of the various demands for bank loans. If it is true, as some maintain, that the demand is already at its peak and that the various price and allocation controls and commodity shortages will tend to check sharply future demands within the next several months, there is good reason to believe that the Federal Reserve proposals would be quite effective at this juncture. If, on the other hand, appearances on this score are deceptive and the demand for new bank loans for non-defense purposes should continue very strong over the next year, it seems quite likely

that the Federal Reserve measures would be of only limited effectiveness. Commercial banks today have \$ 18 (?) billion of short-term government issues and they could finance a multi-billion additional bank loan expansion in the next 12 months merely by letting a billion odd of these issues run out this year.

In view of the uncertainty about the present real demand situation for commercial bank loans for both defense and non-defense purposes, I think that we should try to arrive at an agreement to adopt that method which is most adaptable to changing needs. If, for example, it should turn out that defense program requirements make a further expansion in the level of bank loans desirable it would have been a serious mistake to have imposed too rigid a ceiling on bank loans. If, on the other hand, it later turns out that we are underestimating the demand for non-defense loans, it would have proved advisable to have taken relatively drastic steps in this interim period.

The Federal Reserve approach is, I think, clearly one that falls in a half-way category by the tests of effectiveness and adaptability to changing circumstances. In all likelihood it would have some deterrent effect under almost any conditions, and it would be quite effective in the next few months if the expansionist pressures of the past few months are now nearly at an end. On the other hand it would probably be relatively useless over the next few months if there is a continued strong new demand for commercial loans.

If it can be shown that there are other ways of getting at the problem of unwanted bank-loan expansion which will be at least as effective and flexible as the fractional interest rate adjustment method but without the same adverse fiscal consequences, then I think that serious consideration

should be given by the U. S. Government to the adoption of one of the alternative methods in preference to the Federal Reserve proposals.

There are at least two alternative methods for bringing the level of bank lending under control. They are:

(a) Increased reserve requirements, either general or supplementary special reserves set at, or somewhere below, the level which would freeze the commercial banks holdings of government securities ^{at} ~~are~~ existing levels.

(b) Direct loan ceilings, with some or all new loans requiring approval by Federal Reserve district loan committees.

Both methods could clearly be drawn up in a fashion that would be much more effective in dealing with the loan problem than any feasible central bank open-market technique. The direct loan ceiling technique deals directly with the loan problem while the reserve requirement approach deals with the problem at the next most direct level, the ability of the banking system to create new reserves.

The question then is: can either of the methods be implemented in practice so as to provide the type of flexibility and effectiveness which the present uncertain loan demand situation calls for.

In theory, a loan ceiling technique can be made as flexible as one likes by having some administrative machinery such as Federal Reserve district loan committees with the authority to raise the ceiling and approve new loans. The real difficulty of the direct loan ceiling technique, in my judgment, lies in its implementation. The Federal Reserve district loan committees would find themselves from the outset faced with an exceedingly different ^{sort of} administrative problem unless they confined their activities simply to approval of requests of

individual banks in their districts to raise their loan ceiling in order to be able to make new defense loans. This type of flexible loan ceiling would probably soon become substantially self-defeating inasmuch as any bank could get an increase in its own ceiling more or less at will by submitting its new defense loans to the Committee for approval above the ceilings. On the other hand, an absolutely inflexible loan ceiling would appear to be out of the question in a period of steadily expanding defense requirements. It might, however, be possible to work out some compromise between the above extremes which did not go so far as to require the district loan committees to approve all new loan applications.

Some form of increased reserve requirements would be the more orthodox alternative method for dealing with the bank loan problem that is the direct consequence of the present ability of U. S. commercial banks to increase their reserves at will through sale of governments to the Federal Reserve System. Today member banks hold 50 odd billion of government securities against demand deposit liabilities of 85 billion. Their government holdings would be frozen at present levels and their ability to increase reserves cancelled out if an emergency supplementary special reserve requirement of 60 percent holdings of short or long-term government securities against demand deposit liabilities were imposed. This would compare with the Belgian supplementary reserve requirements, introduced in 1946, of 50 to 65 percent of deposit liabilities. The necessary degree of flexibility could be obtained by obtaining legislative authority to introduce special reserve requirement up to, say, 65 percent of demand deposit liabilities. If special reserve requirements of 65 percent appeared too extreme, it

might be possible to limit the percentage to the figure necessary to freeze the short-term government holdings of the banks, or approximately 20 percent. This would not, however, prevent commercial banks from increasing their reserves through the sale of their long-term government holdings to the Reserve System, hence would be relatively ineffective in bringing bank loan expansion to a halt.

The great advantage of the increased reserve requirement over the direct loan ceiling approach lies in its administrative simplicity. Its drawback is the fact that it would require new legislative authority, a matter of months even if Congressional support could be attained at this session of Congress. For this reason, the practical choice would seem to lie between the use of some form of direct loan ceiling or the Federal Reserve open-market technique if the intent is to deal with the loan problem immediately.

From the Treasury viewpoint a direct loan ceiling would have obvious advantages over the Federal Reserve approach since it would not involve any lifting of the peg on government securities. The question is therefore whether or not a loan ceiling that is administratively feasible can be worked out promptly under existing legislative authority. There seems to be, as I understand it, little question that legislative authority does exist for establishing a direct loan ceiling. If it is felt that the present loan expansion problem can be met adequately by the device of a loan ceiling on everything but new defense loans, the administrative task would be quite simple. Federal District loan committees could quickly be established to approve increases in the loan ceilings of individual banks to take care of new defense loan requirements. If, on the other hand, a loan ceiling somewhat

more rigid than this, yet not an absolute ceiling, were called for, the administrative licensing problems posed thereby would be very great, and I think it is open to question whether or not public support could be long maintained behind such an approach.

As compared with the introduction of a direct loan ceiling, the Federal Reserve proposals have the advantage, at this juncture, of being easy to apply. Furthermore, there is, I think, a general tendency to exaggerate the probable effectiveness of the Federal Reserve proposals. As long as this is the case, those urging alternative courses of action, such as the direct loan ceiling, are called upon to make a stronger case for their approach than is perhaps really necessary. In view of these considerations, it seems to me to be quite difficult to oppose the Federal Reserve proposals effectively with anything short of a fundamental solution to the bank reserve problem. The fundamental solution, in my judgment, is to deprive the commercial banks through legislative action of their power to expand reserves without the approval of the Federal Reserve System. In practice, I feel this can only be achieved through some appropriate form of special reserve requirements. If it is the judgment of the responsible authorities that it is premature to undertake this fundamental step at this time, I can see little hope in obtaining agreement to any alternative half-way measure such as direct loan ceilings.

February 6, 1951

The following are the figures on holdings of all U. S. government securities by the Federal Reserve Banks at the dates indicated, in millions of dollars: (End of the Month except June 21)

May	17,389
June 21	17,678
June	18,331
July	17,969
August	18,356
September	19,572
October	19,252
November	19,693
December	20,778

Following are some comparative figures comparing the assets and liabilities of all banks in the U. S. with certain other figures:

	<u>June 30</u>	<u>November 29</u>	<u>Difference</u>
All banks in U. S. (excluding Federal Reserve Banks)			
Deposits	163,770	168,400	4,630
Loans	51,999	59,660	7,661
U. S. Government Securities	77,320	72,700	-4,620
Cash Assets	34,099	36,100	2,001

The figures after June 30 are preliminary and are partly estimated, since all banks do not report at such frequent intervals. On the basis of these estimated figures, the developments may be summarized as follows:

The banks extended loans in the amount of \$7.6 billion during this five months period. They also added \$2 billion to their cash assets.

To offset these movements, they sold government securities in the amount of \$4.6 billion and added \$4.6 billion to their deposits.

During the five months period, the Federal Reserve System acquired government securities in the amount of \$1,362 million. Member bank reserve balances rose during the five months period by \$829 million.

During this period the banks were able to add about \$5 billion to their total assets and their total liabilities. Of the increase in assets about \$2 billion took the form of cash and about \$3 billion of earning assets. The net change in earning assets reflected an increase of loans in the amount of \$7.6 billion partially offset by sales of government securities in the amount of \$4.6 billion.

The cash basis on which the banks expanded their assets was provided in part by an increase in reserve bank credit in all forms of \$1,935 million, of which \$1,362 million represented net purchases of government securities. The total reserves of the banking system with the Federal Reserve System, however, increased only \$829 million. This difference is largely due to two other factors. Gold reserve decreased \$1,194 million and currency in circulation increased by \$439 million. The remaining difference is accounted for by a decline in Treasury deposits and in non-member deposits (principally foreign bank accounts with the Federal Reserve).

The net effect of all these factors on the credit basis provided to the banking system by the monetary system may therefore be summarized as follows:

The Federal Reserve System extended enough credit to the banks to offset the outflow of gold, the increase in money in circulation, and the decline in Treasury and foreign bank accounts taken together. In addition it provided \$800 million of new reserves to the banking system. Most of the increase in Federal Reserve credit took the form of purchases of government securities.

On the basis of these additional reserves, and some other additions to cash assets of non-member banks, the banking system as a whole increased its assets as indicated earlier, by about \$5 billion. The indications are that the banks sold government securities to non-bank holders in the amount of about \$3.3 billion, while selling about \$1.4 billion in government securities to the Federal Reserve Banks.

From
OFFICIAL VERBATIM TRANSCRIPT
OF
HEARINGS BEFORE JOINT COMMITTEE
ON THE ECONOMIC REPORT
Friday, February 2, 1951

The Chairman. Dr. Clark, do you care to make a statement on the attitude of the Council of Economic Advisers with respect to this general subject?

STATEMENT OF JOHN D. CLARK, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Mr. Clark. Mr. Chairman, may I stand rather than use the microphone?

The Chairman. It will be quite agreeable.

Mr. Clark. Then I will be sure to keep this inside of 10 minutes.

The diversity of view of monetary policy which has been exhibited in recent discussion here today is not surprising. We are dealing with the problem now in an environment which has never before been experienced.

The policies, theories, developed in a period when, as Dr. Seltzer said, business loans constituted the bulk of investments of the banks. Today it exists in a situation where the banks hold billions of dollars of Government securities which, whatever price manipulation may take place, will always be liquid and can be turned into cash upon a moment's notice.

It exists in a period when great institutional lenders likewise hold billions of dollars of these liquid assets and when business itself is a source of credit far beyond any situation that existed before.

So that business does not have to go to banks in order to get loans before they can initiate a project even though later in the course of the project they many want to resort to banks for part of the funds.

These are new situations which have very greatly upset the assumptions upon which monetary policy has been developed in the past century and a quarter. We also have the new situation of an enormous public debt which, because it has been handled successfully, seems now to be looked upon by many people as a tame domestic animal which does not hold within it the seeds of violent disturbance to the economy, and therefore we do not have to do much about it.

That is not the character of the national debt. If it is not handled prudently, if we take such action that some important offering of Government securities is a flop on the market, we will soon learn that the Government credit can be destroyed by imprudent debt management.

These are the two new situations which have to be considered then in considering monetary policy today. And obviously we have an opportunity to come to different conclusions about proper monetary policy. Certainly the lessons of the past have very little to guide us in determining what we are to do in a situation which is so greatly different from that of other years.

The breadth of this diversity of view is illustrated by a couple of statements which have been brought to the attention of the Committee. One I am not certain that you have had. It is a statement issued this week by some of the most important members of the faculty of Chicago University, the department of economics.

I do not know whether that has been received by members of the

Committee. Since we received it I suppose all of you did.

The Chairman. I have not seen it.

Mr. Clark. To show how strongly these various respectable authorities support the most rigorous view of monetary policy, I want to read just a few lines:

"The price rise of the last six months could almost certainly have been largely or wholly avoided by effective monetary action."

Approaching the subject from that standpoint they come to this conclusion of what the policy should be today:

"The Federal Reserve System should at once announce that it will conduct its operations with an eye single to their effects on the supply of money and credit and on the level of prices."

They exclude all idea of monetary policy being related to the problems of debt management in this period when debt certainly is going to be a matter of daily concern. "It should at once begin to sell Government securities to whatever amount is necessary to bring about a contraction in the currently swollen credit base, and it should persevere in this policy to the point that the inflation is checked, even though one of its incidental effects is a rise in the interest rates on Government securities."

Last week you heard Mr. Eccles state a very simple theory of monetary policy based upon the idea of the direct relation between the volume of money--including currency and bank deposits and savings deposits--and prices.

As I understood him, his view was that you could influence prices in either direction by changing the volume of money. That seems to be the view expressed by the Chicago economists. The simple fact is that

prices in July, August and the first part of September had their most rapid price advance when there was almost no change in the volume of money, and had slowed down and there was relatively little price advance from the middle of September until the end of November when there was a very rapid increase in bank loans and in the volume of money outstanding.

The very reverse of the situation implied by these theories.

In 1939 the Federal Reserve Board made a very frank statement to the American people of the monetary theories held by the board. I will read a single short sentence which occurred in that report and which was repeated in the report more than once:

"The board finds it impossible to believe that prices can be controlled by changes in the volume and cost of money."

Before you suggest that that was at a time when we were interested in bringing about price increases, and that the very general and universal terms used by the Board at that time must be interpreted as applying only to efforts to come out of a deflationary condition, let me hurry to tell you that the illustration they used, out of experience, to justify this conclusion, was the events from 1926 to 1929 which as you may recall was not a deflationary period.

The Chairman. Was that a Board statement?

Mr. Clark. Yes, sir.

The Chairman. Not the statement of any individual members?

Mr. Clark. That was a Board statement, published in the Federal Reserve Bulletin in April 1939. The Federal Reserve position today is not so easily determined. They had not made an equally candid statement of the theories behind their operations.

Never let the people know what they are going to do until after

Board--and I have tried to do so--I will say this: They still hold to the view expressed in 1939 that you can not control prices by bringing about changes in the volume of money or in the cost of money, the cost of credit. They first moved into the theory of restricting availability of bank credit, which has been mentioned here today, by finding methods which will induce banks to hold their Government securities--you see it is a new problem they are dealing with, one they did not have in 1939 to any large degree--induce banks to hold their Government securities by giving them a better yield thereon, a policy which Professor Musgrave in his report to you--which has been published--speaks of as buying off the banks from using their credit machinery to endanger the public welfare.

The difficulty, of course, with that is, as has been pointed out by some of these gentlemen today, that every bank in America has plenty of Government securities which it can dispose of in the market without being much concerned about these changes in yields. The banks hold a large proportion of short-terms which are not very much affected by the moderate changes in yields which you can bring about.

The Reserve Board has not apparently a much more sophisticated theory of controlling bank credit under this provision of bank holdings of enormous Government liquid securities. It is perhaps that they will be able to dissuade the banker from disposing of his Government securities if he has to take a book loss thereon.

I can not quote anything officially from the Board itself on that, but this is the explanation given by Mr. Louis Brown, a director of the Federal Reserve Bank of New York, when he undertook to explain the recent policy maneuvers of the Federal Reserve System.

By using open market operations to bring about an increase in the yield--which means a decline in the market price--of the Government securities, including short-terms, the banker will be persuaded not to sell some Governments if he has to add to his reserve in order to make some business loan which is offered to him.

The suggestion has been made that bankers do not think that way and do not act that way. But quite irrespective of that, I do not think that the banks of the country can possibly be put in that squeeze. The little bank that supports me when the Government is not paying me is not entirely typical in that respect, but it is not such a bad example. It is one that I happen to know about. Every Monday or Tuesday morning, whatever the date is, we subscribe for \$200,000 of bills which mature in 13 weeks. \$200,000 happens to be just 10 percent of our required reserve.

So every Monday or Tuesday morning we have \$200,000 of bills maturing. All we have to do in any week to increase our reserve by 10 percent is simply not to subscribe for new bills that week. And in three weeks we can increase our reserve by 30 percent. We are going to continue to use these short-term securities in our total debt structure. They are available to the banks to dispose of.

You could not possibly drop prices on the financial markets low enough--unless you are ready to completely destroy the debt structure--so that any banker is going to be under any particular difficulty of meeting requests that he make attractive loans. We are caught in this trap and we can not get out of it, by these methods.

The bankers do have liquid assets which they are able to turn into reserves and you can not stop them by market manipulations. The view

of the Council upon this tough problem has been presented under two of the three groups of circumstances with which your committee has been concerned during the past year. Last February Mr. Keyserling and I, as the surviving members of the Council of Economic Advisers, in response to your request for a report upon a number of questions, including monetary policy, furnished you our views which you have published in the hearings on the 1950 economic report of the President.

In November we again made a report in response to the request of the staff that we contribute to this very valuable staff report that has been published within the last few days. The first time we were dealing with problems of monetary policy in a period of peacetime inflation. We told the committee that our approach to the problem is not and can not be limited to the monetary aspect, that under the Employment Act of 1946 our approach has to be much broader to consider the total problem of stabilization and not merely the monetary problem, and that we are continually concerned with the problem of economic growth; that we look upon the cost of capital as being no different from any other cost of production; that it is always desirable to have costs of production, including the cost of capital held at as low a point as social policy will permit or will bring about.

Therefore, we were not in favor of monetary policies that were directed to increasing the cost of capital and thereby limiting economic expansion. But in a period of inflation, under ordinary peacetime conditions, a period which is bound to come to an end either through effective policies being applied to it or through the crash which otherwise is the normal result of inflation, that in such a temporary period we think that it is entirely permissible to tighten credit.

And for that reason we had, ever since the Federal Reserve Board presented the proposal in 1947, we have vigorously supported the plan for a special reserve, to be held at the option of the bank in short-term Government securities.

In November the committee was considering the situation that now was dominated by the needs of the defense program following the attack in Korea. A very long term program, so far as we can tell. And the one change that we then made, and for that reason made, in our recommendation was to tell you that under the conditions that we were in following the Korean attack we looked upon the continued expansion of the economy as being far more important than it would have been in another period of inflation.

For that reason we were not in favor of tightening credit, although we did believe that it was still true that the Federal Reserve Board always should have among the tools in its armory of anti-inflationary policy, the right to establish the special reserve requirement under conditions that would make them proper.

Now we are in the third situation. The Chinese attack has aggravated the problem of preparedness and accelerated the defense program so that we immediately shifted from the original position we had taken that it was not necessary to have wage and price controls, that now we thought it was necessary to have wage and price controls. And a second change which that new condition makes in my mind is that if new business loans, the extension of bank credit, are creating a dangerous situation, there is no sense in trying to attack the danger by the use of the awkward, indirect, and indiscriminate control of credit, but that we should do with respect to credit what we are doing with respect to other

sectors of the economy, and that is to apply direct control of the volume of credit.

And when it is suggested, as Mr. Eccles argues with me, that the problems of direct control of the volume of loans which banks may make is an administrative impossibility, I have to say that we certainly are wasting our time in talking about such things as controlling prices of 4,000,000 business institutions and fixing the wages of 60,000,000 workers if the problems of controlling 14,000 banks, the institutions more subject to control than any others in our nation, is too big a job for us to handle. That is a personal view. The Council has not had occasion to pass upon it.

I say if it is necessary to act. Last week, when the committee had an executive hearing, I stated my view that there is probably no great problem in this matter of bank credit, that the situation has already been carried into a pattern which will not only stop the increase in bank credit but will very soon create a plethora of funds seeking investment.

Two days after I made that forecast to you the president of a building and loan association, in an address at one of their conventions, besought them not to establish limits upon deposits which they would accept. And the problem arose because these institutions already are finding it impossible to find outlets for savings and for new investment funds.

If you looked at the schedule that Don Woodward gave you at your hearing the first of the week you may have noticed that he came to the conclusion that in 1951, without any changes in prices, the inability of consumers to find goods to buy would mean that consumers' savings

would be in excess of \$25 billion this year. What are they going to do with the money? It will not be put into houses. That is a kind of a saving or a method of saving. What are they going to do with the funds? What will be done with the funds of these corporations who are going to begin to establish reserves for these higher taxes that the President has proposed today, and which will not be payable until the beginning of next winter?

They will not let those funds idle in the banks. I am sticking by my forecast, Mr. Chairman, that by the middle of the year you are not only not going to have any problem of expansion of bank credit, but you are going to have such a drive upon the Government security markets by those seeking that as the only outlet available for their funds, that it will be absolutely impossible through any open market operations to prevent interest rates from going down.

OUTLINE OF
TESTIMONY ON EUROPEAN EXPERIENCE

The problem facing the United States at this point, namely, the reconciliation of ^{vital} debt management requirements and the ^{handicaps} these requirements ^{pose in the way of (certain)} ~~the use of~~ ^{especially central bank open market operations} traditional instruments of monetary control, is a problem that has been faced by every European country in an acute form since the end of World War II.

The problem arises from the fact that the large volume of public debt held by the commercial banking system ^{tends to} give it a substantial independent capacity to expand reserves at will through sales of the government securities to the central bank. The task posed to the monetary authorities has been to find some means to prevent this "monetization" of the public debt other than ^{deliberate} ~~drastic~~ ^{which have such a disastrous effect on public credit} increases in the yields on the government securities.

A wide variety of methods have been used to deal with this problem.

Some countries have tried the indirect approach, chiefly the use of price and investment controls in order to make it difficult for both banks and individuals to find profitable ^{for uses} the funds they could readily acquire through encashment of government securities.

Other countries have adopted a more direct approach, and have adopted various types of supplementary reserve requirements, which, by freezing a portion of the short or long-term government or both of commercial banks, have made it difficult for the banks to expand their reserves at will.

The usual form chosen has been to require banks to increase their percentage holdings of cash and/or government securities against their *outstanding* deposit liabilities. Belgium, France, Sweden, and Italy all have used this

device deliberately as a means of making it more difficult for the banks to increase their loanable funds by selling securities to the central bank. In some cases the permission to count government securities as legal reserves applies to the standard reserve and in other cases it applies to a special additional requirement.

A related device that has been used in France and Italy is a differential reserve requirement which requires commercial banks to hold much higher reserves against increases in deposits. This device, rather than a blanket increase in reserve requirements, had to be adopted because ~~individual banks varied so greatly in their~~ cash and acceptable assets position ^{of individual banks varied greatly} at the time the requirement was introduced.

In several instances direct steps have been taken to curtail the amount of their reserves that the commercial banks could use for private lending. The United Kingdom has utilized the device of the Treasury deposit receipt for this purpose since 1940 (?). Under this system, the Treasury determines every week the total sum (if any) which the banks are called upon to invest in this non-negotiable, non-transferable instrument. The effect of this ^{arrangement} is that of a variable (weekly-adjusted) supplementary reserve requirement. In France, ~~the~~ Bank of France has supplemented its control over bank reserves exercised via stringent reserve requirements ^{with} individual ceilings on the volume of rediscounts it will undertake for given banks. ^{National} The Bank of Belgium has recently ^{attempted} instituted a similar ceiling.

A wide variety of qualitative measures have been ~~used~~. Qualitative credit controls have been applied in the United Kingdom, France, and the Netherlands. In France ^{and} the Netherlands the extreme device of subjecting

loans above a minimum size to the specific approval of the central bank was tried for a while but not too successfully. ^{on the whole} The United Kingdom has made effective use, however, of the Capital Issues Committee, established during the war, in the post-war period both in the field of new securities floatation and bank loans. The criteria laid down for this Committee in the securities field are used by the commercial banks as a guide to approval of new business loans, and all bank loans in excess of £50,000 must be approved by the Committee.

Finally, central banks have not hesitated to resort to moral suasion, wherever feasible. This has been a very effective weapon in the United Kingdom in view of the standing of the Bank of England and has made possible the use ^{in the U.K.} of a much more flexible approach than is possible in countries where the central bank carries less weight.

Several important lessons to this country may be drawn from the European post-war experience:

In the first place, that experience makes it abundantly clear that one can deal with inflationary pressures far more difficult than any confronting this country today by a variety of measures which deal directly with the problem that faces the United States, namely, the ease of monetization of the large volume of bank-held United States government securities, and ^{that} without resort to deliberate increases in the yield on government securities ^{brought about} ~~and~~ ^{through Planned} withdrawals of central bank supporting open-market operations.

[Individual country experience summarized, as per attached, at this point.]

United Kingdom

The United Kingdom has placed its principal reliance ^{throughout the post-war period} on the Treasury deposit receipt as the means of keeping the reserve position of the commercial banking system under control. This weapon was used effectively, it should be noted, during a period in which the Government was pursuing a deliberate cheaper money policy (1945 to 1947), ^{despite the increase in the price of government securities,} and there was no threat in that period to the power of the Treasury and the Bank to keep the reserves under control through sale of long-term governments to the Bank by the commercial banks. ~~[In the U.K., it should be noted, however, that the strong tradition of the commercial banks against long-term holdings was a considerable deterrent to increased acquisition of governments on the opening.]~~

FRANCE

In the fall of 1948, ^{then very serious,} the inflationary problem in France was tackled vigorously on both the fiscal and monetary fronts. On the fiscal side, increased taxes and ceilings on government expenditures were adopted. On the monetary side, drastic quantitative credit controls were imposed. A supplementary reserve requirement was established. Each bank was required to continue to hold the volume of Government securities it held on October 1, 1948 and to invest 20 percent of any increase in deposits in Governments. This requirement largely prevented the commercial banks from selling their Governments to acquire new reserves. In addition, rediscount ceilings were established at the Bank of France for each commercial bank at a level only slightly higher than that prevailing on October 1. This action reinforced the supplementary reserve requirement by closing an avenue which French banks have traditionally been very ready to use as a means of re-establishing their reserves.

Belgium

Belgium has relied on monetary policy more heavily than almost any other European country as a means of regulating the level of economic activity via a very rigid control over the volume of bank credit. This control was achieved early in 1946 by the introduction of a supplementary reserves requirement system under which the commercial banks are required to maintain, in addition to _____ percent cash reserves, a reserve of Government securities equal to from 50 to 65 percent (depending on the size of the bank) of their deposit liabilities. This requirement has severely ~~restricted~~ ^{restricted} the ability of the banks to sell Governments to the central bank. It has ~~left~~ ^{compelled the commercial banks to} rediscount ~~the~~ commercial paper at the National Bank ~~the~~ ^{in order to expand} ~~principal means by which the banks could expand~~ credit and, as a result, ^{quantitative} rendered the rediscount policy of the Bank an effective method of credit control. In recent months the National Bank has applied individual re-discount ceilings and thus further tightened its control over bank credit.

The Netherlands

In sharp contrast with Belgium, the Netherlands relied on price controls, rationing and subsidies to deal with the inflationary pressures arising from the high level of investment in the post-war period and placed almost no reliance on traditional monetary and credit controls until late in 1950. The only measure of credit control used until that time was a qualitative measure requiring that all bank credits exceeding 50,000 guilders required the approval of the central bank. In _____ 1950, however, a cash reserve requirement system for the commercial banks was instituted for the first time in Dutch history. The Netherlands Bank raised its rediscount rate from 2 1/2 to 3 percent, the first change since 1941.

Italy

Italy, which experienced inflationary pressures during and after the war that ^{for a time} threatened to get out of hand and resulted in a price level in mid-1947 60 times the prewar level and twice that of mid-1947, undertook drastic credit control measures in October 1947 which rather promptly brought the situation under control. All banks were required to set aside an amount equal to 20 percent of their deposits in excess of 10 times their capital or an amount equal to 15 percent of their total deposits, whichever was smaller. These amounts were either to be invested in government or government-guaranteed securities for deposit at the Bank of Italy, or to be held in an interest-bearing blocked account at the Bank of Italy or the Treasury. Furthermore, 40 percent of any increase in a bank's deposits after October 1 was to be set aside in a similar fashion until the bank's total reserves reached 25 percent of its total deposits. At the same time the rediscount rate was raised from 4 to 5 1/2 percent. These new reserve requirements meant that hereafter the banks had to rediscount at the Bank of Italy in order to increase their lending operations. They were ^{so} ~~were~~ reluctant to do this, ^{that} ~~and~~ a general shortage of funds was felt during the months following the adoption of the credit restrictions.

Sweden

In Sweden, the Government undertook to deal with the renewed inflationary pressures arising in early 1950 and intensified after Korea by the adoption in October of a reserve requirement system that effectively tied down assets that might otherwise have been used for further credit expansion:

(a) Cash and supplementary reserve assets (primarily government securities) are set for the five large Swedish banks at 10 percent of total liabilities exclusive of savings deposits and contingent liabilities.

(b) Forty percent of these reserves must be held in cash (till money and sight deposits with the Riksbank) and 25 percent of this 40 percent must be held on deposit with the Riksbank.

The authorities hold the power to increase reserve requirements up to 25 percent of liabilities and to vary the proportion of these reserves to be held in cash.

~~The long-term interest rate on government securities was held at 3 percent from 1945 until July 1950 when the rate was allowed to increase to _____ percent. Since then the rate has~~

Not one of the above-mentioned countries, the United Kingdom, France, Belgium, the Netherlands, Italy, and Sweden, therefore, attempted to prevent the monetization of the government securities holdings of their commercial banks ^{simply} by having the respective central bank withdraw its support of the government bond market over any extended period. In the United Kingdom the long-term government rate declined from 3 percent in 1945 to 2 1/2 percent in 1947 and has since been allowed to return to the wartime 3% level. In France the average yield on governments increased from _____ percent in 1945 to _____ percent in 1951. The corresponding figures for Belgium are _____ percent in 1945 and _____ percent in January 1951. In the Netherlands the average rate was _____ percent in in 1945 and _____ percent in January 1951. In Italy the average rate moved from _____ percent in 1945 to _____ percent in January 1951. In Sweden the rate was pegged at 3 percent from 1945 until _____ 1950, and has since moved to _____ percent in January 1951.

In the second place, the varying degree of success of different countries with essentially similar measures makes it clear that the particular techniques adopted by any country must be related to the basic characteristics of the financial institutions.

The United Kingdom, for example, was able to use qualitative bank credit measures very effectively because of the commercial banks unhesitating acceptance of the advice of the ^{Treasury and the} Bank of England ^{in this field} whereas the theoretically more complete qualitative control measures in France and the Netherlands were no ways near as effective. The supplementary reserve requirements measures introduced in France, Belgium, Italy and Sweden were quite effective, whereas

in the Netherlands it was not until _____ 1950 that the authorities were able to introduce a cash reserve system for the commercial banks for the first time. The United Kingdom was able to deal with the reserve position of the commercial banks directly by placing with them non-neogtiable non-transferable treasury short-term notes, whereas Belgium had to get at the problem by establishing general supplementary reserve requirements at so high a level that the commercial banks had to rediscount commercial paper at the central bank to obtain new reserves.

Conclusion

The Treasury Department believes that European experience, to the extent that it is applicable to the substantially different circumstances in the United States, lends strong support to the view that it is more appropriate to deal with the serious problem of the continuing "monetization" of the public debt by direct increases in reserve requirements than by the indirect route of open-market operations, etc.

INTEREST RATES AND INFLATION

1. Inflationary Factors in Recent Months

We are all aware that there has been substantial inflationary pressure in the United States economy since Korea. Most analysts would agree that the major reason for this inflationary pressure has been the fear that shortages would intensify prices. Under such conditions, consumers and businessmen have expedited their purchases. They looked ahead to see what they needed in the future, and they decided to hurry forward with their plans for expanding their businesses, buying houses, buying automobiles, and other durable goods. The experience of the last war is fresh in everyone's mind, and consequently there has been a particularly strong desire to acquire goods which were scarce during the last war.

This acceleration in the rate of spending has been financed in considerable measure by a reduced rate of saving on the part of the public. In the first quarter of 1950, personal savings were estimated by the Department of Commerce at an annual rate of \$15 billion per annum. By the third quarter of this year, savings had dropped to an annual rate of \$6 billion per annum, despite the fact that the total money income of the community had become substantially greater as the result of higher incomes, associated with the higher prices and the larger volume of output. Personal expenditures on consumption increased from an annual rate of \$182 billion in the first quarter of the year to \$185 billion in the second quarter, and then rose to \$198 billion in the third quarter of the year (all figures seasonally adjusted). In other words, about \$4 billion more was spent in the third quarter than in the first quarter, and the increase over the second quarter of 1950 was about the same.

At the same time, there was a slight increase in private domestic investment. The adjusted annual rate rose from \$41.7 billion in the first quarter of the year to \$46.9 billion in the second quarter and to \$48.4 billion in the third quarter. In the third quarter of the year there was a significant rise in expenditures on producers' durable equipment, offset by a sharp fall in business inventories.

These figures tend to show where the emphasis in the inflationary picture was during the third quarter of 1950. It was on personal consumption expenditures, although there was also some increase in producers durable equipment. In other words, the statistics bear out the practical experience of everyone who lived in the United States during this period. That is, we had an inflationary situation because people tried sharply to increase their expenditure on normal consumption goods and reduced their savings.

2. Bank Credit and Inflation

How did bank credit enter into the inflationary picture?

We have seen that the community as a whole was still saving at the rate of \$6 billion per annum in the third quarter, though it was not saving nearly so much as previously. For the community as a whole, no question of credit arises. It simply decided to save less and to spend more. The role of bank credit in the total picture has been to facilitate expenditures by some consumers and by some producers. If credit had not been available, the rate of expenditure might have been reduced, because some people would not have been able to buy, not having available cash savings.

Generally speaking, credit is a passive rather than an active factor in an inflationary situation. It is the borrower, or would be borrower, who makes the primary judgment that he should increase his rate of spending and gives the impetus to the inflationary move. Moreover, the effect of credit restrictions is largely insignificant in trying to reduce the spending of people or corporations which possess ample reserves of savings. This is particularly significant because of the very large volume of liquid savings of the public, amounting to about \$200 billion. No control of credit can significantly affect the use of these accumulated savings for current expenditures.

As we have indicated, gross private domestic investment was proceeding in the third quarter of this year at an annual rate of about \$48 billion, or about \$16 billion per quarter, seasonally adjusted. Of this total about \$5-1/2 billion was new construction and about a little over \$6 billion went into producers durable equipment. A substantial part of this latter amount may have been financed by the banks, through extending loans, and the remainder either through other financial institutions or through the funds of the organization or person making the basic investment. There is no question that the increase in the rate of expenditure in this field, as in the field of consumer durable goods, tended to push prices up. There is also no question that the non-availability of bank credit might have interfered with some expansion programs in construction and in durable equipment. No one can tell how much the curtailment in this kind of an investment would have been just as no one can tell how much consumers' expenditures would have been reduced if no consumer credit had been available. But it is reasonable to assume that there would have been a somewhat lesser volume of spending by some producers and by some consumers. This would have had some moderating influence, though not to be exaggerated, on the inflation pressure.

Thus it is perhaps not appropriate to regard credit, and particularly bank loans, as an aggressive "engine of inflation." Rather credit

is more like the standby unit of an electrical generating plant. When there is a great demand for current, the standby plant is brought into operation to meet that demand.

3. The Bearing of Interest Rates

It is the expansion of bank lending for commercial and industrial purposes which has given rise to questioning of the present level of interest rates. This supplement to normal sources of funds for investment is charged with a primary responsibility for inflationary problems.

The heart of the interest rate controversy then becomes a discussion of the contribution which could have been made to reducing these investment expenditures by charging a somewhat higher price for loans from the banks. In other words, how many borrowers would have given up their expenditure programs if the banks had charged them one percent more for the funds? A moment's reflection would lead one to doubt that a substantial postponement would have in fact resulted. It may be seen that the fearsomeness of the credit situation in its relation to the inflation problem begins to be more questionable.

Though the level of interest rates is, in a situation like the present, a minimum factor in the inflationary system, it is still worth careful consideration. Anything which we can do effectively to deal with the inflationary problem is worth attention, unless it carries with it unsatisfactory and undesirable consequences.

It is here that the intricacy of monetary theory becomes difficult for the practical man to follow and tends to enter a confused area. The next link in this intricate theoretical chain is that banks must be made more short of funds, so that they will charge higher rates and turn down more borrowers. This, however, is hard to do as long as banks hold substantial amounts of short, medium and long-term government securities which they can sell to the Federal Reserve System to replenish their reserves. So long as this is the case, they do not feel the pinch as their loans and deposits expand. They merely sell some long-term securities to the Federal Reserve, or allow some of their short-term holdings of governments to mature without replacing them. The theory goes on to suggest that perhaps, if we could in some way bring down the price of government securities, the banks would feel the pinch of short cash enough to really tighten up on their lending.

This is at best a rather weak hope, as can readily be seen. The bank will readily raise its interest charge to the public if the rate of government securities is somewhat higher, since the rate on governments is a kind of a minimum which can always be earned and against which other earning assets are judged. But the amount of reserves needed by the banking system to expand loans at the recent rate of \$3 or \$4 billion a quarter is not large. Under present reserve requirements,

probably not more than \$1 billion a quarter would be needed to add to reserves. This can be done very easily by allowing short-term government paper to mature and receiving payment in cash. It is true that a rise in the long-term rate of interest would create an inhibition against selling existing holdings of these securities, because a capital loss would have to be taken. But it is highly questionable whether the banks would find it difficult to increase their cash reserves by the small amount necessary to maintain an active lending policy under present reserve requirements.

Moreover, in the hope of doing what could be done by the instrument of credit controls to dampen the inflationary pressures, controls have been placed on the type of credit most closely related to the inflationary elements in the economy, namely, purchases of durable goods by consumers. Consumer credit has been directly restricted. Since the power to restrict consumer credit is now available, it may be presumed that controls have been extended as far as is considered desirable in this field. They have undoubtedly contributed to restricting the expenditures of that section of the population which does not have ample savings of its own. We have also applied restrictions on real estate credit. Both types of credit controls have been directed not so much toward increasing interest rates as in the direction of requiring higher down payments. The same procedure has been followed in security loans, where the amount to be lent on margin or collateral has been restricted. All of these "selective" controls aim to require a buyer of goods, securities or real estate to have more funds of his own to put into his venture. If anything their effect may be to lower rather than raise interest rates, since they operate to reduce the effective demand for loans from the banking system.

4. Limited Effects from Raising Interest Rates

So much then for the examination of the role of credit, and particularly bank credit other than consumer and real estate credit in the present inflationary situation. From the above review, it would appear that the role of bank credit has been limited significantly in the recent inflationary period and that the relationship of a decrease in prices of government securities to the general availability of credit and the willingness of the banks to lend is vague, doubtful and tenuous.

5. Objections to Rising Interest Rates

Let us now turn to the other side of the picture. However limited a contribution to control of inflation might be made by raising the interest rates on government securities held by the banking system, we should examine it thoroughly to see if it can produce any useful result. We should evaluate the disadvantages as well as the advantages which might be involved. What are these disadvantages? First, a higher level of interest rates for government securities means a heavier charge on the public treasury and a larger budget for the government. This is not a

slight matter when one is entering a period which may involve substantial expansion in the public debt, before we have passed through the current emergency. We must ask, are we really getting anything worth this additional expenditure? We think that it is very doubtful, under prevailing circumstances, that the process of raising interest rates fractionally would reduce bank loans by as much as the additional cost which would be added to the federal budget through the increase in interest rates. If this is the case, the rise in rates might very well prove inflationary rather than the reverse, since public expenditure on interest charges, just as public expenditure on military goods, tends to expand monetary incomes.

There is another area of concern. One of the major objectives of our anti-inflationary program is to influence people not to spend but to save and invest their money in government securities. In fact, as an ideal, all of the savings of the public should be channeled into loans to the government or loans for purposes approved by the government, as directly contributing to the defense program. If we allow the price of government securities to go down steadily, we may hasten the public search for alternative uses for savings which would previously have been invested in government securities. No one likes to put money into assets which are obviously depreciating in value. These alternative uses of funds are in most cases likely to be inflationary. They tend, directly or indirectly, to add either to personal expenditures or to provide funds available for private investment. Thus, even if a slight reduction in bank loans should result from rising interest rates on government securities, the beneficial effect of this reduction may be more than offset by an increased unwillingness of the general public to invest in government securities. It seems probable that an unsettling of the long-term government market will have precisely this result. If the peg in long-term government bonds is abandoned, the uncertainty in the outlook for government securities will be brought home to every potential purchaser. Since other fixed interest securities tend to move with governments he must look for some other type of investment. Most probably he moves into the market for stocks, commodities, real estate or something of that kind. This means that he provides more funds which make it easier for private investment.

At the same time things have been made harder for the government. In addition to paying more interest, it is having more difficulty selling its securities. Since it must raise the money, if it has difficulty selling its securities it must dispose of them directly to the banking system. This, of course, is directly contrary to the avowed objectives of tightening the reserve position of the banks. It may be stated that any action which forces the government to finance itself to a greater extent directly from the banks tends to create additional bank reserves and hence ease any pressure on the banking system which may then be existing.

In a period in which the government is not borrowing appreciably on balance, minor interest rate adjustments in government issues may have a slight deterrent effect on bank lending. But in the years to come the government will be raising larger amounts of new money. If there is an uncertain market for long-term securities both among non-bank investors and banks, the government will be forced to raise its funds by placing its securities with the Federal Reserve System, and substantially increasing bank reserves. If this takes place, it will naturally be necessary to deal with the problem of bank lending, should it arise, in some other fashion. In fact, the extension of allocations and other direct controls may limit the significance of bank loans, as in the last war, and concern with the expansion of bank loans may prove of passing interest.

In sum, the interest rate controversy is an argument over difficult technical problems involving the management of public debt and the management of bank reserves. There is little reason, on the basis of experience, to believe that any minor increase in interest rates during the next few months will appreciably decrease the availability of bank credit, which today in itself is a minor and supplementary factor rather than a major cause of inflationary pressure.

Nevertheless, it would be worth testing this intricate chain to see whether the hair of the tail can wag the dog, or at least move the dog slightly, if there were no offsetting disadvantages. There are, however, two significant disadvantages. The first is a very simple, direct and obvious one. The money to finance the experiment will be a direct charge on our budgets of considerable magnitude which is only worth considering unless we really believe the experiment is worth it. On our part, we do not believe it will contribute anything like the cost.

The second disadvantage is, we believe, not quantitatively measurable, at least with any exactitude. It is the effects of rising interest rates, and particularly of an uncertainty as to future rates of interest, on the market for public securities. This tends to divert savings into expenditures for the financing of private investment, rather than the financing of the public deficits in our defense expenditures. Secondly, when the government is borrowing actively and in large amounts, it tends to force the government to sell its securities to the Federal Reserve System, thus expanding bank reserves and cancelling or negating efforts to tighten bank reserves.

In view of these two disadvantages, we do not believe the experiment should be carried any further. First, credit controls do not affect expenditures carried out from the current income or savings of individuals and corporations. Second, credit to finance consumers'

durable goods, security purchases, and housing has been controlled directly by reducing the availability of this credit rather than increasing the price. These "selective" controls are effective, direct and flexible and can be expanded or contracted to permit the desired amounts of financing for consumer credit and credit for new housing. There remains to be controlled by fluctuation in interest rates or otherwise, loans for business, commercial and agricultural enterprises. When we ask ourselves how many such borrowers would have been disposed to postpone their projects or would have been refused by their banks, if interest rates were one percent higher, we still further reduce the significant area of controversy. The "engine of inflation" becomes indeed a very small, if not negligible, factor. In fact, if we pursue our analogy further and say that the credit system is a standby plant to an electrical generating system, a change in the interest rate might be regarded as a rather small change in the speed of the standby plant. How is changing this speed going to help obtain the objective of diverting the use of electricity from ordinary consumption to special uses? That is really what we have to do with the country's income--divert as large a portion as necessary to the special needs of defense.

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Author: Lionel D. Edie & Company
Article Title: Political Developments: The Inflation Question
Journal Title: Confidential Monthly Analysis
Date: January 30, 1951
Pages: 1-3

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Author: Lionel D. Edie & Company
Article Title: General Business
Journal Title: Confidential Monthly Analysis
Date: March 21, 1951
Pages: 1-3

An Address given before the 55th Annual Meeting of Group Two of the
Pennsylvania Bankers Association
held at the Bellevue-Stratford Hotel, Philadelphia, Pennsylvania
By Aubrey G. Lanston, President of Aubrey G. Lanston & Co. Inc.
On February 12, 1951

THE TREASURY-FEDERAL RESERVE DISPUTE

I would like to talk to you this morning about the differing convictions of the Treasury and the Federal Reserve, because these involve questions of policy that are of great importance to our economy and, therefore, to you as bankers. Public opinion is being brought to bear on the impasse that exists, and it is being marshalled through statements that oversimplify the points at issue. It would be unfortunate, as we see it, if too many people accepted the thought that, if the Federal Reserve were freed of its compulsion to buy Treasury securities at fixed prices, the Federal could necessarily exercise a deflationary influence. Nor should we accept the generality that preys upon our love for tradition, namely, that the Federal Reserve was created as a supreme court of finance and that it would be a sacrilege if it were interfered with in any way.

Let me tell you at the outset where we stand on these matters. We believe it is most desirable that the Federal become more free than it has been in the past decade to follow a restrictive credit policy at times when this is needed. We agree with those who say that Treasury domination of Federal Reserve credit policy is dangerous. We do not go along, however, with the sophomoric contention that the Federal Reserve should be omnipotent or that it should be free to assume an attitude that might be described as "the Treasury be damned". There is much appeal in the thought advanced by Mr. Russell Leffingwell that the Treasury and the Federal Reserve be equal partners. On such a plane each can act to restrain the other or to goad the other as the case may be.

The question of domination or partnership is important largely as a matter of who holds the final say. The real problem involves many technical phases of debt and credit management and the need for a continuing understanding of investor psychology. Perhaps the outstanding problem in the technical field is whether 2 1/2% Treasury bonds need be supported forever at par or better. We have long been of the firm belief that par support should not be a permanent practice. At the same time we are equally firm in our belief that we cannot depart from such a practice overnight, particularly in an atmosphere of contention between the Federal Reserve and the Treasury. We also believe that if the two partners in money and debt management are so far apart in their convictions that agreement can be reached only by literally hitting one of the two of them over the head, the public cannot be blamed if it loses confidence in both, and in the dollar, and in Treasury securities.

We are inclined to place a great deal of weight on the importance of the state of mind of the investor and on the degree in which this must be considered in the management of both debt and credit.

The open-market operation is the principal instrument with which the Federal may affect the amount, availability, and cost of money. We know quite well how readily the Federal can expand the amount and can increase the availability of credit by the purchase of securities in the market.

We believe that some misconception exists as to the ability of the Federal to contract credit by the sale of Treasury securities. Success in this regard depends upon the Treasury's cash position. If the Treasury is operating with a substantial cash surplus, the Federal can contract reserve credit by selling securities in the market or by redeeming obligations as they mature.

If the Treasury does not have a cash surplus, attempts by the Federal to sell in the market cannot contract credit against the will of the market and may only expand the amount of credit in use.

At the present time the Treasury faces a deficit, and the prospect of the Treasury attaining a surplus seems remote. Therefore, in future open-market operations the Federal will be unable to contract credit to any appreciable extent by sales of Treasury securities on balance.

Perhaps this is why we are confronted with the demand that the Federal Reserve be restored to the independence conceived for it thirty-seven years ago. Such independence would permit of an attempt to reduce the inflation problem by denying credit to the market, with the obvious result that a sharp upward trend in interest rates would follow. In the meanwhile the Federal Reserve creates, on occasion, a situation where there is no market for Treasury securities.

This brings us to the second phase of open-market operation, namely, the techniques employed by the Federal that would produce a trend toward higher interest rates. One can be certain that if the Federal were free to precipitate, directly or indirectly, a sharp upward trend in interest rates and if it were determined to use this mechanism to the necessary extent, it could stop the present inflation spiral. But once this had been accomplished, or during the process, another series of chain reactions would be started, such that the resultant inflation potential would cause our present problem to be dwarfed by comparison.

The February National City Bank letter offered a comment that was of great interest to us in this connection. It was directed primarily to the defense effort, but it applies equally to those phases of credit and debt management that have precipitated the Federal-Treasury dispute. The National City Bank noted that during most of the time since Korea, people have been uncertain as to the extent of the requirements of defense and what was expected of them. The Bank went on to say that little authentic information had been available on the size of the defense program, and it admitted that, although such uncertainties may have been unavoidable, the lack of a firm basis for calculations left the way open for uninformed opinions, speculation, and extreme statements both public and private. The comment closed with the following quotation, "Undoubtedly there has been 'inflation by publicity', which has fostered a contagious state of alarm and scare buying".

We believe that the drawn-out public discussion over the clash between a fixed interest rate and credit control, a discussion in which Federal Reserve officials have taken a long lead, has contributed importantly to the expansion of bank credit.

How much weight should be given by the Federal to the impact of its credit policies on holders of Treasury securities such as businesses and individuals? For an idea we might turn to an estimate of the so-called inflationary gap that was recently made by a noted Federal Reserve economist. He said that the gap during the next year could be as much as \$20 billion and will stem from a contraction of \$10 billion in the goods available for civilian purchase and an increase of a like amount in consumer and business income. He cautions that the estimate is premised on (1) no further price or wage increases, (2) no substantial credit expansion, (3) no further tax increases, and (4) a consideration of particular potency to our discussion -- namely, no large use of available liquid assets. He then points out that individuals and businesses hold \$176 billion of bank deposits and currency and \$90 billion of Treasury securities, a large part of which are redeemable on demand or have short maturities. The total is \$266 billion. The question, therefore, is whether attempts by the Federal to reduce the size of the inflation gap will suggest that some portion of the \$90 billion of these Treasury securities be sold or whether such investors thereby will be encouraged to increase their holdings.

The Federal Reserve, as a special guardian of the purchasing power of the dollar, also must keep in mind that some \$100 billion of Treasury securities rest in the portfolios of commercial banks, savings banks, insurance companies, and the like, and that such investors hold additional billions of other marketable securities, the value of which would be affected, along with their Treasury securities, should a sharply increasing trend in interest rates occur.

Managers of these portfolios, such as yourselves, are concerned with the decreasing purchasing power of the dollar, but you also take into consideration in the management of your portfolio the dollar prices that your security investments command in the market. Many of the decisions that you make with respect to the purchase, sale, or retention of these securities are based upon changes in market values. Collectively these decisions of yours, influenced as they must be by the Federal Reserve's policies, will bear importantly on whether individuals and businesses prefer to acquire additional securities or are inspired to bring their liquid assets into play in a manner that will heighten our inflation.

Thus, the Federal is quite correct in saying that it must protect the purchasing power of the dollar, but the Treasury is also on sound ground when it says that investor confidence in Treasury securities should not be impaired by unexpected sharp fluctuations in the dollar prices of its securities. These two statements are the crux of the dispute.

Now let us digress for a moment in order to examine the weight that should be given to the Board's contention that it has a responsibility for credit that it is not able to discharge. There is nothing new about this. The Federal Reserve was charged just as fully in this connection nine years ago as it is today. Yet nine years ago, as a consequence of the war emergency, the Federal agreed to underwrite a pattern of rates for Treasury wartime financing. The Federal had no option, because the Treasury faced an unprecedented deficit, the money had to be raised, and there was nothing else to do.

Since the Treasury again faces a deficit, is there any better way to resolve matters than to bring about an agreement between the Treasury and the Federal in the technical area of interest rates and support techniques?

Nine years ago when the Federal accepted the responsibility of protecting the prices of Treasury securities, the Secretary of the Treasury would have accepted a support price that was fractionally below par. When I say this I am not making an assumption. The choice of par, as a precise figure, was made by the Federal, and with the passage of time most Treasury security investors have come to believe that whenever "the cards were down", neither the Treasury nor the Federal would elect to drop the support price of the 2 1/2% bonds below that figure.

Indeed, you will recall that by the time we had to face up to the inflationary problems of 1947 and 1948 a leading official of the Federal proclaimed that failure to support Treasury 2 1/2% bonds at par would lead to a catastrophic condition. We repeat that we firmly believe that we need to get away from par support, and we believe that a program should have been and could have been worked out long before this. A period of national emergency and of bitter dispute between the Treasury and the Federal, however, is not a propitious moment to engage in drastic changes or to withdraw support.

Furthermore, if the reasons for supporting outstanding Treasury bonds were compelling in 1948, how do we justify ignoring similar reasons today?

The Federal has lived with its conscience for nine years. Why must it suddenly choose a war emergency and a period when the Treasury faces a deficit of unknown size to suggest that it be free to act independently?

Indeed the differences between the type of inflation that we face today and that with which we were confronted in 1947 and 1948 should leave the Federal Reserve with less rather than more reason to have precipitated these questions. During 1947 and 1948 the inflationary problem arose primarily from activity in the private economy, at a time when the Treasury had a substantial cash surplus. The present inflation has been enlarged by the prospect of controls, of shortages, and of an undefined but large defense program.

Some portion of the plant and equipment expansion necessary to the defense program is yet to be met. The money needed from outside sources must come largely from either the insurance companies or the commercial banks. At the present time great emphasis is being placed on the expansion of bank credit. Few seem to realize that under existing conditions loans granted by banks are less inflationary than the extension of an equal amount of credit by insurance companies.

Now, the Treasury security and other bond markets have remained relatively calm throughout this drawn-out Federal Reserve-Treasury dispute and its accompanying publicity. This calm is the result of a general confidence that the Treasury long-term rate of 2 1/2% will stand, and so will par support for outstanding long-term bonds. In other words the rank and file of investors do not believe that the Federal will be or will feel free, in the final analysis, to unstabilize the Treasury security market by decreasing the support prices or by withdrawing support.

My first question, therefore, is as follows: If against the contentious background of recent months, the Federal reduced its support price for Victory 2 1/2s to 100 and, at the same time, became a more-than-usually reluctant buyer of short-term Treasury securities, would investors continue to be calm or would their confidence be somewhat shaken?

Second, would a drop in the support price of 2 1/2% bonds to 100 or an increasing denial of a market to some holders of Treasury securities produce an increased volume of precautionary sales?

Third, if the Federal Reserve were to drop the support price to 99 1/2 or 99, how confident would institutional investors be that such support prices would hold?

If the Federal breaks par in support of Treasury bonds, will this be deemed, by investors, to be evidence that it has adopted a program of retreat to successively lower prices depending upon the volume of bonds offered to it?

If, to make its credit less readily available, the Federal decided to let the market decline to whatever point was necessary to dry up selling, how far would prices have to decline? Does anyone know? Can we afford to act on optimistic guesses?

Now let's go to the other side of these things. Let us assume that, to reduce the availability of credit, the Federal Reserve drops its support prices sufficiently low that it ultimately dries up any substantial selling. How many institutional investors would become buyers of Treasury securities?

We are asked to believe that more Treasury securities can be placed if the interest rate offered on them is made more "attractive". When bond prices decline interest rates become more attractive, but I have never seen a bond market that was undergoing a major decline that could be characterized as a confident one. If the bond market is caused to decline sharply while institutional investors are net sellers on balance, where are the additional buyers of these bonds going to come from?

We believe that the important consideration is not whether interest rates become more "attractive" or whether a higher level of rates is brought about. It is the trend of rates that is important. As bankers, you may agree that there is a tendency to feel more "loaned-up" when the outlook is for higher rates of interest than is the case if the outlook is for lower ones. The same thing is true with respect to bond buyers. A given rate is unattractive if the trend of the market is down, but the same rate can appear attractive if the price trend is stable or rising.

Please do not misunderstand. We are not an advocate of low interest rates. We would have much preferred a Treasury decision calling for a long-term 2 3/4% bond or a long-term 2 1/2% bond at a discount to yield 2.70% or 2.75%. Both of these would have been possible without disturbing the stability of outstanding bonds if the Treasury and the Federal had evidenced an ability to resolve their differences.

We have been told that market conditions have clearly shown that the Treasury has insisted upon interest rates that are "too low". In justification, our attention is called to the natural forces of supply and demand as they appear in the market and to the amount of Treasury securities that the Federal has been forced to acquire. The market for Treasury securities during the past year has been made almost entirely by the Federal Reserve, and the market has looked, most of the time, the way the Federal open-market operations caused it to look.

Let me illustrate this by comparing two financings a year apart. First, we will go back to November 1949. When the Treasury and the Federal Reserve were discussing the terms to be set on the approaching refunding of that period, the market "looked" as though a 1 1/8% rate were no longer suitable. The Treasury, nevertheless, decided to continue with a 1 1/8% one-year rate. It also offered a 1 3/8% note with a 4 1/4 year term. This note quickly reached a premium of 11/32 above 100. Why? Because investors took the financing decision of the Treasury as an indication that the Federal had lost the fight to advance the pattern toward higher yields. Both offerings were an outstanding success.

During the months following the Federal showed, by its handling of the open market, that it had not given up the fight. Even when the Treasury, in the spring of last year, acceded to somewhat higher interest rates for shorter-term securities, the Federal appeared to be dissatisfied. At least, that is the impression gained by close observers, an impression that was more than fully justified by the open break that occurred in August of last year.

Let us now consider the latest refunding in which the offering consisted of a single issue of five-year 1 3/4% notes. The terms set by the Secretary of the Treasury were those recommended by the Federal Reserve, ones that were later characterized by the Federal as appropriate and attractive. Most market observers, and we believe the Treasury as well, were skeptical of the appropriateness and the attractiveness of a five-year obligation for corporations, who were large holders of the maturing securities. But there are grounds for believing that the Federal assured the Treasury that this refunding would be a success.

What is the record? Only about 52% of the public holdings of the maturing securities were exchanged for the new issue and held throughout the exchange period. The remaining 48% of the public holdings were sold to the Federal or redeemed for cash. This hardly could be construed as a successful exchange from the point of view of the sound objectives of debt management.

About 15% of the public holdings were redeemed for cash. This compares with a 21% cash redemption last September and October and with the more normal cash redemptions of 5% or less. The drain on the Treasury's balance resulting from these two refundings was \$3 1/2 billion.

The differences between the successful refunding of November 1949 and the unsuccessful exchange offering made in November 1950 are twofold. In the first place, it is a testimony to the deterioration in investor confidence that has been brought about by the public wrangling over differences. Second, it suggests that the Treasury is a better judge of the type of securities that investors will buy than is the Federal.

This brings to mind something that has occurred to us with increasing frequency over recent months. We have wondered whether the Governors of the Board and the other members of the Open Market Committee could possibly be too far removed from an intimate contact with the Treasury security market, that is, from the changing states of mind, the preferences, and the reactions of those whose activities create the supply and demand with which the Federal open-market operation must contend. These are details of great importance when it becomes necessary to refine the terms of Treasury offerings. We also have wondered whether an adequate exchange of technical information takes place between the Treasury and the Federal. We have wondered about these things, because if such

situations were to exist they would explain why some of the misunderstandings arise.

But let us get back to more tangible things. The apparent calmness of institutional investors will be put to a full test when the Treasury begins to refund almost \$40 billion of maturing or callable securities. The bulk of these refundings covers a span hardly longer than four months and begins this June.

Were the Treasury to experience the same percentage of cash redemptions that it suffered in the last refunding, it would have to pay out about \$6 billion. No wonder the Secretary of the Treasury believes a stable and confident Treasury security market is a prerequisite to financial mobilization.

If, therefore, the Federal Reserve were to endeavor to make credit unavailable by reducing support or by withdrawing it, what would be the attitude of holders of the maturing and callable Treasury securities?

Many have substantial forward commitments in mortgages and the like. A larger number would be offered good loans at rates substantially higher than those now prevailing. Some of these loans will be necessary to the defense program.

Would investors accept the refunding offerings to be made by the Treasury?

Or would they deem it prudent to redeem their securities in order to meet their commitments or to make loans?

If, in the final analysis, the Treasury met with no greater success in these financings than in those just past, would potential buyers of long-term Treasury bonds gain or lose in confidence?

And, wholly aside from the Treasury's cash position, if it must meet large-scale cash redemptions, from whom will it obtain the funds? From the Federal Reserve Banks? Or from the commercial banks?

In either event it would appear that banks as a whole might be forced to cope with some more or less unworkable plan such as a secondary reserve requirement, a ceiling reserve plan, higher cash reserves, or they may be told to accept Treasury certificates of deposit bearing interest at some rate such as 1/4%. Yet none of these devices will insure an improvement in the credit condition over what it can be if debt management is permitted to work in our favor instead of against us.

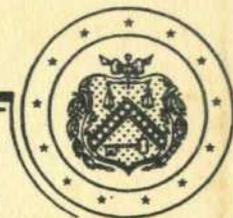
This is not a question of interest costs. Surely many would prefer higher rates, but the determining element in the equation is the maintenance of investor confidence. This requires a stable and confident Treasury security market and confidence among Treasury-security investors that they will not be subjected to some abrupt manipulation of the market, by either the Federal Reserve or the Treasury.

It seems to us important that the attitude of the institutional investor toward the market for Treasury securities may determine the confidence that business corporations and individuals have in these same securities.

To parlay the reduction in the value of the dollar by decreasing the dollar price of Treasury securities abruptly may be the worst way to deal with inflation.

In summation we suggest that the differences between the Federal and the Treasury involve questions of policy that are most important to the economy and to you. It is dangerous to accept over-simplifications, either of principle or of the technical aspects of the points at issue. Federal Reserve open-market operations designed to reduce the availability of credit cannot do so on a quantitative basis except as the Treasury is armed with a substantial cash surplus. The Treasury will soon be operating at a deficit. A substantial cash surplus is hardly a possibility. To reduce the support rendered to Treasury securities, against the present contentious background, or without warning, would be most dangerous. The withdrawal of support would be intolerable. Yet, we need to plan for its ultimate elimination. Of greater importance than an increase in interest rates, is the trend of rates. But, this is no time to attempt to control credit by starting a trend to higher rates. To do so would multiply not reduce the inflation potential. Neither the Federal nor the Treasury should be omnipotent or dominant. Each should consider itself to be an equal partner charged with responsibilities of equal weight.

TREASURY DEPARTMENT



Information Service

WASHINGTON, D.C.

IMMEDIATE RELEASE,
Monday, April 9, 1951

S-2654

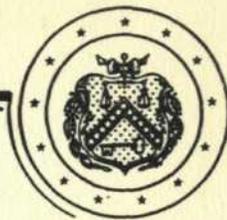
Secretary of the Treasury Snyder announced today that he was gratified by the response to the Treasury's offering of 2-3/4 percent Treasury Bonds, Investment Series B-1975-80, which were available during the past two weeks in exchange for outstanding 2-1/2 percent Treasury Bonds of June 15 and December 15, 1967-72. The exchange offering closed at midnight last Friday, April 6, 1951.

The Secretary said that subscriptions thus far received and tabulated, which will be augmented somewhat by mail subscriptions not yet tabulated, exceed \$13,450,000,000. This figure includes about \$5,583,000,000 for Federal Reserve and Treasury Investment Accounts.

Announcement of the total amount of subscriptions received and their division among the several Federal Reserve Districts will be made later in the week.

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TREASURY DEPARTMENT



Information Service

WASHINGTON, D.C.

IMMEDIATE RELEASE,
Tuesday, April 3, 1951.

S-2648

Secretary of the Treasury Snyder announced today that the subscription books for the current offering of 2-3/4 percent Treasury Bonds, Investment Series B-1975-80, in exchange for the 2-1/2 percent Treasury Bonds of June 15 and December 15, 1967-72, will close at midnight Friday, April 6, 1951.

Subscriptions addressed to a Federal Reserve Bank or Branch or to the Treasury Department, and placed in the mail before midnight of April 6 will be considered as having been entered before the close of the subscription books.

Announcement of the total amount of subscriptions and their division among the several Federal Reserve Districts will be made later. The Secretary said that subscriptions received and tabulated by Federal Reserve Banks as of Monday, April 2, (including about \$5,365,000,000 for Federal Reserve and Treasury investment account) exceed \$11,000,000,000. This figure of course does not include subscriptions in the mails.

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TREASURY DEPARTMENT



Information Service

WASHINGTON, D.C.

RELEASE, MORNING NEWSPAPERS,
Monday, March 19, 1951.

S-2631

Secretary of the Treasury Snyder today released the official circular governing the offering of 2-3/4 percent Treasury Bonds, Investment Series B-1975-80. Holders of 2-1/2 percent Treasury Bonds of June 15 and December 15, 1967-72 may, at their option, exchange their bonds of either or both series for the new 2-3/4 percent Treasury bonds, in authorized denominations. The amount of the offering will be limited to the amount of Treasury Bonds of 1967-72 of either or both of the specified series tendered and accepted.

As announced by the Secretary on March 4, 1951, the subscription books will open on Monday, March 26, for a period of about two weeks, although the Secretary reserves the right to close the books at any time without notice.

The Secretary also today released the offering circular governing the 1-1/2 percent five-year marketable Treasury notes which will be available for exchange to owners of the new 2-3/4 percent Treasury bonds, at their option, during the life of the bonds. The first issue of the new notes will be dated April 1, 1951, and will be available as soon as the 2-3/4 percent bonds are issued.

Pursuant to the provisions of the Public Debt Act of 1941, as amended, interest upon the bonds and notes now offered shall not have any exemption, as such, under the Internal Revenue Code, or laws amendatory or supplementary thereto. The full provisions relating to taxability are set forth in the official circulars released today.

Subscriptions for the bonds will be received at the Federal Reserve Banks and Branches, and at the Treasury Department, Washington, and should be accompanied by a like face amount of the 2-1/2 percent bonds to be exchanged. Subject to the usual reservations, all subscriptions will be allotted in full.

The texts of the official circulars follow:

UNITED STATES OF AMERICA

2-3/4 PERCENT TREASURY BONDS, INVESTMENT SERIES B-1975-80
Nontransferable

Dated and bearing interest from April 1, 1951

Due April 1, 1980

REDEEMABLE AT THE OPTION OF THE UNITED STATES AT PAR AND ACCRUED
INTEREST ON AND AFTER APRIL 1, 1975

Interest payable April 1 and October 1

1951
Department Circular No. 883

Fiscal Service
Bureau of the Public Debt

TREASURY DEPARTMENT,
Office of the Secretary,
Washington, March 26, 1951.

I. EXCHANGE OFFERING OF BONDS

1. The Secretary of the Treasury, pursuant to the authority of the Second Liberty Bond Act, as amended, invites subscriptions, at par, from the people of the United States for bonds of the United States, designated 2-3/4 percent Treasury Bonds, Investment Series B-1975-80, in exchange for 2-1/2 percent Treasury Bonds of 1967-72, dated June 1, 1945, due June 15, 1972, or 2-1/2 percent Treasury Bonds of 1967-72, dated November 15, 1945, due December 15, 1972, in aggregate amounts of \$1,000, or multiples thereof. The amount of the offering under this circular will be limited to the amount of Treasury Bonds of 1967-72 of either or both of the specified series tendered and accepted.

2. Commercial banks will be permitted to exchange the 2-1/2 percent Treasury Bonds of December 15, 1967-72, acquired by them on original issue and bonds of either series held in trading accounts pursuant to Treasury Department Circular No. 787, dated May 17, 1946.

II. DESCRIPTION AND TERMS OF BONDS

1. The bonds will be dated April 1, 1951, and will bear interest from that date at the rate of 2-3/4 percent per annum, payable semiannually by check on October 1, 1951, and thereafter on April 1 and October 1 in each year until the principal amount becomes payable. They will mature April 1, 1980, and will not be redeemable prior thereto except as follows:

(a) They may be redeemed at the option of the United States on and after April 1, 1975, in whole or in part, at par and accrued interest, on any interest day or days, on 4 months' notice of redemption given in such manner as the Secretary of the Treasury shall prescribe. In case of partial redemption the bonds to be redeemed will be determined by such method as may be prescribed by the Secretary of the Treasury. From the date of redemption designated in any such notice, interest on the bonds called for redemption shall cease.

(b) They may be redeemed at the option of the duly constituted representatives of a deceased owner's estate, at par and accrued interest to the date of payment^{1/} if at the time of death they constitute part of the decedent's estate and the Secretary of the Treasury is authorized by the representatives to apply the entire proceeds of redemption to the payment of Federal estate taxes. Bonds submitted for redemption hereunder must be duly assigned to "The Secretary of the Treasury for redemption, the proceeds to be paid to the Collector of Internal Revenue at _____ for credit on Federal estate taxes due from estate of _____". The bonds must be accompanied by Form PD 1782^{2/} properly completed, signed and sworn to, and by a certificate of the appointment of the personal representatives, under seal of the court, dated not more than six months prior to the submission of the bonds, which shall show that at the date thereof the appointment was still in force and effect. Upon payment of the bonds appropriate memorandum receipt will be forwarded to the representatives, which will be followed in due course by formal receipt from the Collector of Internal Revenue.

2. Although the bonds are payable only at maturity except as provided in the preceding paragraph, they may, at the owner's option, as provided in Department Circular No. 884, be exchanged for 1-1/2 percent five-year marketable Treasury Notes to be dated April 1 and October 1 of each year during the life of the bond. If the bonds surrendered are in order for exchange, the new notes will ordinarily be issued within ten calendar days from the date of surrender to the Treasury Department or to a Federal Reserve Bank or Branch. The notes to be issued will bear the April 1 or October 1 date next preceding the date of the exchange. Interest will be adjusted to the date on which the exchange is made. Partial exchange of the bonds in multiples of \$1,000, and reissue of the remainder, will be permitted.

3. The bonds will not be acceptable to secure deposits of public moneys, but they may be used as collateral for loans and may be pledged as security for the performance of an obligation or for any other purpose. In the event of a default on the loan or in the performance of the obligation, the pledgee will have the right only to exchange the bonds for 1-1/2 percent five-year marketable Treasury notes. The bonds may not be sold or discounted, and are not transferable in ordinary course, but they may be transferred (by way of reissue) (1) to successors in title, (2) (in the event of the death of the owner) to legatees, next of kin,

1/ An exact half-year's interest is computed for each full half-year period irrespective of the actual number of days in the half year. For a fractional part of any half year, computation is on the basis of the actual number of days in such half year.

2/ Copies of Form PD 1782 may be obtained from any Federal Reserve Bank or from the Treasury Department, Washington, D. C.

and other persons entitled, in accordance with the provisions of Department Circular No. 300, and (3) to State supervisory authorities in pursuance of any pledge required under State law. A bond which has been registered in the title of a State supervisory authority may be reissued in the name of the original owner upon assignment by such authority for that purpose. The term "successors" as used in this paragraph includes but is not limited to succeeding organizations, succeeding trustees, and persons entitled upon the termination of a trust or the dissolution of a fund or organization. Judgment creditors, trustees in bankruptcy, and receivers of insolvents' estates will be entitled only to exchange the bonds for 1-1/2 percent five-year marketable Treasury notes. Persons entitled to reissue under the provisions of this paragraph will succeed to all the rights and privileges of the registered owners.

4. The income derived from the bonds shall be subject to all taxes now or hereafter imposed under the Internal Revenue Code, or laws amendatory or supplementary thereto. The bonds shall be subject to estate, inheritance, gift or other excise taxes, whether Federal or State, but shall be exempt from all taxation now or hereafter imposed on the principal or interest thereof by any State, or any of the possessions of the United States, or by any local taxing authority.

5. The bonds will be issued only in registered form, and in denominations of \$1,000, \$5,000, \$10,000, \$100,000, \$1,000,000 and \$10,000,000.

6. Except as otherwise specifically provided in this circular, Treasury Bonds of Investment Series B-1975-80 issued hereunder will be subject to the general regulations of the Treasury Department, now or hereafter prescribed, governing United States bonds. The regulations in Department Circular No. 815, (which govern 2-1/2 percent Treasury Bonds of Investment Series A-1965), will not govern Treasury Bonds of Investment Series B-1975-80. All questions concerning bonds issued hereunder and transactions pertaining thereto should be submitted to a Federal Reserve Bank or Branch or to the Treasury Department, Division of Loans and Currency, Washington 25, D. C.

III. SUBSCRIPTION AND ALLOTMENT

1. Subscriptions will be received at the Federal Reserve Banks and Branches and at the Treasury Department, Washington. Banking institutions generally may submit subscriptions for account of customers, but only the Federal Reserve Banks and the Treasury Department are authorized to act as official agencies.

2. The Secretary of the Treasury reserves the right to reject any subscription, in whole or in part, to allot less than the amount of bonds applied for, and to close the books as to any or all subscriptions at any time without notice; and any action he may take in these respects shall be final. Subject to these reservations, all subscriptions will be allotted in full. Allotment notices will be sent out promptly upon allotment.

IV. PAYMENT

1. Payment for bonds allotted hereunder must be made on or before April 1, 1951, or on later allotment, and may be made only in Treasury Bonds of 1967-72, due June 15, 1972, or Treasury Bonds of 1967-72, due December 15, 1972, which will be accepted at par and should accompany the subscription. Coupons dated June 15, 1951, and all subsequent coupons, must be attached to bearer bonds of either series when surrendered. If any such coupons are missing, the subscription must be accompanied by cash payment equal to the face amount of the missing coupons. Accrued interest from December 15, 1950, to April 1, 1951 (\$7.3489 per \$1,000) will be paid to subscribers tendering coupon bonds following acceptance of the bonds. In the case of registered bonds of either series tendered in payment, checks in payment of accrued interest from December 15, 1950, to April 1, 1951, will be drawn in accordance with the assignments on the bonds surrendered.

V. ASSIGNMENT OF REGISTERED BONDS

1. Treasury Bonds of 1967-72, due June 15, 1972, or Treasury Bonds of 1967-72, due December 15, 1972, in registered form tendered in payment for bonds offered hereunder should be assigned by the registered payees or assignees thereof in accordance with the general regulations of the Treasury Department governing assignments for transfer or exchange, in one of the forms hereafter set forth, and thereafter should be presented and surrendered with the subscription to a Federal Reserve Bank or Branch or to the Treasury Department, Division of Loans and Currency, Washington, D. C. If the new bonds are desired registered in the same name as the bonds surrendered, the assignment should be to "The Secretary of the Treasury for exchange for 2-3/4 percent Treasury Bonds, Investment Series B-1975-80". If the new bonds are desired registered in another name, the assignment should be to "The Secretary of the Treasury for exchange for 2-3/4 percent Treasury Bonds, Investment Series B-1975-80, in the name of _____".

VI. GENERAL PROVISIONS

1. As fiscal agents of the United States, Federal Reserve Banks are authorized and requested to receive subscriptions, to make allotments on the basis and up to the amounts indicated by the Secretary of the Treasury to the Federal Reserve Banks of the respective Districts, to issue allotment notices, to receive payment for bonds allotted, to make delivery of bonds on full-paid subscriptions allotted, and they may issue interim receipts pending delivery of the definitive bonds.

2. The Secretary of the Treasury may at any time, or from time to time, prescribe supplemental or amendatory rules and regulations governing the offering, which will be communicated promptly to the Federal Reserve Banks.

E. H. FOLEY

Acting Secretary of the Treasury.

UNITED STATES OF AMERICA

1-1/2 PERCENT FIVE-YEAR TREASURY NOTES

Dated and bearing interest from
April 1 and October 1 of each year

Due five years from issue date

Interest payable April 1 and October 1

ISSUED ONLY IN EXCHANGE FOR 2-3/4% TREASURY BONDS, INVESTMENT SERIES B-1975-80

1951
Department Circular No. 834

TREASURY DEPARTMENT,
Office of the Secretary,
Washington, March 26, 1951.

Fiscal Service
Bureau of the Public Debt

I. OFFERING OF NOTES

1. Treasury notes described herein are issued pursuant to the Second Liberty Bond Act, as amended, and are offered by the Secretary of the Treasury only to owners of 2-3/4 percent Treasury Bonds, Investment Series B-1975-80, and other persons entitled thereto, in accordance with the provisions of Department Circular No. 383, dated March 26, 1951.

2. The first issue of these notes will be dated April 1, 1951. The last issue will be dated October 1, 1979, or the April 1 or October 1 next preceding the date on which the 2-3/4 percent Treasury Bonds, Investment Series B-1975-80, cease to bear interest if called for redemption prior to maturity.

II. DESCRIPTION OF NOTES

1. The notes will be issued each six months during the life of the 2-3/4 percent Treasury Bonds, Investment Series B-1975-80, in two series, to be dated April 1 and October 1 in each year. The notes to be dated April 1 will bear the series designation EA followed by the year of maturity and the notes to be dated October 1 will bear the series designation EO followed by the year of maturity. The notes will bear interest from their respective issue dates at the rate of 1-1/2 percent per annum, payable semiannually on April 1 and October 1 in each year until the principal amount becomes payable. They will mature five years from their respective issue dates, and will not be subject to call for redemption prior to maturity.

2. The income derived from the notes shall be subject to all taxes, now or hereafter imposed under the Internal Revenue Code, or laws amendatory or supplementary thereto. The notes shall be subject to estate, inheritance, gift or other excise taxes, whether Federal or State, but shall be exempt from all taxation now or hereafter imposed on the principal or interest

thereof by any State, or any of the possessions of the United States, or by any local taxing authority.

3. The notes will be acceptable to secure deposits of public moneys. They will not be acceptable in payment of taxes.

4. Bearer notes with interest coupons attached will be issued in denominations of \$1,000, \$5,000, \$10,000, \$100,000 and \$1,000,000. The notes will not be issued in registered form.

5. The notes will be subject to the general regulations of the Treasury Department, now or hereafter prescribed, governing United States notes.

III. ISSUE OF NOTES

1. The notes offered hereunder will be issued in exchange for 2-3/4 percent Treasury Bonds, Investment Series B-1975-80, following presentation and surrender of the bonds duly assigned for exchange. The new notes will ordinarily be issued within ten calendar days from the date of surrender of the bonds to a Federal Reserve Bank or Branch or to the Treasury Department. The notes will bear the April 1 or October 1 date next preceding the date of the exchange and interest will be adjusted to the date on which the notes are issued by the Federal Reserve Bank or Branch or the Treasury Department. Interest accrued at 2-3/4 percent on the bonds surrendered from the next preceding April 1 or October 1 to the date of exchange will be credited and interest at 1-1/2 percent for the same period will be charged to the owner making the exchange and the difference will be paid to the owner at the time the exchange is made.

IV. ASSIGNMENT OF BONDS

1. Treasury Bonds, Investment Series B-1975-80, tendered in exchange for notes offered hereunder should be assigned to "The Secretary of the Treasury for exchange for the current series of EA or EO Treasury notes to be delivered to _____", in accordance with the general regulations of the Treasury Department governing assignments for exchange, and thereafter should be presented and surrendered with appropriate instructions to a Federal Reserve Bank or Branch or to the Treasury Department, Division of Loans and Currency, Washington 25, D. C. The bonds must be delivered at the expense and risk of the owners.

V. GENERAL PROVISIONS

1. As fiscal agents of the United States, Federal Reserve Banks are authorized and requested to accept applications for the exchange of Treasury Bonds, Investment Series B-1975-80, for 1-1/2 percent five-year Treasury notes, and following discharge of registration to issue the new notes.

2. The Secretary of the Treasury may at any time, or from time to time, prescribe supplemental or amendatory rules and regulations governing the exchange offering, which will be communicated promptly to the Federal Reserve Banks.

E. H. FOLEY

Acting Secretary of the Treasury.

TREASURY DEPARTMENT

Mr. Martin



Information Service

WASHINGTON, D.C.

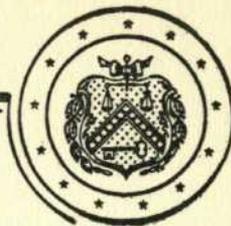
IMMEDIATE RELEASE,
Thursday, March 8, 1951.

S-2620

In response to numerous inquiries, the Secretary of the Treasury announced today that the new investment series of 2-3/4% Treasury bonds which will be offered March 26, 1951, in exchange for outstanding 2-1/2% Treasury bonds of June 15 and December 15, 1967-72, will be dated April 1, 1951, will mature on April 1, 1980 and be callable on April 1, 1975. The bonds will be non-marketable and non-transferable, but will be exchangeable into marketable 5 year 1-1/2% Treasury notes. The notes offered in exchange will be dated April 1 and October 1 of each year with appropriate interest adjustments to dates of exchange. Interest on such bonds and notes will be payable semi-annually on the 1st days of April and October in each year.

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TREASURY DEPARTMENT



Information Service

WASHINGTON, D.C.

RELEASE MORNING NEWSPAPERS,
Sunday, March 4, 1951.

S-2613

The Secretary of the Treasury announced today that there will be offered for a limited period a new investment series of long-term non-marketable Treasury bonds in exchange for outstanding 2-1/2% Treasury bonds of June 15 and December 15, 1967-72, the details of which will be announced on March 19.

The new bonds will be issued in registered form only, with appropriate maturity, and will bear interest at the rate of 2-3/4% per annum payable semi-annually. They will not be transferable or redeemable prior to maturity; however, owners of such non-marketable bonds will be given an option of exchanging them prior to maturity for marketable Treasury notes bearing terms to be announced in the official offering.

The new non-marketable 2-3/4% Treasury bonds will be acceptable at par and accrued interest in payment of Federal estate and inheritance taxes due following the death of the owner. They will not be acceptable in payment of Federal income taxes.

The offering of this new security is for the purpose of encouraging long-term investors to retain their holdings of Government securities, in order to minimize the monetization of the public debt through liquidation of present holdings of the Treasury bonds of 1967-72.

The Secretary stated that he planned to open the subscription books on Monday, March 26, and that the full terms of the offering and the official circular would be made available on March 19. The subscription books will remain open for a period of about two weeks, although the Secretary will reserve the right to close the books at any time without notice.

The Secretary indicated that a special offering of Series F and G bonds, or an offering similar to the 2-1/2% Treasury bonds, Investment Series A-1965, will probably be made available for cash subscription at a later date when it appears that a need therefor may exist.

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JOINT ANNOUNCEMENT BY THE SECRETARY OF THE TREASURY
AND THE CHAIRMAN OF THE BOARD OF GOVERNORS, AND OF THE
FEDERAL OPEN MARKET COMMITTEE, OF THE FEDERAL RESERVE SYSTEM

RELEASE MORNING NEWSPAPERS,
Sunday, March 4, 1951.

S-2614

The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt.

oOo

RELEASE SUNDAY MORNING NEWSPAPERS
MARCH 4, 1951

Statement by Senator A. Willis Robertson (D. Va.):

"A French proverb says patience is bitter but its fruits are sweet.

"Some two weeks ago I asked extreme partisans of the Treasury position and of the Federal Reserve Board position with respect to the management of the national debt to be patient while representatives of the two agencies were attempting to reconcile their differences. At that time I predicted that an area of agreement could be reached that would be geared to the general welfare.

"Naturally, I am very happy that such an agreement has been reached, under which we may reasonably expect a refinancing of a portion of the outstanding long term marketable bonds without an undue inflationary effect, and under which the type of independence which the Congress intended the Federal Reserve Board to enjoy will not be destroyed."

Chairman McCabe

CONFIDENTIAL

Board of Governors

March 5, 1951.

Harold F. Chapin

Government security market-10:15 a.m.

The New York Reserve Bank reports that the market opened quiet and orderly, with the dealers apparently handling the situations very well. The only price change noted was the increase of $1/32$ in the restricted June 1967-72's. Purchases of \$1.6 million June 1967-72s and \$1.7 million December 1967-72's had been made which had not been allocated to System or Treasury Account.

GOVERNMENT FINANCE SECTION, BOARD OF GOVERNORS

Proposed Schedule for Hearings on Tax Matters

Tuesday, July 25, 1950

Roy Blough Mr. Kaiserling	9:00 a.m.	Council of Economic Advisers
Charles Sawyer	10:00 a.m.	Department of Commerce
Charles Brannan	10:45 a.m.	Department of Agriculture
Maurice Tobin	11:30 a.m.	Department of Labor
Oscar Chapman	2:00 p.m.	Department of the Interior
Tom McCabe	2:45 p.m.	Federal Reserve
Oscar L. Endler	3:30 p.m.	National Security Resources Board

Wednesday, July 26, 1950

Cameron Thompson	9:00 a.m.	Committee on Economic Development
Ralph Bradford	10:00 a.m.	Exec. Secy., U. S. Chamber of Commerce
William Green	10:45 a.m.	American Federation of Labor
Walter Chamblin, Jr.	11:30 a.m.	Nat'l Association of Manufacturers (V.P.)
Philip Murray	2:00 p.m.	C.I.O.
Albert Goss	2:45 p.m.	GRANGE
W.E.D. Brown	3:30 p.m.	Finance

MR. WIGGINS' DRAFT NO. 2

We are bringing up to date our tax studies in the light of the current situation and would like to have your suggestions and a conference with you or your representative.

Our present interest is in a program that will increase substantially the revenues of the Federal Government.

We would prefer to have your suggestions in the form of a written statement to be supplemented with a brief personal conference.

Government agencies - Tuesday, July 25th.

Non-government agencies - Wednesday, July 26th.

Hours - 9:00 A.M. to 1:00 P.M. and 2:00 P.M. to 5:00 P.M.

At the Office of Mr. Graham, Assistant Secretary of the Treasury,
Room 3312.

As a part of its continuous study of the tax problem, the Treasury has requested Mr. A.L.M. Wiggins, former Under-Secretary and continuing Consultant, to focus attention on the war-time aspects of raising revenue. He will be assisted in this work by Assistant Secretaries Graham and Martin and it is proposed to examine as rapidly as possible the amount of revenue that can be raised without unduly hampering business expansion or increasing inflationary pressures.

~~A study of~~ purchasing power rationing and spending taxes as well as voluntary borrowing ^{and} ~~as opposed to~~ compulsory lending will be analyzed. It is assumed for the purpose of this study that total war, while a possibility, is not likely in the near future and that the incidence of taxation must not seriously impair business health or normal spending habits. The flow of investment, the flow of income, the flow of savings and the flow of expenditures must be maintained in parallel streams until they reach the point that their merger in a common stream does not overflow its banks or unduly accelerate its current.

Rationing and price controls are essential in the total war economy. They can be avoided here if the American people are sufficiently patriotic and intelligent with respect to current habits and current standards of living. There is, of course, no more reason to draft men than there is to draft dollars. In a psychological and political sense it is more important to draft dollars than it is to draft men. What is needed as never before is a device to induce saving, or to act as an incentive for saving. If an incentive can be found which will induce people to add to their savings, neither price controls nor rationing will be required.

EXPORT-IMPORT BANK OF WASHINGTON

Date 8/26/46

TO: Mr. Gauss - Mr. Stambaugh

Wsh

Herewith initial work re
"Promotion of Imports". This
outline was prepared by
Dr. Pumphrey and any ideas you
may have, it might be worth-while
for you to discuss with him.

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Wm. McC. Martin, Jr.
Chairman of the Board

REPORT ON CONVERSATIONS AT THE TECHNICAL LEVEL OF
TREASURY AND FEDERAL RESERVE SYSTEM REPRESENTATIVES

Participants: Treasury - Mr. Wm. McC. Martin, Jr.
Dr. George C. Haas
Mr. Edward F. Bartelt

Federal Reserve - Mr. Winfield W. Riefler
Mr. Woodlief Thomas
Mr. Robert Rouse (N.Y. Federal)

First Meeting - Tuesday, February 20, 1951, 1:00 p.m.,
beginning at luncheon in Mr. McCabe's
office.

Adjourned at 2:45 p.m. to Federal Reserve Board
Room and continued until 4:30 p.m.

Reconvened - Tuesday, February 20, 1951, 8:30 p.m.,
home of Mr. Riefler

Adjourned at 11:30 p.m.

Reconvened - Wednesday, February 21, 1951, 2:30 p.m.,
Library of Federal Reserve Building

Adjourned at 6:15 p.m.

Reconvened - Friday, February 23, 1951, 9:45 a.m.,
Library of Federal Reserve Building

Adjourned at 12:15 p.m.

It was clearly understood by all that these were explorations at the technical level and not negotiations.

Lengthy discussion of the techniques of the Open Market Committee and the necessity for better liason between the Federal Reserve and Treasury was a part of the early discussion, and it was clear that both of us could be better informed on the thinking of the other.

Inasmuch as the Federal Reserve group had a specific proposal, approved by the Open Market Committee, in the letter of February 7 of Chairman McCabe to the Secretary, most of the discussion attempted to clarify what was intended in that letter.

The Federal Reserve group continuously asserted the unhappiness of the Open Market Committee in monetization of the Federal Debt, particularly at premium prices, and they made it clear it was the desire to drop the long-term issues to par.

There was considerable discussion of the rigidities in the present market and the fact that a large amount of selling was probably because of commitments already made by insurance companies, savings banks, loan associations and the banking system, and the consequent replenishing of reserves through sales to the Federal Reserve in the open market of Government securities.

In pursuing the policy proposed in the February 7 letter, the Federal intends to withdraw support from the short-term securities market and let it adjust itself around the 1-3/4 percent discount rate now prevailing. They felt that when these adjustments were made, a groundwork would be laid in the market which would act as a deterrent to lending and make it possible to undertake in a more orderly fashion, although at somewhat higher rates, the refinancings which the Treasury faces in the final six months of the Calendar Year 1951.

Much of their argument revolves around the traditional abhorrence of the banks for borrowing from the Federal Reserve and an aggregate reduction of needed reserves. Under these conditions, the rate adjusts to the discount rate. 2
1

Under considerable pressing by the Treasury group, they were willing to explore with the Committee for a period of time running through December 1951, the maintenance of the 1-3/4 percent discount rate to facilitate Treasury planning of new money and refinancing at the new levels established as a result of these adjustments.

There was long discussion, and much of it sympathetic to a proposal advanced principally by Mr. Riefler that the Secretary announce an installment retirement non-marketable 2-3/4 percent long-term bond (29-1/2 years) which could be exchanged for the existing June and December 2-1/2's, the desire being to lock these two issues up as much as possible and remove them as an important market factor. A feature of this issue might be an alternative of exchange for 1-1/2 percent, five-year notes for those who desired to cash them.

At the concluding session it was suggested by the Treasury group that if the Secretary should accede to the Federal Reserve proposal with respect to the adjustment of the short-term rates and should decide to announce a 2-3/4 percent non-marketable long-term issue to be exchanged for the existing long-term restricted issues, the Federal Reserve might consider maintaining the current levels in the June and December issues until it was demonstrated that they would continue to require support. In that event, the Federal Reserve and Treasury group would then reconsider the problem.

This was put forward, not as a counter proposal, but on an exploratory basis and with an earnest plea on the part of Mr. Bartelt that we not attempt

to prejudge the market. It was his hope that such an arrangement would release pressure from the market and permit us to get a start on the refinancing program without impairing any further public confidence in the markets.

It was suggested by the Federal that if the Treasury desired to test the new exchange issue this way, they might consider an agreement that cost of supporting the first 200 million purchased be shared equally by the Treasury and the Federal Reserve, that the Treasury carry 75 percent of the cost of the succeeding 400 million and that the Treasury carry the whole amount if any purchases in excess of 600 million are required.

There was a lot of talk about secrecy and the difficulty if such an agreement leaked in any other way than through the published statements of the Federal and the Treasury, and the belief on Mr. Bartelt's part that knowledge that the Treasury and the Federal had gotten together would act as a tonic in restoring confidence to the market.

There was general agreement throughout the discussions that the so-called feud between the Treasury and Federal was by far the most significant psychological factor in the current situation.

After extended discussion, it seemed to be generally agreed by all that the Federal Reserve approach was essentially a "package one" and is not susceptible, with any consistency, to very much compromise, unless there is a drastic change in the existing market situation, which on the basis of our talks appeared unlikely in the near future. It is the Federal view that their proposal would involve no serious disruption of the security market, and they felt that the increased flexibility of the market would produce more confidence.

Their major point is an unwillingness on their part to continue monetization of debt. They concede that maintenance of orderly markets will entail some further monetization which they would hope to keep at a minimum.

There was general agreement that we were discussing degrees rather than absolutes, and the Treasury was questioning the effectiveness of the operation, and also questioning the Federal evaluation that the repercussions in the market would not be serious.

Both sides agreed that monetization of debt must be stopped as far as possible. The Federal Reserve position was firm that this could not be done without repercussions in the money market while the Treasury view has been that it could be minimized through direct approaches which were preferable to revisions in interest rates. This was the philosophy back of the Secretary's January 18 address. Upon exploration of that address it was agreed, however, that there was nothing in the proposals discussed which ran counter to that address. He did not discuss an exchange issue - but such an issue at 2-3/4 percent if it were long-term and non-marketable would not be considered inconsistent with a 2-1/2 percent rate.

At the end of the meetings it was made clear again that these were only exploratory talks. Accordingly, it was suggested that the matter now be referred to a higher level where negotiations or counter proposals might take place.

REPORT ON CONVERSATIONS AT THE TECHNICAL LEVEL OF
TREASURY AND FEDERAL RESERVE SYSTEM REPRESENTATIVES

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Inasmuch as the Federal Reserve group had a specific proposal, approved by the Open Market Committee, in the letter of February 7 of Chairman McCabe to the Secretary, most of the discussion attempted to clarify what was intended in that letter.

The Federal Reserve group continuously asserted the unhappiness of the Open Market Committee in monetization of the Federal Debt, particularly at premium prices, and they made it clear it was the desire to drop the long-term issues to par.

There was considerable discussion of the rigidities in the present market and the fact that a large amount of selling was probably because of commitments already made by insurance companies, savings banks, loan associations and the banking system, and the consequent replenishing of reserves through sales to the Federal Reserve in the open market of Government securities.

In pursuing the policy proposed in the February 7 letter, the Federal intends to withdraw support from the short-term securities market and let it adjust itself around the 1-3/4 percent discount rate now prevailing. They felt that when these adjustments were made, a groundwork would be laid in the market which would act as a deterrent to lending and make it possible to undertake in a more orderly fashion, although at somewhat higher rates, the refinancings which the Treasury faces in the final six months of the Calendar Year 1951.

Much of their argument revolves around the traditional abhorrence of the banks for borrowing from the Federal Reserve and an aggregate reduction of needed reserves. Under these conditions, the rate adjusts to the discount rate.

Under considerable pressing by the Treasury group, they were willing to explore with the Committee for a period of time running through December 1951, the maintenance of the 1-3/4 percent discount rate to facilitate Treasury planning of new money and refinancing at the new levels established as a result of these adjustments.

There was long discussion, and much of it sympathetic to a proposal advanced principally by Mr. Riefler that the Secretary announce an installment retirement non-marketable 2-3/4 percent long-term bond (29-1/2 years) which could be exchanged for the existing June and December 2-1/2's, the desire being to lock these two issues up as much as possible and remove them as an important market factor. A feature of this issue might be an alternative of exchange for 1-1/2 percent, five-year notes for those who desired to cash them.

At the concluding session it was suggested by the Treasury group that if the Secretary should accede to the Federal Reserve proposal with respect to the adjustment of the short-term rates and should decide to announce a 2-3/4 percent non-marketable long-term issue to be exchanged for the existing long-term restricted issues, the Federal Reserve might consider maintaining the current levels in the June and December issues until it was demonstrated that they would continue to require support. In that event, the Federal Reserve and Treasury group would then reconsider the problem.

This was put forward, not as a counter proposal, but on an exploratory basis and with an earnest plea on the part of Mr. Bartelt that we not attempt

to prejudge the market. It was his hope that such an arrangement would release pressure from the market and permit us to get a start on the refinancing program without impairing any further public confidence in the markets.

It was suggested by the Federal that if the Treasury desired to test the new exchange issue this way, they might consider an agreement that cost of supporting the first 200 million purchased be shared equally by the Treasury and the Federal Reserve, that the Treasury carry 75 percent of the cost of the succeeding 400 million and that the Treasury carry the whole amount if any purchases in excess of 600 million are required.

There was a lot of talk about secrecy and the difficulty if such an agreement leaked in any other way than through the published statements of the Federal and the Treasury, and the belief on Mr. Bartelt's part that knowledge that the Treasury and the Federal had gotten together would act as a tonic in restoring confidence to the market.

There was general agreement throughout the discussions that the so-called feud between the Treasury and Federal was by far the most significant psychological factor in the current situation.

After extended discussion, it seemed to be generally agreed by all that the Federal Reserve approach was essentially a "package one" and is not susceptible, with any consistency, to very much compromise, unless there is a drastic change in the existing market situation, which on the basis of our talks appeared unlikely in the near future. It is the Federal view that their proposal would involve no serious disruption of the security market, and they felt that the increased flexibility of the market would produce more confidence.

Their major point is an unwillingness on their part to continue monetization of debt. They concede that maintenance of orderly markets will entail some further monetization which they would hope to keep at a minimum.

There was general agreement that we were discussing degrees rather than absolutes, and the Treasury was questioning the effectiveness of the operation, and also questioning the Federal evaluation that the repercussions in the market would not be serious.

Both sides agreed that monetization of debt must be stopped as far as possible. The Federal Reserve position was firm that this could not be done without repercussions in the money market while the Treasury view has been that it could be minimized through direct approaches which were preferable to revisions in interest rates. This was the philosophy back of the Secretary's January 18 address. Upon exploration of that address it was agreed, however, that there was nothing in the proposals discussed which ran counter to that address. He did not discuss an exchange issue - but such an issue at 2-3/4 percent if it were long-term and non-marketable would not be considered inconsistent with a 2-1/2 percent rate.

At the end of the meetings it was made clear again that these were only exploratory talks. Accordingly, it was suggested that the matter now be referred to a higher level where negotiations or counter proposals might take place.

REPORT ON CONVERSATIONS AT THE TECHNICAL LEVEL OF
TREASURY AND FEDERAL RESERVE SYSTEM REPRESENTATIVES

Participants: Treasury - Mr. Wm. McC. Martin, Jr.
Dr. George C. Haas
Mr. Edward F. Bartelt

Federal Reserve - Mr. Winfield W. Riefler
Mr. Woodlief Thomas
Mr. Robert Rouse (N.Y. Federal)

First Meeting - Tuesday, February 20, 1951, 1:00 p.m.,
beginning at luncheon in Mr. McCabe's
office.

Adjourned at 2:45 p.m. to Federal Reserve Board
Room and continued until 4:30 p.m.

Reconvened - Tuesday, February 20, 1951, 8:30 p.m.,
home of Mr. Riefler

Adjourned at 11:30 p.m.

Reconvened - Wednesday, February 21, 1951, 2:30 p.m.,
Library of Federal Reserve Building

Adjourned at 6:15 p.m.

Reconvened - Friday, February 23, 1951, 9:45 a.m.,
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It was clearly understood by all that these were explorations at the technical level and not negotiations.

Lengthy discussion of the techniques of the Open Market Committee and the necessity for better liason between the Federal Reserve and Treasury was a part of the early discussion, and it was clear that both of us could be better informed on the thinking of the other.

Inasmuch as the Federal Reserve group had a specific proposal, approved by the Open Market Committee, in the letter of February 7 of Chairman McCabe to the Secretary, most of the discussion attempted to clarify what was intended in that letter.

The Federal Reserve group continuously asserted the unhappiness of the Open Market Committee in monetization of the Federal Debt, particularly at premium prices, and they made it clear it was the desire to drop the long-term issues to par.

There was considerable discussion of the rigidities in the present market and the fact that a large amount of selling was probably because of commitments already made by insurance companies, savings banks, loan associations and the banking system, and the consequent replenishing of reserves through sales to the Federal Reserve in the open market of Government securities.

In pursuing the policy proposed in the February 7 letter, the Federal intends to withdraw support from the short-term securities market and let it adjust itself around the 1-3/4 percent discount rate now prevailing. They felt that when these adjustments were made, a groundwork would be laid in the market which would act as a deterrent to lending and make it possible to undertake in a more orderly fashion, although at somewhat higher rates, the refinancings which the Treasury faces in the final six months of the Calendar Year 1951.

Much of their argument revolves around the traditional abhorrence of the banks for borrowing from the Federal Reserve and an aggregate reduction of needed reserves. Under these conditions, the rate adjusts to the discount rate.

Under considerable pressing by the Treasury group, they were willing to explore with the Committee for a period of time running through December 1951, the maintenance of the 1-3/4 percent discount rate to facilitate Treasury planning of new money and refinancing at the new levels established as a result of these adjustments.

There was long discussion, and much of it sympathetic to a proposal advanced principally by Mr. Riefler that the Secretary announce an installment retirement non-marketable 2-3/4 percent long-term bond (29-1/2 years) which could be exchanged for the existing June and December 2-1/2's, the desire being to lock these two issues up as much as possible and remove them as an important market factor. A feature of this issue might be an alternative of exchange for 1-1/2 percent, five-year notes for those who desired to cash them.

At the concluding session it was suggested by the Treasury group that if the Secretary should accede to the Federal Reserve proposal with respect to the adjustment of the short-term rates and should decide to announce a 2-3/4 percent non-marketable long-term issue to be exchanged for the existing long-term restricted issues, the Federal Reserve might consider maintaining the current levels in the June and December issues until it was demonstrated that they would continue to require support. In that event, the Federal Reserve and Treasury group would then reconsider the problem.

This was put forward, not as a counter proposal, but on an exploratory basis and with an earnest plea on the part of Mr. Bartelt that we not attempt

to prejudice the market. It was his hope that such an arrangement would release pressure from the market and permit us to get a start on the refinancing program without impairing any further public confidence in the markets.

It was suggested by the Federal that if the Treasury desired to test the new exchange issue this way, they might consider an agreement that cost of supporting the first 200 million purchased be shared equally by the Treasury and the Federal Reserve, that the Treasury carry 75 percent of the cost of the succeeding 400 million and that the Treasury carry the whole amount if any purchases in excess of 600 million are required.

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February 26, 1951

MEETING IN CABINET ROOM
WHITE HOUSE
11:00 A.M.-12:00 M.

Present - The President in the Chair
Mr. C. E. Wilson, Director, Office of Defense Mobilization
Mr. Leon Keyserling, Chairman, Council of Economic Advisers
Mr. John D. Clark, Council of Economic Advisers
Mr. Roy Blau, Council of Economic Advisers
Mr. Harry McDonald, Chairman, SEC
Mr. Thomas McCabe, Chairman, FRB
Mr. Allan Sproul, President, New York Federal Reserve
Mr. Edward Foley, Under Secretary of Treasury
Mr. Wm. McC. Martin, Jr., Assistant Secretary of Treasury
Mr. Charles Murphy, White House Staff
Mr. David Bell, White House Staff

The President opened the meeting in the most pleasant and conciliatory manner, and stated that he had been worried with this problem for some time and wished to get this group together for the purpose of frank and open discussion of the problems. He said that the RFC (obviously mis-spoken as he clearly intended the CEA) and the Treasury Staff had been working on some ideas which seemed to him to make a lot of sense and so he wanted to take the liberty of reading them to the group.

This he did, very clearly and with emphasis on certain points, such as the importance of the public credit of the United States, which he said several times was vital to Mr. Wilson's work, and so important that unless it were maintained the Russians would have achieved their purpose completely. Mr. Wilson nodded agreement.

After the President finished, he said that he wanted frank and open discussion of the ideas in the memorandum.

Mr. McDonald opened the discussion by passing around a memorandum on the volume of new securities and indicating that Municipal financing in particular had boomed. The President thought this very interesting.

Mr. Clark spoke next. He said the President's comments made good sense to him and recalled historical situations, such as the one calling for the creation of the Federal Reserve System and the Banking Act of 1933. He felt we might have a similar type of situation today and the powers required to meet the current problem should be studied. He thought the Treasury position in the matter of interest rates sound and appropriate in the light of mobilization efforts and the Federal Reserve certainly ought not to drive rates up by selling in the market and should work with the Treasury to keep confidence in a stable orderly market and that later in the year after tax receipts which were going to be large wherein more money for investment would appear and the financing problem would be possible of solution at current levels.

Mr. Sproul spoke next. He stated there was no disagreement on maintaining the credit of the government. If the Federal Reserve had anything to reproach itself on to date, it was the dilatory actions it had taken to restrict bank reserves. The System should have stopped net-buying governments on the scale it has been doing so long ago. This, he said, under current conditions, was monetizing the debt in a way which strained the conscience of the Open Market Committee with respect to their responsibilities. He did not think the actions contemplated by the Committee would impair confidence in

the markets as most of these securities were marketable and held by experienced investors who were used to the hazards of the market and expected it. In fact, he was of the opinion that elimination of existing artificialities and more dependence on the market itself would generate confidence and improve the outlook for the refinancing and new money issues which the Treasury would be faced with later in the year.

Mr. McCabe spoke next. He started off by stressing the element of time. He was interested in the memorandum the President had read from, and he would be particularly pleased to have the support of other agencies of the Government for increased reserve requirements. Up to date, he had never been able to obtain any support for this. However, he was concerned at the moment with the necessity for making a decision on operations in the market for which the Open Market Committee was pressing.

He then spoke of the fine work that had been done by Bill Martin and Win Riefler in trying to see if there was an area of agreement that could be worked out. He thought both Treasury and Federal Reserve were opposed to monetization of debt and they ought to be able to get together on a program.

He stressed the fact that life insurance companies and corporations and other large non-banking investors had purchased the long-term restricteds at par and now were in a position to cash them in at a handsome profit to make good on their commitments, while purchasers of savings bonds could only cash in their securities at the face price and by sacrificing the interest to maturity.

He wanted to emphasize to the President the clear purpose of the Open Market Committee to maintain an orderly and stable market but to depend as

far as possible on the judgment of the market itself. The Federal Reserve had a statutory responsibility given to it by Congress, and he felt that they must act on their judgment in the matter and despite his best efforts, he had been unable to arrive at an understanding with the Secretary of the Treasury, who is now in the hospital. He was very sorry the Secretary was in the hospital, but thought that time was very important and they ought not to be asked to delay indefinitely. Mr. Foley had called him and suggested that they might delay two weeks which, coming on top of a previous delay of two weeks, meant roughly thirty days without any action. He urged the President to appreciate how sincere they were in endeavoring to stop inflation and protect the purchasing power of the dollar but how apprehensive they were about the way things were developing.

Mr. Foley spoke next. He said he wanted to clarify a point Mr. McCabe had made with respect to the Secretary which was perhaps due to a misunderstanding. It was possible the Secretary might be able to engage in negotiations before two weeks were up but he had expressed to Mr. McCabe, whom he had tried to get repeatedly over the weekend without success until late Sunday evening, how anxious he was not to upset the Secretary unduly. On Friday neither he nor Mr. Martin had been able to see the Secretary as there was some evidence that a possible hemorrhage might occur in the eye and the Doctors refused to permit anyone to see him. The constant visits for instructions which he and Mr. Martin and others in the Treasury had been forced to make during the past week had unquestionably retarded his recovery and in asking for two weeks time of Mr. McCabe, he was merely making an estimate of what he thought would be desirable without intending to close the door to negotiations more immediately.

He then stated the Treasury's fear that lowering the pegs in the long-term restricted issues would unsettle the market, bring an avalanche of selling, and seriously impair public confidence in the issues. He said the debt was very large and that we were very apprehensive of creating any unnecessary danger which would make it difficult to refinance or obtain new money. He pointed out that the debt was now \$257 million and a panic in the market would be a catastrophe.

He stated that the conversations which had been conducted at the technical levels appeared to be making some progress and there was a fine spirit of cooperation and good will on both sides. He hoped that these could be continued and that ultimately they might be brought to a successful understanding which would benefit both the Treasury and the Federal. He thought it vital that everything possible be done to maintain stability in the market.

Mr. Keyserling spoke next. He said he had listened carefully to what had been said by his colleague Mr. Clark, Mr. Sproul, Mr. McCabe, and Mr. Foley and without commenting on what had been said, he wanted the President to know that he didn't think the problem was being faced. He felt that it was important to determine whether there was a forum or vehicle by which two clearly opposing positions could be resolved by men of good will. He took that to be the purpose of this meeting, and he thought it important that a real effort be made to work out this specific problem.

The President then commented that he thought it was very important to work it out and was very vital to Mr. Wilson's work, and he was very anxious to get everybody together -- that's why he was asking for this frank discussion. He was not trying to reach a decision today but hoped this would not work out the way Wage Stabilization did where a fight had developed with everyone

resigning. He didn't want to take arbitrary action, but he had certain powers and there came a point when he would have to exercise them.

Mr. Wilson spoke up -- said he didn't think it was necessary to delay this matter too long, and he wondered if we couldn't contact the Secretary of the Treasury about this particular matter promptly. Mr. Foley interjected that he was sure that could be done, and he hoped that if Mr. Wilson would undertake to get the ball in motion and get the task forces or subcommittees set up, he knew the Secretary would be most appreciative.

There seemed to be general agreement that this would be a good idea and the meeting broke up a little after twelve with the President asking that an effort be made to report to him as promptly as possible.

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Mr. Clark spoke next. He said the President's comments made good sense to him and recalled historical situations, such as the one calling for the creation of the Federal Reserve System and the Banking Act of 1933. He felt we might have a similar type of situation today and the powers required to meet the current problem should be studied. He thought the Treasury position in the matter of interest rates sound and appropriate in the light of mobilization efforts and the Federal Reserve certainly ought not to drive rates up by selling in the market and should work with the Treasury to keep confidence in a stable orderly market and that later in the year after tax receipts which were going to be large wherein more money for investment would appear and the financing problem would be possible of solution at current levels.

Mr. Sproul spoke next. He stated there was no disagreement on maintaining the credit of the government. If the Federal Reserve had anything to reproach itself on to date, it was the dilatory actions it had taken to restrict bank reserves. The System should have stopped net-buying governments on the scale it has been doing so long ago. This, he said, under current conditions, was monetizing the debt in a way which strained the conscience of the Open Market Committee with respect to their responsibilities. He did not think the actions contemplated by the Committee would impair confidence in

the markets as most of these securities were marketable and held by experienced investors who were used to the hazards of the market and expected it. In fact, he was of the opinion that elimination of existing artificialities and more dependence on the market itself would generate confidence and improve the outlook for the refinancing and new money issues which the Treasury would be faced with later in the year.

Mr. McCabe spoke next. He started off by stressing the element of time. He was interested in the memorandum the President had read from, and he would be particularly pleased to have the support of other agencies of the Government for increased reserve requirements. Up to date, he had never been able to obtain any support for this. However, he was concerned at the moment with the necessity for making a decision on operations in the market for which the Open Market Committee was pressing.

He then spoke of the fine work that had been done by Bill Martin and Win Riefler in trying to see if there was an area of agreement that could be worked out. He thought both Treasury and Federal Reserve were opposed to monetization of debt and they ought to be able to get together on a program.

He stressed the fact that life insurance companies and corporations and other large non-banking investors had purchased the long-term restricteds at par and now were in a position to cash them in at a handsome profit to make good on their commitments, while purchasers of savings bonds could only cash in their securities at the face price and by sacrificing the interest to maturity.

He wanted to emphasize to the President the clear purpose of the Open Market Committee to maintain an orderly and stable market but to depend as

far as possible on the judgment of the market itself. The Federal Reserve had a statutory responsibility given to it by Congress, and he felt that they must act on their judgment in the matter and despite his best efforts, he had been unable to arrive at an understanding with the Secretary of the Treasury, who is now in the hospital. He was very sorry the Secretary was in the hospital, but thought that time was very important and they ought not to be asked to delay indefinitely. Mr. Foley had called him and suggested that they might delay two weeks which, coming on top of a previous delay of two weeks, meant roughly thirty days without any action. He urged the President to appreciate how sincere they were in endeavoring to stop inflation and protect the purchasing power of the dollar but how apprehensive they were about the way things were developing.

Mr. Foley spoke next. He said he wanted to clarify a point Mr. McCabe had made with respect to the Secretary which was perhaps due to a misunderstanding. It was possible the Secretary might be able to engage in negotiations before two weeks were up but he had expressed to Mr. McCabe, whom he had tried to get repeatedly over the weekend without success until late Sunday evening, how anxious he was not to upset the Secretary unduly. On Friday neither he nor Mr. Martin had been able to see the Secretary as there was some evidence that a possible hemorrhage might occur in the eye and the Doctors refused to permit anyone to see him. The constant visits for instructions which he and Mr. Martin and others in the Treasury had been forced to make during the past week had unquestionably retarded his recovery and in asking for two weeks time of Mr. McCabe, he was merely making an estimate of what he thought would be desirable without intending to close the door to negotiations more immediately.

He then stated the Treasury's fear that lowering the pegs in the long-term restricted issues would unsettle the market, bring an avalanche of selling, and seriously impair public confidence in the issues. He said the debt was very large and that we were very apprehensive of creating any unnecessary danger which would make it difficult to refinance or obtain new money. He pointed out that the debt was now \$257 million and a panic in the market would be a catastrophe.

He stated that the conversations which had been conducted at the technical levels appeared to be making some progress and there was a fine spirit of cooperation and good will on both sides. He hoped that these could be continued and that ultimately they might be brought to a successful understanding which would benefit both the Treasury and the Federal. He thought it vital that everything possible be done to maintain stability in the market.

Mr. Keyserling spoke next. He said he had listened carefully to what had been said by his colleague Mr. Clark, Mr. Sproul, Mr. McCabe, and Mr. Foley and without commenting on what had been said, he wanted the President to know that he didn't think the problem was being faced. He felt that it was important to determine whether there was a forum or vehicle by which two clearly opposing positions could be resolved by ~~ment~~ of good will. He took that to be the purpose of this meeting, and he thought it important that a real effort be made to work out this specific problem.

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. Wm. McC. Martin, Jr.

February 26, 1951

MEETING IN CABINET ROOM
WHITE HOUSE
11:00 A.M.-12:00 M.

Present - The President in the Chair
Mr. C. E. Wilson, Director, Office of Defense Mobilization
Mr. Leon Keyserling, Chairman, Council of Economic Advisers
Mr. John D. Clark, Council of Economic Advisers
Mr. Roy Blau, Council of Economic Advisers
Mr. Harry McDonald, Chairman, SEC
Mr. Thomas McCabe, Chairman, FRB
Mr. Allan Sproul, President, New York Federal Reserve
Mr. Edward Foley, Under Secretary of Treasury
Mr. Wm. McC. Martin, Jr., Assistant Secretary of Treasury
Mr. Charles Murphy, White House Staff
Mr. David Bell, White House Staff

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Wm. McC. Martin, Jr.

APR 4 1950

Lines of Approach to Convertibility

There seem to be developing several possible approaches to the objective of convertibility. Some of these are:

1. The expansion of the use of inconvertible sterling as widely as possible, in the hope that it will then be easy at some stage to make sterling convertible. This assumes that the British can be persuaded that it is to their advantage to make the final shift from inconvertible sterling to convertible sterling.
2. The improvement of the bargaining power of the non-sterling countries and the sterling area countries against Britain, by various means. This approach now appears to be favored by ECA and given expression in its proposals for a EPU. However, there is little indication that it is expected to carry so far as to divert dollars to a greater extent to the European participants on the continent at the expense of the U.K.

More fundamentally, there appears to be a good deal of uncertainty as to whether the objective of convertibility is best approached by liberal assistance to foreign countries which should make it possible for these countries to accumulate reserves as a cushion against the dangers of convertibility, or whether the objective is best approached by rather limited dollar assistance which forces countries to become more competitive with the dollar area. The second course makes more rapid progress towards the fundamental economic adjustments which must be made to establish firm underpinning of the current account balances in the international financial picture. It is, however, productive of increased controls and vigorous public planning as a result of the competitive scramble to earn dollars and to avoid dollar payments.

On the other hand, the first approach, while easing the risks of movement toward convertibility, tends to produce both in the minds of public planners and the private sector, a tendency to drift along with an inconvertible system and to hope that dollar needs will continue to be met by some form of U.S. assistance. It is also not certain that in fact a great deal more relaxation of bilateral arrangements will accompany such an approach, merely because it makes the risks of abandoning bilateralism less pronounced. The advantages to themselves of bilateralism apparently are becoming more and more clearly evident to such countries as the U.K.

It may be that the resolution of this dilemma could lie along the following lines. To the extent possible, U.S. assistance might be diverted from the stronger countries to the weaker countries but provided insofar

as possible in the form of transferable dollars. Under this arrangement, the stronger countries would be under increasing pressure to compete to earn dollars and thus to improve their fundamental economic position. This tendency would be reinforced by their desire to earn some of the large volume of free dollars which is now provided by U.S. imports from Latin America and Canada. A beginning toward this approach could be made through the Payments Union, which makes possible the setting up of a pool of free dollars from the ECA appropriation. The stronger countries could have their direct allocations reduced to provide the larger portion of this pool, and could be required to earn what they obtain from the pool. At the same time any program of assistance by the U.S. to Asia could assist in this process, especially if it were possible to provide any transferable dollars to Asia.

In general this approach suggests that it may be desirable first to produce fully competitive and strong economies in the stronger countries before trying to deal directly with the financial barriers to convertibility. Once the countries have become really competitive with the dollar area, then attention may be devoted to an improvement in their reserves which would facilitate the assumption of convertible obligations if they could be persuaded to do so. In general, therefore, the broad principle might be enunciated that progress toward convertibility may best be furthered by the U.S. through providing a maximum amount of transferable dollars to the weaker countries, both through financial assistance and through imports, while restricting to the minimum dictated by political considerations the dollar assistance given directly to the stronger countries of the world.

It must be recognized, however, that this approach recognizes a continued dependence of the weaker areas on U.S. assistance. It tends to move away from the opposite concept that the weaker countries should begin to earn their dollars from stronger countries such as the sterling area. Perhaps, therefore, there could be a second stage of the program, comprising a direct convertibility drive, which might follow the attainment of full competitive status by the stronger countries.