William McChesney Martin, Jr., Papers

Box 24/Folder 6

HEARINGS

Series V, Subseries C

Miscellaneous, 1957-1959

September 4, 1959.

Dear Mr. Waage:

Thank you for your thoughtfulness in sending me a copy of the letter the President of your Chamber sent to Speaker Rayburn with respect to the interest rate ceiling on Government bonds. I am very interested to see it.

I also wanted to say that I am sorry I cannot accept your nice invitation to address your Finance Committee in October, about which Jerry Shay spoke to me. Unfortunately my commitment at that time are so heavy I just can't add anything more to the schedule. I did want you to know, however, that I appreciated your thinking of me.

With all good wishes,

Sincerely yours,

Wm. McC. Martin, Jr.

Mr. Dbn Lester Waage,
Secretary, Finance Committee,
Chamber of Commerce of the
United States,
Washington, D.C.

We believe
this may interest you.

DON LESTER WAAGE
Secretary

Finance Committee

CHAMBER OF COMMERCE OF THE UNITED STATES
WASHINGTON, D. C.

CHAMBER OF COMMERCE OF THE UNITED STATES

ERWIN D. CANHAM
PRESIDENT

1615 H STREET, N. W.
WASHINGTON 6, D.C.
NATIONAL 8-2380

September 3, 1959

The Honorable Sam Rayburn
Speaker of the House
House of Representatives
Washington 25, D. C.

Dear Mr. Rayburn:

On behalf of business and community leaders throughout the nation who are members of the National Chamber, I express deep concern about reports that Congress may adjourn without acting to remove the inflation-producing interest rate ceilings on Government bonds.

The views of members of the National Chamber on the importance of these ceilings were expressed to the House Ways and Means Committee during its deliberations on the serious debt-management problems of our Government.

The fact that the House Ways and Means Committee agreed on a measure that would meet the immediate problems of debt financing (H. R. 8637, introduced by Representative Harrison of Virginia) makes prompt action by the House more readily attainable, of course.

And the announced willingness of Senator Byrd, Chairman of the Senate Finance Committee, to give immediate committee consideration to a House-passed measure, heightens the prospect of Senate action at this session.

This action is imperative if we are to prevent serious damage to the Treasury's debt management program, additional inflationary pressures upon the economy, and added costs to the taxpayers.

Interest rates paid on federal borrowings should be determined in the market place like any other price that is free to move. To freeze rates on Treasury bonds of over five years maturity to a standard based on an economy of forty years ago is unrealistic.

Interest rates cannot be arbitrarily fixed by legislation without unstabilizing the supply of money and the whole economy. If the U. S. Treasury is confined to short-term financing, the money supply will be artificially expanded and thereby create more inflation.

This in turn has a detrimental effect on all buyers -- the general consumer and the government -- since it increases the cost of goods and services they require. In fact, the taxpayer is actually affected adversely in two ways: first, by the increase in the cost of consumer purchases, and secondly, by the increased taxes required for the inflated prices which government must pay to continue to operate.

It seems clear that from the standpoint of sound economics, the fundamental issue involved in this situation is which is the better -- for the interest rate on borrowed money to be fully responsive to market prices even if at times this means somewhat-higher interest rates, or the general price level of goods and services to rise. Obviously, the latter would have a larger economic impact. Nor is it obvious that the removal of the interest rate ceiling on long terms will raise the overall cost of debt service. Short term rates would likely fall and we would in time have a much better distribution of public debt ownership. Indeed, it is quite possible that the total interest cost on the debt would be lower if the Treasury is free to operate across the entire money market spectrum.

Your personal leadership in urging the Congress to act promptly on this question of vital importance to the national welfare is respectfully requested.

Sincerely yours,

Ernest T. Cookson

President

August 19, 1959.

Dear Lennie:

Many thanks for the humorous piece, "Spending Ourselves Rich," and for sending me the copy of the Secretary's excellent statement of yesterday.

With all good wishes,

Sincerely yours,

Wm. McC. Martin, Jr.

Mr. Nils A. Lennartson,
Assistant to the Secretary,
Treasury Department,
Room 3420,
Washington 25, D.C.

TREASURY DEPARTMENT

TO: Dear Bill

In case you didn't see.

NALennartson

8/19/59

Nils A. Lennartson
Assistant to the Secretary
Room 3420

TD-OAS-DC

IN ANSWER TO INQUIRIES August 18, 1959

STATEMENT BY SECRETARY OF THE TREASURY ANDERSON

The action of the Ways and Means Committee this morning in connection with the Administration's debt management proposals is a matter of grave concern. The Nation cannot afford to sit idly by at a time of rising levels of business activity and allow a situation to continue in which both the fact and the fear of future inflation can be generated.

We have tried to make it clear that under present restrictions the Government in the management of the debt can actively contribute to inflationary pressures by being confined to short term financing, which, the shorter it gets, is more nearly like money.

We have tried to make it clear that the Government has a dual responsibility to forty million savings bonds holders. First, we should see to it that they get a fair return on their savings and, second, we should take such actions as will help guarantee their savings against loss in the purchasing power of the invested dollar.

We have tried to make it clear that vital to the security of the free world is the maintainence of international confidence in our collective resolve to maintain sound financial systems. Because of our position as a leader in this community of nations, many countries hold large dollar deposits with us and have large investments in our securities. They have therefore a real concern in the way in which the United States manages its financial affairs. In asking to have the artificial restrictions removed from our debt management legislation, we seek to assure the people both at home and abroad that we will manage the debt in a way consistent with the preservation of the dollar as an international standard of value.

The Administration will continue to earnestly urge appropriate action to obtain adequate flexibility in the management of our debt. This is a matter of such great importance as to require the best efforts of all Americans on a bi-partisan and national basis.

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NEWS from the AFL-CIO
NA. 8-3870

FOR RELEASE P.M. PAPERS, FRIDAY, JULY 17, 1959

The AFL-CIO today called on Congress to reject President Eisenhower's proposal of higher interest rates on long-term government bonds. Such a step is "not needed at this time to protect the solvency of the federal government," the federation said.

The AFL-CIO statement was sent to all members of Congress by Andrew J. Biemiller, the organization's legislative director. In a covering letter, Biemiller pointed out that the government "for over 42 years...has successfully met its needs -- through wars and depressions as well as booms -- without breaching the 4½% interest rate ceiling...The AFL-CIO believes no change can be justified."

Biemiller charged that the Administration's "hard money" policy, pursued since 1953, has saddled millions of private borrowers with ever-higher interest rates "while money-lenders are reaping handsome profits without providing added service."

The AFL-CIO statement gave these reasons for opposing the President's proposals:

* Any present scarcity of loanable funds is due to temporary factors arising from the upturn in the business cycle.

* The Administration has "undermined the market" for long-term bonds by "incessant scare talk about inflation" which has driven savers out of the bond market and into the stock market. The 1954 dividend tax credit law pushed by the Administration also has encouraged investors to favor stocks over U.S. bonds.

* The new money needs of the Treasury will be "greatly diminished" as the current recovery substantially raises federal revenue.

* The Treasury can meet its needs through short-term borrowing on which no interest rate ceiling exists or the Federal Reserve Board could purchase long-term bonds and sell off short-term bills.

* The use of long-term bonds has not been a major source of federal financing. Only $39 billion of the $283 billion debt at the end of February 1959 was in obligations of over five years.

The long-run effect of repeal, said the statement, "would be to transfer even more of the income of American families to the banking community."

The AFL-CIO noted that Administration policy of stretching out the long-term debt by raising interest rates has failed. In six years the maturity of the debt has been reduced from 5.4 years to 4.9 years.

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High interest rates, the statement added, did not achieve economic growth and stability as seen from the record of two sharp recessions. Higher interest rates have also increased the interest cost of the national debt from less than $6.4 billion in 1954 to an expected $8.5 billion for fiscal 1960.

The Administration policy has also inflated interest charges on personal and business loans and on state and local debt, the AFL-CIO noted. Since 1952, personal income from interest payments has skyrocketed from $12 billion to $20.5 billion.

(A copy of the AFL-CIO statement is attached).

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AFL-CIO STATEMENT ON PROPOSAL TO INCREASE INTEREST RATES ON LONG TERM BONDS

It is the view of the AFL-CIO that Congress need not, and should not, lift the interest rate ceiling on long term bonds nor should they give this dangerous authority to the President, for many reasons.

1. If there is a present scarcity of lonable funds, it is essentially the result of temporary factors related to the turn in the business cycle. We have shifted from a $1 billion liquidation of inventories in the last quarter of 1958 at annual rates, to an accumulation of $5 billion in the first quarter of 1959. Besides, outlays for construction, equipment and installment credit are on the rise. However, the shortage of funds, usually associated with the early stage of a recovery, is likely to taper off as abnormal borrowing to build inventories diminishes and as the recovery itself generates a substantial increase in private and corporate savings.

2. Administration spokesmen have undermined the market for long-term Treasury obligations and have stimulated higher interest rate demands by their own incessant scare talk about inflation, even though the wholesale and consumer price indexes have been remarkably stable for over a year. Thus, the Administration spokesmen from the President on down have been largely responsible for driving savers out of the bond market and into the stock market, as a hedge against anticipated inflation. The Federal dividend tax credit enacted by the Administration in 1954 -- which never was justifiable by any equity consideration -- has further encouraged investors to favor stocks over U.S. bonds. This tax bonanza on divided income should never have become law and should be speedily repealed.

3. The new money needs of the Treasury during fiscal 1960 will be greatly diminished or may end entirely, as the recovery substantially raises Federal revenue.

4. No long-term U.S. bonds will have to be redeemed before late 1960. In the meantime, the Treasury can continue to meet its needs through short-term borrowing on which no interest ceiling exists, or the Federal Reserve Board could purchase long-term bonds and sell off short-term bills, notes and certificates, thus keeping the credit resources of the nation unchanged. It would permit some longer term bonds to be issued and sold. The adoption of this approach could halt the speculation of whether interest rate ceilings on bonds could go up and thus could stabilize the whole interest rate structure.

5. The use of long-term marketable obligations by the Treasury is not, and, for the last six years, has not been a major source of Federal financing. Of a total interest bearing debt of $283 billion at the end of February 1959, only $147 billion -- or about 50% -- represents marketable Treasury obligations. Of these, only $39 billion are obligations maturing in over five years.

These are the reasons in the main, that have led us to conclude that the Congress should reject completely any proposal to allow the 4¼% ceiling on Treasury bonds issued for five years or more to be repealed. The proposed increase in the interest rate is not needed at this time to protect the solvency of the Federal Government. There are other alternatives. The only long-run effect of the repeal would be to transfer even more of the income of American families to the banking community.

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It is instructive to recall a little recent monetary history.

Back in 1953, Secretary of the Treasury Humphrey boosted interest rates on a long-term U.S. bond issue one-half of one percent with the argument that he had to do it to encourage the "stretching out" of the U.S. debt. Although this action helped trigger an upward push of all interest rates, it did not extend the maturity of the outstanding U.S. debt. As a matter of fact, it reduced the maturity of the debt from 5.4 years in 1953 to 4.9 years in January 1959.

Since then, interest rates have been pushed up further by a combination of Federal Reserve Board and Treasury actions -- all with the avowed purpose of checking inflation and assuring stable economic growth. Here, too, the achievement is highly questionable. They did succeed, however, in transferring billions of dollars from those who borrow to the bankers who provide no additional service for the increase in price they now receive for lending.

In the first place, the interest rate manipulators and the "tight money" planners haven't been able to deter the spending at will of wealthy corporations and rich individuals who don't have to borrow to meet their needs. Furthermore, the record of two sharp recessions in the last five years indicates that high interest rates did not achieve economic growth and stability. Instead, high interest rates succeeded in actually slowing down personal consumption, business and government investment at times when expansion was clearly desirable.

Finally, it is evident that important factors besides interest rates influence the demand for money and that Federal Reserve Board policies did not prevent rising prices.

The Administration and the Federal Reserve Board have persisted in a policy of raising interest rates -- as though raising the profits of bankers was a major objective -- even when they had a choice of other instruments to use to try to restrict the amount of outstanding credit in our economy.

For example, the Federal Reserve has not increased bank reserve requirements at any time since the Eisenhower Administration came into power. When inflation has been the assumed problem they have raised interest rates but never the level of bank reserve requirements. On the contrary, since 1953 the maximum reserve requirement of member banks has been cut from 24% to 18%. In fact, at precisely the same time the Administration is demanding higher interest rates to fight the alleged inflationary danger, it is also supporting passage of the vault cash bill by the Congress which would raise the lending potential of the banks by billions of dollars through a further reduction in reserve requirements. But this would increase the money supply and, presumably, the inflationary danger.

As a consequence of policies pursued since 1953, interest rates are already artificially high. Since fiscal 1954, interest payments on the Federal debt have skyrocketed from less than $6.4 billion to an expected $8.5 billion for fiscal 1960. More than $1 out of every $8 we now pay in Federal taxes already is being spent for interest payments alone.

Furthermore, additional billions of dollars are being paid to the money lenders for high interest charges on personal and business

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loans and on state and local debt. (Since 1952, annual personal income from interest payments has skyrocketed from $12 billion to $20½ billion.)

What is more, higher interest rates, which always have been excused as necessary to fight inflation, are themselves tremendous inflating the cost of government, raising a family, and operating a business -- particularly a small or moderate sized one.

Nonetheless, it is being argued by the Administration once again that the only way the Treasury can meet the competition for funds to pay its debts is by raising interest rates still higher.

We are confident that the findings of the comprehensive studies of monetary, fiscal and other economic issues now being initiated by various Committees of the Congress will sustain our view and will reveal the shortsightedness of the Administration's proposal in view of the realities this nation must face.

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FOR RELEASE ON DELIVERY

STATEMENT OF WRIGHT PATMAN, M. C., BEFORE
THE COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES,
ON PROPOSALS TO RAISE THE FEDERAL DEBT LIMIT AND REPEAL THE
INTEREST RATE CEILING ON TREASURY BONDS
JUNE // , 1959

Mr. Chairman, it is good of the Committee to hear me. I am opposed to increasing the legal debt limit. I am also opposed to repealing, or even raising, the interest rate ceiling which was enacted during Woodrow Wilson's Administration, in 1918, and I am opposed to increasing interest rates on the Series E and H Bonds.

The Government Is Now Holding $25 Billion Of Its Own Debt Obligations, At Least $15 Billion Of Which Can And Should Be Canceled

As to the proposal to raise the debt ceiling, it is unnecessary for this reason. The Federal Government is now holding $25 billion of its own interest-bearing debt obligations. At least $15 billion of these obligations can and should be canceled immediately so as to reduce the present debt by that amount.

The fact is, as you may know, Congress is now considering a bill which will give away to the private banks about $15 billion of these securities, which will be the biggest giveaway in all history. This legislation, the so-called Vault-Cash bill, was recommended by the Administration and by the Federal Reserve Board. It has already passed the Senate; it has been approved by the House Committee on Banking and Currency and by the Rules Committee of the House; and we may expect the House will pass it within the next few days.

The $25 billion of interest-bearing obligations that I refer to are held by the Federal Reserve System. They have been purchased in the open market and paid for with Government funds. They are owned by the Government and not by the private banks. The private

banks have no claim to them whatever. In purchasing these securities the Federal Reserve System has not used any reserves deposited by the private banks, or any other funds of the private banks. These statements of mine about the ownership of the $25 billion of obligations are not in dispute. They have been agreed to many times by all authorities, including the present Chairman of the Federal Reserve Board and the past Chairmen of the Federal Reserve Board.

Now as to the question of what amount of these securities the Vault-Cash bill will give away, this is in dispute. The bill gives the Federal Reserve System authority to reduce bank reserves by about $12 billion immediately, which authority could be used only by either (a) setting off the biggest inflation in history, or (b) transferring ownership of an equal amount of the Fed's securities, without cost to the banks. Some of my colleagues on the Committee on Banking and Currency would no doubt tell you, however, that they are unaware of anything in the legislative history of this bill which indicates the Federal Reserve will use this authority for either of the two purposes for which it could be used. I think the legislative history is clear and unmistakable, but I will not impose on this Committee a question which is in dispute. I simply call the Committee's attention to the fact that the Federal Reserve Board has reported to Congress that its present holdings of $25 billion of bonds and other interest-bearing obligations of the United States are a great deal more than the needs for all purposes and all possible contingencies. Consequently, there is no reason why $15 billion of these obligations should not be canceled immediately, and thus remove any need for increasing the debt ceiling. I might add also that if $15 billion of these securities are canceled, this will remove any possibility that this amount of securities will be given away. If these securities are given away, the Government will have to pay for them again, when they become due; and in the meantime the Government will have

to pay interest on the securities, which interest will go into bank profits. At the present time the interest on these securities is paid back into the Federal Treasury. The Federal Reserve System meets its operating expenses out of these interest payments, sets aside some money in a so-called surplus fund, and returns the balance to the Treasury.

There is an added point about which there is also no dispute. The $25 billion of Government securities which the Federal Reserve System is holding have, in the last analysis, been paid for by the issuance of noninterest-bearing obligations, namely, Federal Reserve notes. Federal Reserve notes are, of course, currency in the pockets of individuals and in the cash registers of business firms. They are obligations of the United States, as is plainly stated on the face of them. They are signed by the Secretary of the Treasury, not

by the Chairman of the Board of Governors of the Federal Reserve System. They are obligations of the Unites States, but they are not obligations which are subject to the legal debt limit. They are not expected to be redeemed. They will remain in circulation for the convenience of business and consumers in carrying on trade and commerce.

Now, let me read from a report which the Board of Governors of the Federal Reserve System submitted to the Committeeson Banking and Currency of the Senate and House with reference to the Vault-Cash bill. This is the Board's position as of April 7, 1959 with reference to the amount of its $25 billion of interest-bearing securities which it feels it needs to keep:

> To the extent necessary to avoid undue credit expansion, reserves released by any reduction in requirements could be absorbed by Federal Reserve sales of securities in the market. This would in effect shift earning assets from Federal Reserve banks to member banks. The present System portfolio is adequate to permit a substantial reduction and still leave enough to provide sufficient earnings to cover necessary expenses, as well as for current purposes of policy.
>
> Any decrease in requirements, however, should leave the Federal Reserve with a portfolio adequate to cover possible future contingencies, such as a large inflow of gold or economies in the use of currency that might add reserves in excess of appropriate needs. 1/

May I suggest an estimate of the amount which the Federal Reserve would need to keep in its portfolio for the purposes which it has specified? Six billion dollars of securities would provide the Federal Reserve System with an income sufficient to meet expenses. In 1957, which is the latest year for which we

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1/ U.S. Congress, House of Representatives, Subcommittee No. 2, Committee on Banking and Currency, Hearings, "Member Bank Reserve Requirements," 86th Cong., 1st. Sess. (1959) p. 28.

have a report, the Fed's interest income on its holdings of Government securities amounted to 3.15%. Six billion dollars, yielding an annual interest income of 3.15%, would give the Fed an income of $189 million. Its expenses in 1957 came to $169 million, including amounts set aside for various reserves, for its retirement systems, and including some very "plush" luxuries.

As to the amount of securities which the Fed would need to hold, to sell at a later time to meet the contingencies which it has mentioned, actually it does not need any amount. These contingencies could be met by raising reserve requirements. One contingency is a possible large gold inflow from abroad, which would increase bank reserves and which would be inflationary unless offset by Federal Reserve action. The other possible event is a decline in the public's preference for currency, as opposed to bank deposits, in which case bank reserves would also be increased. In either case, the Fed would no doubt prefer, however, to meet such contingencies by selling securities from its portfolio rather than by raising required reserves of the member banks. The experience record of the past 40 years would indicate that $2 billion would cover both of these contingencies. In other words, an $8 billion portfolio of Government securities would be more than adequate to give the Fed a luxurious expense income and leave it in a comfortable position to meet the contingencies it envisions and in the manner in which it would prefer to meet them. But to be extra generous, so there could be no possibility of objection, I have proposed leaving the Fed with a portfolio of $10 billion of Government securities and canceling immediately $15 billion. This will make the proposed increase in the debt ceiling completely unnecessary.

Now, if the Committee should wish to cancel other amounts of unnecessary debt, there are two other suggestions it might consider.

First, the Federal Reserve System is holding approximately $1 billion dollars in a so-called surplus fund, for which no conceivable need could ever arise. If this $1 billion dollars were paid promptly into the Treasury, the present Federal debt could be reduced by that amount.

Second, it is really not necessary, and I cannot imagine by what reasoning it is appropriate, for the Federal Reserve System to hold interest-bearing obligations of the United States for the purposes of having an interest income to meet its expenses. The $6 billion of debt which I have suggested leaving with the Fed for this purpose should be canceled, and the Federal Reserve Board should come to Congress for annual appropriations, just as other Government agencies do. This would reduce the present debt by another $6 billion.

When the Vault-Cash bill comes to the floor of the House for debate, I expect to offer an amendment to the bill which will require the Federal Reserve Board to turn over to the Treasury immediately $15 billion of the securities it is holding for cancellation. If the Congress and the President accept this amendment, the Administration's proposal to increase the Federal debt by $12 billion will be completely unnecessary.

Removing The 1918 Ceiling On Interest Rates Is Unwise And Unwarranted

I come now to the Administration's chronic problem - interest rates.

Like most people today, I accept and believe in the collective bargaining processes. Furthermore, there is no question that when the bankers and money-lenders want a wage increase, they must come to the Government to get it. There is no place else to go. In this I am assuming, of course, that the Federal Reserve System is still in reality a part of the Government. It is true that it has, under this Administration, assumed the posture of a fourth non-elected branch of the Government, exercising powers to overrule or reverse economic policies decided upon by Congress and the President through Constitutional law-making processes. Furthermore, the President has repeatedly ratified this posture so that we would seem to have a super-bankers Government sitting over and above the Constitutional Government. It is hardly reasonable to assume, however, that the President would agree to this independent-government position of the Federal Reserve System if there were any serious policy differences between the Administration and the Federal Reserve.

We should be fair and open-minded on the question whether there is really any need to give the bankers and money lenders a larger share of the national income. We should expect, however, that some reasonable argument would be advanced for such a proposal. There is no claim, however, that the money lenders are entitled to a cost-of-living increase, that their productivity has increased, or that there is a hardship which should be met. Rather the arguments which Secretary Anderson made to the Committee yesterday are these.

One, the Federal debt is now at an alltime high, having reached $1600 for each man, woman and child in the country.

Two, the demand for savings has increased and the Federal Government cannot compete with the demands of State and local governments, private industry, or the stock market; in fact, cannot even compete with itself.

Three, the main problem is that interest rates have been pushed up by a growing belief that there will be inflation, an inflation which Secretary Anderson says has not materialized and a belief which he says is mistaken.

Four, monetary policy is an all-controlling factor in times of recession and becomes what is called one of aggressive ease. But at times when interest rates are being raised, and all the Government instruments of monetary policy disappear into the thin air of "flexibility" and interest rates are made by something called a free play of market forces.

Five, we have demonstrated the ability of a free economy to come out of an economic recession and the high interest rates have been caused by the $13 billion deficit, which it is suggested to be a product of Congress' fiscal irresponsibility.

Six, the same old saw that this Administration inherited a short-term Federal debt and wants to lengthen the maturity of the debt.

And finally, Democratic Administrations financed the tremendous debt of World War II, while holding the bond rate at 2½%, and the consequences were horrible.

Let us give a little examination to these arguments. First, the Federal debt is at an alltime high, and it does average $1,600 for each man, woman and child in the country. But in past years it has averaged a great deal more when the country was presumably less rich, and when interest rates were a great deal lower. In 1946, the debt was $1,903 per capita, and in 1950, it was $1650 per capita. In 1954, it was $1,670 per capita, and in 1956, it was $1,622 per capita. In all of these years interest rates were lower than now, so we can hardly blame interest rates on the high per capita debt.

Let us come now to this question of the total demand for savings. If we add up the figures on pages 139 and 157 of the President's Economic Report for 1959, we can see what the total demand for savings have been in the years 1951 through 1958. This includes total private demand, demand of State and local governments, the Federal surplus or deficit, and the net export of capital abroad. We find that the total demand for savings amount to 15.3% of the national income in 1951, and 15.4% in 1952. In none of the subsequent years has it been as high. It has ranged from 15.2% in 1953 down to 14.5% in 1958. Why then the increase in interest rates? Let us make some comparisons. In 1953, total demand for savings was a smaller percentage of the gross national product than in either 1951 or 1952. But the rate on 91-day Treasury bills was raised by 25%, from 1951. The yield on long-term Government bonds was raised by 14%, and the rate on prime commercial paper was raised by 17%.

Then, of course, in 1957, we had what the Federal Reserve Board thought was a runaway investment boom. The demand for savings in that year was 15.2% of the gross national product.

And compared to 1951, interest rates on 91-day Treasury bills were raised by 111%. Interest yields on long-term Governments was raised by 27%, and the rate on prime commercial paper was raised by 76%.

In this span of years, the gross national product was going up, the country was becoming more affluent, and we would normally expect that a larger percentage of the national income would go into savings, since people presumably had more money left over after meeting the cost of food, clothing and shelter.

Let me make one other point. Since 1951, there have been years of low interest rates, medium interest rates and extortionate interest rates. But the evidence is that neither the high nor the extortionate interest rates cause people to save any larger percentage of their income. On the contrary, people saved the highest percentage of their disposable personal incomes in 1951, 1952, and 1953, when the interest yields on long-term Governments ranged between 2.57% and 2.94%. In 1956 and 1957, interest yields on long-term Governments were 3.08% and 3.47% respectively, yet people saved only 7.2% and 6.8% of their disposable personal incomes in those years.

Now this I admit -- the Administration does have quite a problem with this belief that inflation is coming and that anyone who puts his savings into fixed-return securities will be repaid with cheap dollars. This has been the subject of one of the greatest propaganda crusades of all times. "Inflation" has been made a household word in every home in the land. Over the past year, particularly, the President has taken to television and to numerous press conferences to carry on a tremendous word battle against the coming inflation which seemed clearly visible to him. The National Advertising Council has cooperated.

Substantially all the big-business firms that profit from high interest rates or from a rising stock market have cooperated -- with newspaper ads and so on. Altogether, $4 billion of new money was poured into the stock market last year, and stock prices were driven up by 25 times that amount, or an increase of 40%, within 12 months. The big-money boys on Wall Street have made millions and paid taxes at capital gains rates, and the banks and money lenders have enjoyed a fat increase in interest rates.

My suggestion for the cure of Secretary Anderson's problem is not to come to Congress and ask Congress to ratify what he calls a mistaken belief in inflation, but to go back to the opinion-makers in his own Administration and have them correct the belief which he thinks to be erroneous.

Now on this matter of the Government's monetary policy, I don't believe it is quite fair of the Secretary to try to have it both ways, that monetary policy makes low interest rates to help the people in time of recession, but that monetary policy disappears when interest rates are being raised. The fact of the matter is that somebody in the Government decides every day, and every hour of the day, what the money supply will be and what interest rates will be. We are back into a period of tight money and high interest.

A few years ago there was no such timidity about admitting tight money and high interest policies. They were boasted about and were presented to the public as being a cure-all for all of our problems. In 1955, the money managers instituted tight money and high interest to fight what they thought was a boom in consumer installment purchases. In 1956 and 1957, the money managers squeezed money and raised interest for the purpose of dampening what they thought was a runaway investment boom. They finally choked off the investment boom and brought on a recession. Then they sat back and counselled that we all wait for adjustments to take place in the market, saying they were hopeful that the level of investments would soon increase again and everything would be all right.

Three things pulled us out of the recession: (1) The raising of the debt limit which permitted an increase in defense spending. (2) The retroactive pay increase for Federal employes. And (3) the unusually large farm crops.

Now the Secretary of the Treasury comes forward and says that the reason for the high interest rate is the $13 billion deficit, and the fact of the matter is the deficit came about in the first place because of the recession brought on by the high interest, tight-money policies.

When the Administration first embarked on a program to raise interest rates, with its first issue in February 1953, it said then that its purpose was to lengthen the maturity of the debt. That has been said repeatedly since, and it has also been said repeatedly that this Administration inherited a debt of short maturity.

The fact is that on December 31, 1952, 70% of the debt was in bonds and nonmarketable securities, and it hasn't been as high since, nor has the average maturity of the debt been raised. On June 30, 1952, the marketable debt had an average maturity of 5 years and 8 months. By mid-1953, it had an average maturity of 5 years and 4 months. By mid-1954, it had an average maturity of 5 years and 6 months. By January of this year, it was down to 4 years and 9 months.

It seems to me that after 7 years of hearing about raising interest rates so as to lengthen the maturity of the debt, everybody would be weary of it. We have now had some clear demonstrations on the way to manage the Federal debt and on the way not to manage it.

We financed the unprecedented burden of World War II without having the bond rate go above 2½%, and we had the least inflation that any country has ever had as the result of any major war. Maintaining low interest left the Treasury in a good position to make substantial reductions in the national debt after the war. Between 1945 and 1950 the debt, including guaranteed issues, was decreased by $22 billion. Furthermore, the Government was in a

good position to make savings in other ways. In 1948, bank profits were high so the Federal Reserve Board increased its contribution to the money supply and decreased the private banks' contribution, thus acquiring $2 billion of the debt so that the interest payments went back into the Treasury. Interest rates on the obligations were not high then so the bankers didn't object too much. Today, of course, just the reverse is true. The interest rates are high and the bankers are demanding a transfer of the Federal Reserve securities over to them.

In contrast, we have seen two disastrous consequences of trying to impose high interest and tight money on the country. Certainly by now everyone should know that these policies will not work.

Now, as to the proposal to raise the interest rates on the Series E and H Bonds, we have been playing this kind of ring-around-the-rosy for a long time, raising one rate to make it competitive with the others, and at the same time raising the others. This is a fruitless exercise. I am opposed to raising any of them.

May I close with an example we may take from the business firms of the country. In 1956 and 1957, many of the big corporations believed that the high interest rates that had been imposed then could not be sustained. Consequently, instead of going to the bond market for long-term financing at high interest rates, they went to the commercial banks and got temporary short-term financing. Then, in 1958, when there was a change in policy, and interest rates were brought down, the corporations paid off their bank loans and went to the bond market for long-term contracts.

There is no limit to the rate which the Treasury can pay for short-term obligations. I would suggest that in this period of high interest rates, the Government not be committed to any long-term contracts. There could be, in the next Administration, another change in policy to low interest rates.

6/11/59

Chairman Martin

You may be interested in the attached testimony of Congressman Reuss on his proposed amendment to the legislation being currently considered by the House Ways and Means Committee. His proposal is much the same as his H. Con. Res. 196 recently called to your attention.

Enz Okey

TESTIMONY OF REPRESENTATIVE HENRY S. REUSS (Wis.)
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS
IN CONNECTION WITH LEGISLATION RELATING TO THE PUBLIC DEBT
THURSDAY MORNING, JUNE 11, 1959

Proposed amendment: Add a new section 8, as follows:

> "Sec. 8. It is the sense of Congress that the Federal Reserve System, while pursuing its primary mission of administering a sound monetary policy, should, to the maximum extent consistent therewith, utilize such means as will assist in the economical and efficient management of the public debt; that the System, to the greatest extent possible, should bring about needed future monetary expansion by purchasing U. S. securities, of varying maturities, rather than by further lowering bank reserve requirements; and that the System should promptly and fully explore methods whereby use of the power to raise reserve requirements may become a more useable and effective anti-inflationary tool."

The House Committee on Ways and Means is considering a bill to remove the present interest ceilings on savings bonds and on Treasury bonds, and to raise the public debt limit from $283 billion to $288 billion, with a temporary increase to $295 billion.

The bill to accomplish this is called "A bill to facilitate management of the public debt". It has been brought about by the crisis in our debt management -- higher and higher interest rates, lower and lower market prices for U.S. securities, less and less investor interest in the national debt.

If the bill merely removes the ceilings on the interest rate and on the amount of the national debt, it might better be entitled "A bill to facilitate mismanagement of the public debt". For it will encourage our monetary managers to continue on the dead-end course on which they are embarked.

Merely raising the interest paid on the national debt is not going to solve anything. The $8.5 billion carrying charge on the national debt for fiscal 1960 is already the largest single non-defense item in the budget. Further increases in the interest rate are not merely going to increase the burden on the taxpayer. As high interest rates communicate themselves throughout the entire economy, economic activity everywhere, but particularly in housing, local government activities, public utilities, and small business is going to be hurt.

The amendment I propose would express the sense of Congress that the Federal Reserve System should not continue to turn its back on the management of the national debt, as it has been doing for some years. Of course the Federal Reserve's sole mission should be a sound monetary policy. But there is no reason why a sound monetary policy cannot be used to help, rather than to hurt, debt management. The proposed amendment involves no backtracking on the Treasury-Federal Reserve Accord of 1951, no commitments to peg the U. S. security market at par, no support measures at a time when monetary expansion would be inflationary.

The principal directive of the amendment would be that the Federal Reserve "should bring about needed future monetary expansion by purchasing U. S. securities, of varying maturities, rather than by further lowering bank reserve requirements".

Consistently since 1953, the Fed has expanded the money supply, where it has expanded it at all, by lowering reserve requirements of member banks. In the case of central reserve city banks (New York and Chicago), reserve requirements have been lowered from 24 in 1953 to 18 today. In the case of reserve city banks, requirements have been lowered from 20 in 1953 to 16½ today. In the case of country banks, reserve requirements have been lowered from 14 in 1953 to 11 today.

About $4.3 billion of reserves has been added to the banking system by this method -- enough to create 6 time as much credit, or almost $26 billion worth.

Never once since 1953 has the Federal Reserve, when it was pursuing anti-inflationary policies, tightened reserve requirements. Instead, it has tightened money solely by raising the rediscount rate and by selling U.S. securities from its portfolio.

What is more, the Federal Reserve System has recently stated very clearly its continuing intention of adding to the money supply by purchasing U. S. securities for its portfolio. I recently collected these policy statements from the Federal Reserve System and set them forth in the Congressional Record for June 4, 1959, at pages 8963-8964.

The proposed Congressional directive to the Federal Reserve to use purchases of U.S. securities as its principal method of expanding the money supply would help the cause of debt management in three major ways:

(1) It would raise somewhat the price of U. S. securities, and thus lower somewhat the going interest rate, not only on U.S. securities, but on all debt, public or private. Cushioning fluctuations on the downward side would make governments more attractive to investors. Even if the additions to the money supply in the future need to be only the modest 3% currently recommended by the Federal Reserve (I think 4 or 5% would be more like it), this requires an addition to the money supply of close to $6 billion annually, or close to $1 billion in new reserves. If the Federal Reserve achieves this expansion in reserves by purchases of U.S. securities, it will have assured the maximum amount of support for U. S. securities, consistent with sound monetary policy (assuming reserve requirements remain unchanged). It should be noted that the proposed Congressional directive to the Federal Reserve speaks of purchasing U. S. securities "of varying maturities". The Fed presently restricts itself to a "bills only" policy which needlessly deprives the U.S. security market of the maximum support per dollar that it ought to have.

(2) It would save many millions of dollars annually for the taxpayers, because the interest charge on the national debt owned by the Fed comes back to the Treasury. For example, if the Fed had purchased $4.3 billion of U.S. securities in recent years, instead of achieving this increase in outstanding reserves by lowering reserve requirements, at current interest rates something in the neighborhood of $160 million would be saved for U.S. taxpayers. For the future, if the Fed's net purchases of U.S. securities average only $1 billion a year, in 10 years this would amount to $10 billion worth of national debt. The savings on this sum could be close to $400 million a year, at current interest rates.

(3) It would at least partially protect the Treasury against the frequent embarrassment of "attrition", whereby holders of maturing national debt suddenly elect to take cash, rather than a refunding security. In May, for example, one-third of the holders of a maturing one-year note suddenly demanded cash, rather than to take another one-year refunding note.

So far we have been discussing solely decreases in the reserve requirement, and making the point that this method of increasing the money supply does not help in the management of the national debt, as does the method of purchasing, or at least retaining in the Fed's portfolio, U.S. securities. However, there may well be occasions when the Federal Reserve, from the standpoint of both sound monetary policy and sound debt management policy, may wish to, and in fact should, raise reserve requirements. The Fed gives as its reason for not having done so, and for proclaiming its intention of not doing so in the future, that the reserve-raising power is a clumsy weapon, in that it may operate harshly upon certain member banks.

There is strong reason to believe that the Federal Reserve, if it really wanted to smooth off the rough edges of its debt management policy, could do so by a series of very simple amendments. A number of sound and sensible ways of doing this, recommended by the late E. A. Goldenweiser, former Director of Research for the Federal Reserve System, and published by the Committee for Economic Development, are set forth in my remarks on the floor on June 4, 1959 (Cong. Rec., p. 8965).

The House Committee on Banking and Currency on May 28, 1959 formally requested the Federal Reserve to explore methods of making the reserve-raising power a useable and effective method. The Committee said:

> "Your Committee firmly believes that the Board's monetary tools must be as efficient as possible. We are concerned over indications that increases in reserve requirements may be considered too blunt a weapon to use effectively. Accordingly, the Federal Reserve Board is requested to give further study to this problem, and to report to the committee as soon as practicable concerning possible improvements in the techniques of employing reserve requirements as an anti-inflationary tool, together with recommendations for any remedial legislation that may be necessary to put these improvements into effect." (Committee Report, p.6)

House Committee Report on the reserve requirements bill S.1120

The entire Congress should express the same wish as did the House Committee on Banking and Currency -- that the Fed should refurbish its reserve-raising powers, both to fight inflation when inflation threatens, and to permit a decent Fed participation in the debt management processes without giving rise to inflationary dangers.

Our debt managers need some guidance from Congress. The proposed amendment endeavors to provide this. In the long run, sustained economic growth, increased savings, reasonable price stability, national budgets balanced at full employment and production, are the royal road not only to a healthy economy, but to a well-managed national debt. Meanwhile, Congress must give the clearest kind of immediate directive that it can.

* * *

NOT FOR RELEASE UNTIL
AFTER PRESENTATION
OF TESTIMONY

NPA
M 3865

Statement of

Gerhard Colm

Chief Economist, National Planning Association

before the

House Ways and Means Committee

June 11, 1959

I am happy to appear before this Committee in response to your invitation. I do so as an individual interested in the problems of public finance and not as a representative of the National Planning Association with which I am associated. I would like to focus my brief statement on one specific proposal, namely on the removal of the present 4¼% interest ceiling on new Treasury bond issues. I will, of course, gladly try to answer questions you may have with respect to other provisions of the bill which is before you.

I am in favor of the proposed removal of the interest ceiling, first, because in principle it is not desirable to tie the hands of the debt managers by statutory provisions; second, because such restrictions may induce the Treasury to rely more heavily on short term securities and to raise their short-term interest rates. A ceiling on the interest rate on bonds would not necessarily put a ceiling on the cost of the Government's debt service as a whole, but might result only in a further shortening of debt maturities.

There is, however, one argument that could be advanced against adopting this legislation at the present time. It would be unfortunate if this action by Congress were interpreted by the monetary authorities and the financial community as advice -- or even as a mandate-- for a further rise in the rate of interest on government securities with a consequent further increase in the already heavy interest burden on the Federal Budget.

There are already signs that the Presidential request is being understood as foreshadowing a further rise in interest rates. If the Congress decides that the request should be granted, the legislation should be accompanied by the strongest possible statement which will dispell any misinterpretation of the intent of Congress with respect to the present interest rates on government securities. If the Treasury and Federal Reserve adopt appropriate measures, it may well be that a further rise in interest rates can be prevented and that a decline in interest rates in the foreseeable future will be a possibility. Perhaps, some parts of the concurrent resolution proposed by Congressman Reuss could very well be adapted to the legislative proposal before you.

With your permission, Mr. Chairman, I would like to elaborate in the remainder of this statement why I believe that a further general rise in interest rates is not a necessity under present and foreseeable circumstances. Let me begin by stating the opinion of those who believe that a further general rise in interest rates is unavoidable. They refer to the law of supply and demand, namely the supply of funds on the one hand through saving, and the demand for funds on the other through investments by business in plant, equipment, and inventories, through consumer and mortgage credit, through state and local borrowing, and last, but certainly not least, through the financial needs of the Federal Government. Some believe that there are so many claimants on the funds provided by saving that there simply are not enough funds available to satisfy everyone. Then, in accord with the law of supply and demand, the price for funds must go up in order to cut out some of the claimants, i.e. those

unable to pay the high price for funds. If that is the situation, no artificial holding down of the interest rate would do any good unless at the same time savings could be substantially increased.

Mr. Chairman, our factual knowledge in the field of saving is not very good. Therefore, I cannot offer a statement of absolute certainty, but can only express an opinion based on fragmentary factual information. I see no evidence of a general shortage of funds in the near future. During recent months an extraordinary demand for funds took place when nonfarm inventories shifted from a liquidation of about $1 billion in the 4th quarter 1958 to an accumulation of $5 billion in the first quarter of 1959 (annual rate), when outlays for residential construction and for plant and equipment increased by an annual rate of about $3 billion and installment credit increased too. As a consequence of this bunching in the demand for loanable funds, financial transactions of the Treasury got into a kind of traffic jam. (See table attached).

In addition, it was not only a shortage of funds but also special conditions which discouraged investments in government securities. Government securities are bought to some extent by individual and institutional investors who are interested in steady capital values as much as in a high interest yield. The dramatic decline in government security prices in recent years, which in part resulted from a rise in interest rates, paradoxically deterred some investors and made for still higher interest rates.

Also, the fear of inflation and the corresponding devaluation in the real value of fixed obligation in contrast with the expected growth in stock values helped to channel some funds from bonds into the stock market. Finally, the Federal Reserve has in recent months given only a minimum of support to the

government security market because such support was believed to be in conflict with the anti-inflation policy of the Board.

Mr. Chairman, I draw the following conclusions from these considerations:

1. If there has been an absolute scarcity of funds in recent months, it was largely the result of temporary factors. It is not unreasonable to maintain that the Federal Reserve should tide the market over a period of merely temporary stringency rather than add to it by a restrictive credit policy. I believe that with advancing recovery as great an increase in private and corporate savings will be generated as will be absorbed by private and public demand under present or possibly even somewhat lower interest rates.

2. Such a development will be enhanced if the Federal Reserve System assists in the maintenance of an orderly market for government securities through open market operations to mitigate major fluctuations and to promote the development of an interest rate which corresponds to the longer run supply and demand conditions rather than to short run fluctuations.

In the face of temporary or seasonal increases in the debt, the Federal Reserve should play a more active part. The inflationary impact of purchases of government securities could, if necessary, be mitigated by increases in reserve requirements. In the present economic juncture no definite advice can be given about the appropriate monetary policy for a longer period ahead. I do not propose that your Committee go on record with a recommendation that the Federal Reserve Board should switch to an easy money policy. With the end of the recent inventory boom it is still not clear whether the pace of recovery will slow down, will turn into balanced and sustained economic growth, or will develop into an inflationary boom. In such a situation the monetary authorities need to be on guard and should be prepared to respond

promptly to changes in the employment and production outlook. But the readiness to take anti-inflationary action if excessive demand develops should not and need not prevent the monetary authorities from playing their role in debt management.

3. The problems of debt management cannot be solved merely by increasing the rate of interest. Improvements in tailoring debt issues to potential markets and improvements in the marketing techniques should be explored. Lessons should be learned from past failures. Also the relationship between fiscal policies, especially tax policies, debt management, and credit policies require reexamination.

4. The Federal Government should do everything in its power to combat the notion that promotion of a desirable rate of economic growth will lead of necessity to continuing inflation. Policies needed to reconcile the objective of economic growth with a reasonable degree of price stability should be explored and adopted. This will be more helpful to the restoration of confidence in government securities than scare talk about unavoidable inflation. I believe that such restoration of confidence is entirely possible. The fact that saving deposits and similar fixed forms of savings have been rising all through 1958 and into 1959 demonstrates that the confidence of the American people in the soundness of the dollar has not been shaken. (From April 1958 to April 1959 time deposits increased by $6.3 billion).

In conclusion, I would like to repeat that I favor removal of the interest ceiling on government bonds. The increase in the debt limit and the removal of the interest ceiling on bonds should be used as an opportunity for the Treasury and the Federal Reserve System to improve their debt management

policies. In order to avoid possible misinterpretations and unwarranted expectations resulting from such Congressional action, it would be most desirable if the appropriate committees and the Congress as a whole would make it clear that this action is not taken in support of higher interest rates on government securities in general. The Congress could direct, as in the words of the proposed concurrent resolution that the Federal Reserve System "while pursuing its primary mission of administering a sound monetary policy, should, to the maximum extent consistent therewith, utilize such means as will assist in the economical and efficient management of the public debt". With such affirmative policies a further rise in the interest rate on the national debt may be avoided and in time a decline may be possible. Such policies would also make a contribution to the broader national objective of economic growth without undermining confidence in the dollar.

6/10/59
jt 200

Sources and Uses of Gross Saving

(Seasonally adjusted at annual rates)

Billions of dollars

	2nd Quarter 1957	1st Quarter 1958	4th Quarter 1958	1st Quarter 1959
Sources of Saving	71.0	62.3	69.5	72.2
Private saving:	68.4	62.3	69.5	72.2
Personal saving	23.2	19.9	19.9	20.4
Business retained earrings	45.2	42.4	49.6	51.8
Government surplus (Federal)	2.6	--	--	--
Uses of Saving	72.5	60.7	69.2	70.4
Gross private domestic investment	67.1	50.9	61.6	70.2
Investment in plant and equipment	47.7	42.1	41.5	42.8
Residential construction	16.5	17.1	20.1	21.7
Inventories	2.9	-8.2	0	5.7
Net foreign investment	4.2	.5	-1.0	-1.7
Government deficit	1.3	9.3	8.5	1.9
Federal	-	6.6	7.4	1.8
State-local	1.3	2.7	1.1	.1
Statistical discrepancy	1.5	-1.5	- .3	-1.8

Sources: Survey of Current Business; Federal Reserve Bulletin; and National Planning Association

TREASURY DEPARTMENT

TO: Dear Bill

Attached is Secretary Anderson's statement on our debt management proposals.

NAL

6/10/59

Nils A. Lennartson
Assistant to the Secretary
Room 3420

TD - OAS - DC

TREASURY DEPARTMENT
Washington

Statement on Public Debt Management
by Secretary of the Treasury Robert B. Anderson
before the House Ways and Means Committee,
10:00 A. M., June 10, 1959

I appear this morning to support policies I sincerely believe to be in the best interests of 176 million Americans. I do so in the realization that all thoughtful people share common objectives. We realize there are honest differences of opinion as to the methods by which these objectives may be attained.

Fundamentally, we Americans endeavor to achieve sustainable economic growth in terms of real goods and services. We seek a sustainable rate of growth that would promote maximum job opportunities, continuity of employment, and real earnings. We seek as well to insure that the process of saving, which underlies the growth of this or any other country, is not diminished but encouraged. We seek to protect the welfare of those individuals who now depend for their livelihood on accumulated savings, the proceeds of insurance policies, benefits of retirement systems, the aid of social security payments, and similar accumulations from a lifetime of effort.

We seek also to insure that those who plan for the education of their children, who guard against adversity, and who provide for their own economic well-being through any process of accumulated savings shall not have the rewards of their diligence and thrift diminished.

We live in a world of tensions and in a world where new nations with new freedoms are seeking to improve their standards of living and

their economic well-being, where all eyes are turned toward America. A sound domestic economy is essential if we are to maintain sufficient military strength to preserve freedom and liberty for ourselves and our friends abroad. If we are to witness the growth of better conditions for our neighbors all over the world, we must adopt and staunchly support enduring sound monetary and fiscal policies -- the same policies that we have strongly encouraged them to adopt in their own interests.

We must not be unmindful of the lessons to be learned from the financial history of others who have tried methods less demanding and less exacting, nor must we succumb to the belief that real wealth is created by any other means than by the physical and mental labor of human beings working with the physical resources with which each country is blessed.

Mr. Chairman, it is with this belief that we support the proposals which have been laid before you by the President. In a world of economic complexities, there is a constant interrelationship between fiscal policy, monetary policy, and the individual and collective actions of all who participate in our economic structure. We cannot isolate one and set it apart as controlling, but we can say that each, in its own sphere, is a sine qua non to the achievement of our total objectives.

It is because of my belief that the people of our country are willing to subscribe to the disciplines which freedom exacts from government and individuals that I have confident faith in the security and well-being of our Nation's future.

I should like now to address myself to one important element of our economic life -- the management of our National debt.

Our Debt Management Environment

The public debt rose last month to an all-time high of $287.2 billion and is now only slightly below that figure. This represents over $1,600 for each man, woman and child in America. The Federal Government owes as much money as all of the corporations in the United States put together. Our debt is as large as the debts of all the individual borrowers in the country put together plus the debts of all of our State and local governments.

The United States Government, therefore, owes about one-third of all of the debt in the United States and is the largest single borrower. In the calendar year 1958 the Treasury issued $69 billion of new marketable securities -- $19 billion for cash and $50 billion in refinancing maturities, quite apart from the continuing rollover of about $22 billion of weekly bill maturities. All of the corporations in America issued slightly under $10 billion of new bonds and notes last year while State and municipal new security issuances amounted to $7-1/2 billion.

In the year ahead the Treasury faces the refinancing of $76 billion of short-term securities that will mature. In some ways the volume of this short-term debt is as important a factor in our financing picture as the size of the total debt. Each time the Treasury goes to the market -- either for refunding operations or for new cash borrowing needed to cover seasonal requirements or retirement of other securities -- it

is a significant event in all financial markets. Both the size of our borrowing requirements and the frequency of our trips to the market tend to interfere with the smooth marketing of new corporate and State and local government securities.

Another problem related to the large size of the debt maturing within one year is that such debt is only one step away from money. It should be realized, however, that in this country we have a large active and continuous demand for short-term debt instruments outside of the banking system inasmuch as corporations, State and local governments, foreign accounts and many other investors invest their short-term funds in this manner. Almost 60% of our under-one-year debt, therefore, is held outside of the banks -- a larger percentage than in any other country we are aware of.

Even though it is preferable to have large amounts of short-term securities in the hands of nonbank investors rather than in commercial banks, we must never lose sight of the fact that a well-balanced debt structure calls for continued offerings of intermediate and longer-term securities whenever conditions permit if debt management is to be conducted in a manner consistent with economic growth and stability.

The quest for a balanced structure of the debt is never-ending since the passage of time brings more and more of the outstanding debt into the short-term area. The high point of our under-one-year debt was reached at the end of 1953 when the total was $80 billion. The total is now $76 billion, having dropped below $60 billion for short periods in 1955 and 1956.

If the Treasury should be able to do nothing but issue short-term securities to replace maturing issues between now and December 1960, instead of the present $76 billion we would have almost $100 billion of under-one-year debt outstanding at that time.

The Treasury does not intend this to happen. We must, therefore, continue to sell intermediate and longer-term bonds whenever appropriate as we try to keep the short-term debt from growing. The only reason we have been able to keep the short-term debt from growing since December 1953 is that since then we have issued $34 billion of 5 - 10 year bonds, $2 billion of 10 - 20 year bonds, and $6-1/2 billion of over 20 year bonds.

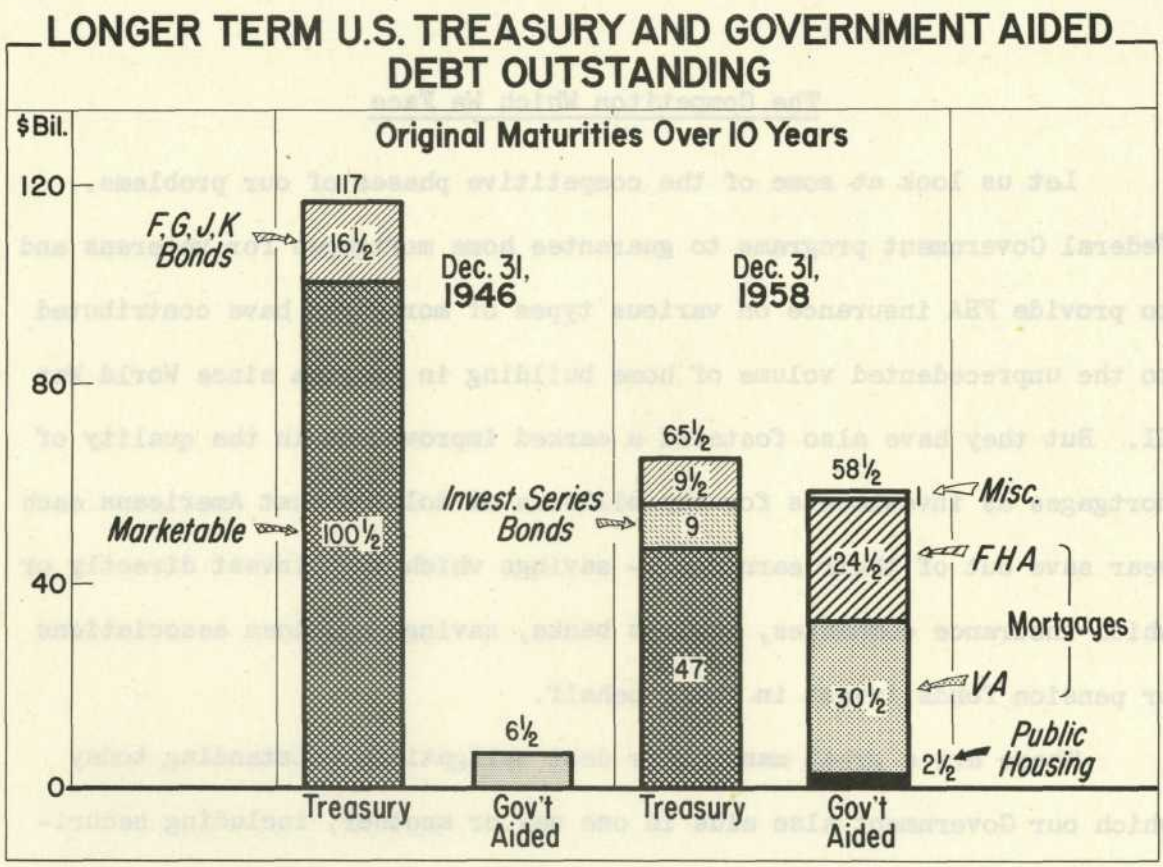
The Competiton Which We Face

Let us look at some of the competitive phases of our problems. Federal Government programs to guarantee home mortgages for veterans and to provide FHA insurance on various types of mortgages have contributed to the unprecedented volume of home building in America since World War II. But they have also fostered a marked improvement in the quality of mortgages as investments for the billions of dollars that Americans each year save out of their earnings -- savings which they invest directly or which insurance companies, savings banks, savings and loan associations or pension funds invest in their behalf.

There are a great many other debt obligations outstanding today which our Government also aids in one way or another, including securities issued by many Federal Government agencies, even though those securities are not actually guaranteed by the United States Government. While

the volume of long-term Government-aided obligations has been growing, the volume of long-term Treasury bonds has been declining. At the end of 1946, for example, there were $117 billion of U. S. Treasury bonds outstanding which originally bore maturities of over 10 years. In contrast, there was $6-1/2 billion of what might be called long-term "Government-aided" debt outstanding. Twelve years later -- December 31, 1958 -- the $117 billion total of long-term Government bonds had shrunk to $65-1/2 billion, while the $6-1/2 billion Government-aided total had grown to $58-1/2 billion, $55 billion of which is in FHA and VA mortgages alone.

Chart-I



Office of the Secretary of the Treasury B-1371

In addition, the continuation of high individual and corporate income tax rates in the postwar period has made the complete exemption from Federal income taxes which is enjoyed by State and local government securities very valuable. State and local debt outstanding has increased from $16 billion in 1946 to $59 billion in 1958. Tax exemption has contributed to the ability of State and local governments to sell their securities, but it has also meant that Federal securities are relatively that much less attractive.

Competition for funds available for investment has also been increased in other ways. A high corporate income tax rate has made corporations more inclined to borrow than to issue stock, since interest payments are deductible for income tax purposes, but dividend payments are not. Moreover, from the standpoint of the average small saver, Federal insurance of bank deposits and savings loan shares has practially eliminated any difference in risk between private savings and government bonds.

The problem of encouraging more long-term investors to buy and hold Treasury securities is also increased by the tendency among some investors to prefer stocks to fixed dollar obligations because of what I believe to be a mistaken conviction that the purchasing power of the dollar will decline further. It is in this environment that the sale of enough long-and intermediate-term Treasury securities sufficient to keep the debt from getting shorter must also compete with large and growing demands for borrowing by State and local governments, by corporations for plant and equipment needs and by home builders and buyers.

Many investors have also become increasingly confident in the continued growth potentials of our Nation. As this grows the high quality of Government securities becomes relatively less important than in the past and the safest bonds in the world -- U. S. Government securities -- are more difficult to sell.

In recent years there has been substantial liquidation of long-term Government securities by investors who bought large amounts of such securities during World War II, based on the improvement in the relative attractiveness of other investments.

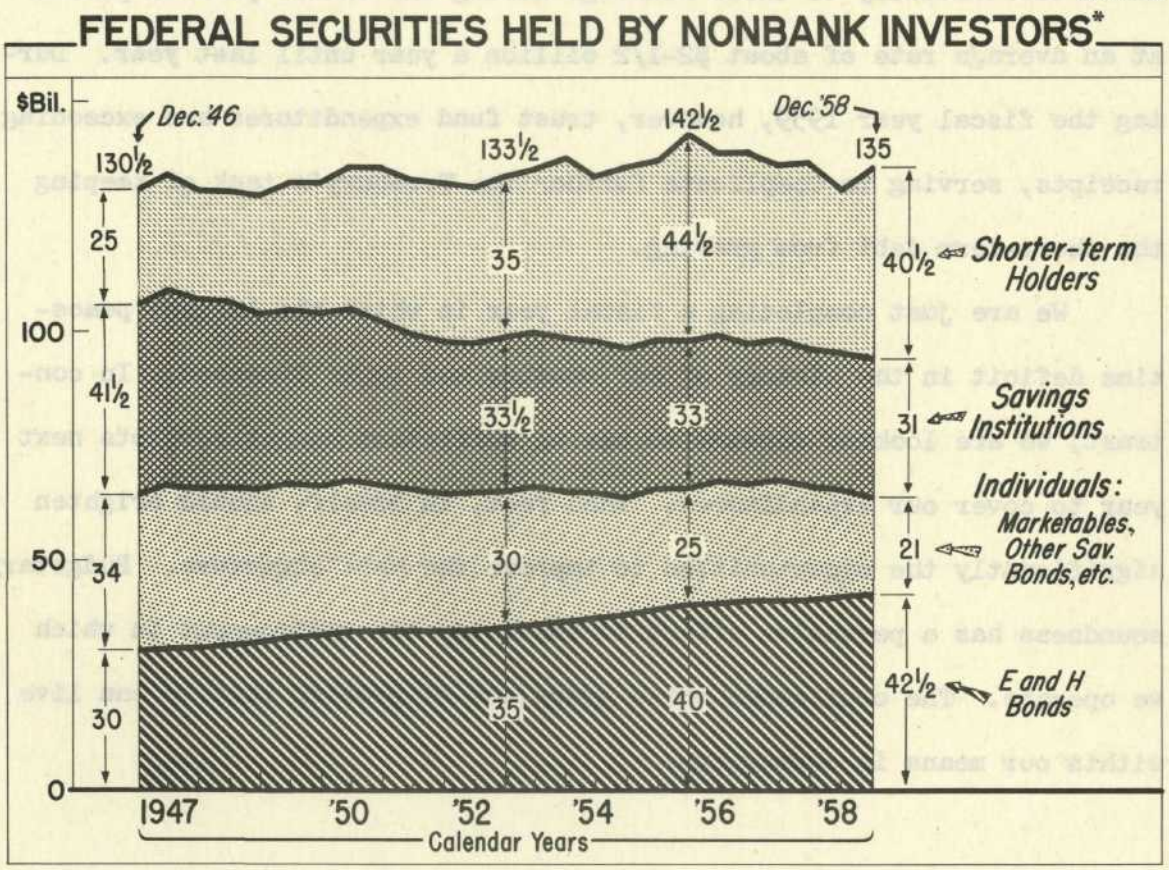
Long-term Treasury securities are held primarily by three broad classes of private investors other than commercial banks. The first group consists of savings institutions such as insurance companies, mutual savings banks, saving and loan associations, corporate pension funds, and State and local government pension funds. These investors, in the aggregate, held only $31 billion of Government securities in December 1958, as compared with $41-1/2 billion twelve years ago.

When the rapid growth of institutional assets generally is taken into consideration the decline in their holdings of Government securities is even more striking. In 1946 life insurance companies had 45% of their assets invested in Government securities; the percentage now is 7%, far below the 18% level back in 1939. Twelve years ago mutual savings banks had 63% of their assets invested in Government securities; that has now been reduced to 19%. Savings and loan associations now have only 7% of their assets in Governments, although their percentage has never been much higher. Corporate pension funds have 12% of their assets in Gov-

ernments as against 30% just a few years ago. Even in State and local pension funds, where statutory requirements are much less favorable to investments outside of Government securities, the percentage invested in Governments has fallen from 54% to 35% in the last six years alone.

The second group of long-term investors includes principally personal trust accounts and individuals in the upper income brackets. Their holdings of Governments have also declined substantially in the postwar years -- from $34 billion in December 1946 to $21 billion now. It is in this group where competition with tax-exempt State and local obligations becomes most important.

Chart-2



*Excluding Government Investment Accounts.

Office of the Secretary of the Treasury

B-1353-3

By contrast, there is a third group whose holdings have been growing. This group includes the millions of "small savers" who buy and hold Series E and H savings bonds. Through the savings bond program they have added substantially to their holdings of Government securities in the postwar period -- from $30 billion in 1946 to more than $42-1/2 billion now.

There is also a fourth area of long-term investment demand for Government securities apart from private investors -- Federal Government investment accounts. These accounts -- social security funds, veterans' life insurance funds, civil service and railroad retirement funds, etc., added substantially to their holdings during the entire postwar period at an average rate of about $2-1/2 billion a year until last year. During the fiscal year 1959, however, trust fund expenditures are exceeding receipts, serving to complicate further the Treasury's task of keeping the short-term debt from growing.

We are just completing a fiscal year in which the largest peacetime deficit in the history of our country had to be financed. In contrast, we are looking forward to having sufficient budget receipts next year to cover our expenditures. That fact, in itself, should brighten significantly the opportunities to improve the debt structure. Budgetary soundness has a pervasive effect in improving the environment in which we operate. The confidence which grows out of proving that we can live within our means is contagious.

Our willingness and ability to act soundly in managing our debt and in conducting our fiscal affairs is important also to our friends throughout the free world who have a right to look to the United States as an example of fiscal integrity.

While the gold movements of the past 18 months have been in response to the normal functioning of gold in international exchange, the correction of prior adjustments, and the historical rebuilding of monetary reserves, they should serve as a reminder that the postwar dollar shortage has long since disappeared, although there remains a shortage of capital resources in many of the less developed countries. These gold movements should remind us that other nations have built strong financial and industrial communities and that we must reorient our thinking in order to perform our full responsibility in the conduct of our internal and international economic affairs.

We have demonstrated the ability of a free economy to come out of an economic recession; it remains for us to demonstrate the willingness to pursue appropriate policies during a period of high and rising business activity. Under current conditions, such policies would include at least a balanced budget and sufficient flexibility for the Treasury to permit sound management of the public debt.

We would be less than frank, however, to suggest that living within our means as a national government will automatically cure the entire problem of managing the public debt. We would also be less than frank if we suggested that the legislation which you have before you will solve all of our problems. We feel very strongly, however, that the

proposed legislation can contribute significantly to a fuller realization of our goals of managing the debt in a way that is consistent with sound economic progress.

The President has already outlined his program to you, incorporating principally improvements in the savings bond program, removing the 4-1/4% ceiling on Treasury bond interest rates, and an increase in the debt limit. Proposed legislation on these three parts of the program is incorporated in Sections 1 through 3 of the first of the bills we have placed before you. With your permission I should like to discuss each of these three items with you, and also to take up the second proposed bill.

Sections 4, 5, and 6 of the first proposed bill deal with three somewhat technical matters on which I am submitting a short written statement for the record. These sections would provide a 10-year statute of limitations on the liability of paying agents who in rare instances may redeem savings bonds by erroneous payments; clarify the statute which exempts United States obligations from State and local taxes, and authorize the issuance of bonds to the Government's various trust funds at the same prices as bonds are issued from time to time to the public. If there are any questions on these provisions, one of my associates will be glad to answer them later.

Improvements in the Savings Bond Program

The statement on the savings bond program which was attached to my letter to the Speaker of the House of Representatives on June 8, 1959,

contains a complete description of our savings bond plans, if the first proposed bill is enacted.

As I pointed out in that statement, the new savings bond program has three major features:

(1) All Series E and H bonds sold beginning June 1, 1959, will earn interest of 3-3/4% per annum if held to maturity -- 1/2% more than at present -- with lesser improved yields for shorter periods of holding.

(2) All Series E and H bonds outstanding will also earn approximately 1/2% per annum more than they do now, if held to maturity, starting with their first full semiannual interest period which starts on or after June 1, 1959, with lesser improvement if redeemed earlier.

(3) All Series E bonds on which an extension has already been promised and which had not yet reached first maturity before June 1, 1959, will be offered an improved extension on which 3-3/4% will be paid if held the full additional 10 years, with lesser yields (starting at 3-1/2%) for shorter periods of holding.

The savings bond program is a program that every American has a right to be proud of. It puts more of the public debt in the hands of long-term investors -- few people realize that the average dollar invested in these bonds stays with the Treasury approximately seven years.

It also encourages desirable habits of thrift throughout the Nation. Almost half of the current E and H bond sales are accounted for by purchases on payroll savings plans by some 8 million Americans throughout industry and Government. Many of these savings grow out of the convenience of the payroll plan, savings which would not be taking place in such volume if it were not for the savings bond program. Corporations throughout America, large and small alike, are administering these payroll savings plans on a voluntary basis because they realize their importance and the benefits to their employees of regular habits of thrift. Similarly thousands of banks and other financial institutions across the country are selling bonds every day without compensation because this is a program they sincerely believe in.

As you know, Series E and H bonds are designed particularly for small savers. We have more than $42-1/2 billion of E and H bonds outstanding at the present time -- $38 billion in the accrual-type Series E bonds issued at 75% of their face value with the interest reflected in successively higher redemption values each six months to maturity -- and $4-1/2 billion in Series H bonds which pay interest currently by semi-annual check to give a sliding scale of investment yields approximating E bond yields for similar periods of holding. These are the only series of savings bonds which the Treasury has currently on sale, although approximately $8-1/2 billion of the old Series F, G, J and K bonds (sales of which were discontinued 3 years ago) are still outstanding.

There are many reasons why so many millions of Americans buy and hold Series E and H savings bonds. I have already mentioned the con-

venience of buying bonds on the payroll savings plan, and you are familiar with the convenience of savings bond redemption privileges throughout the country. Owners of savings bonds never need to worry about market fluctuations; their redemption values at all times are known in advance and are guaranteed by the Treasury. Furthermore, unlike savings accounts, where rates may move either up or down from year to year, the Treasury guarantees whatever rate of interest it puts on the bond for the full term of that bond.

Americans also know that savings bonds are perfectly safe; the Treasury has replaced over a million of them which have been lost or destroyed since the program began. These are attributes of savings bonds which have not changed over the years, quite apart from the relative attractiveness of the interest rate.

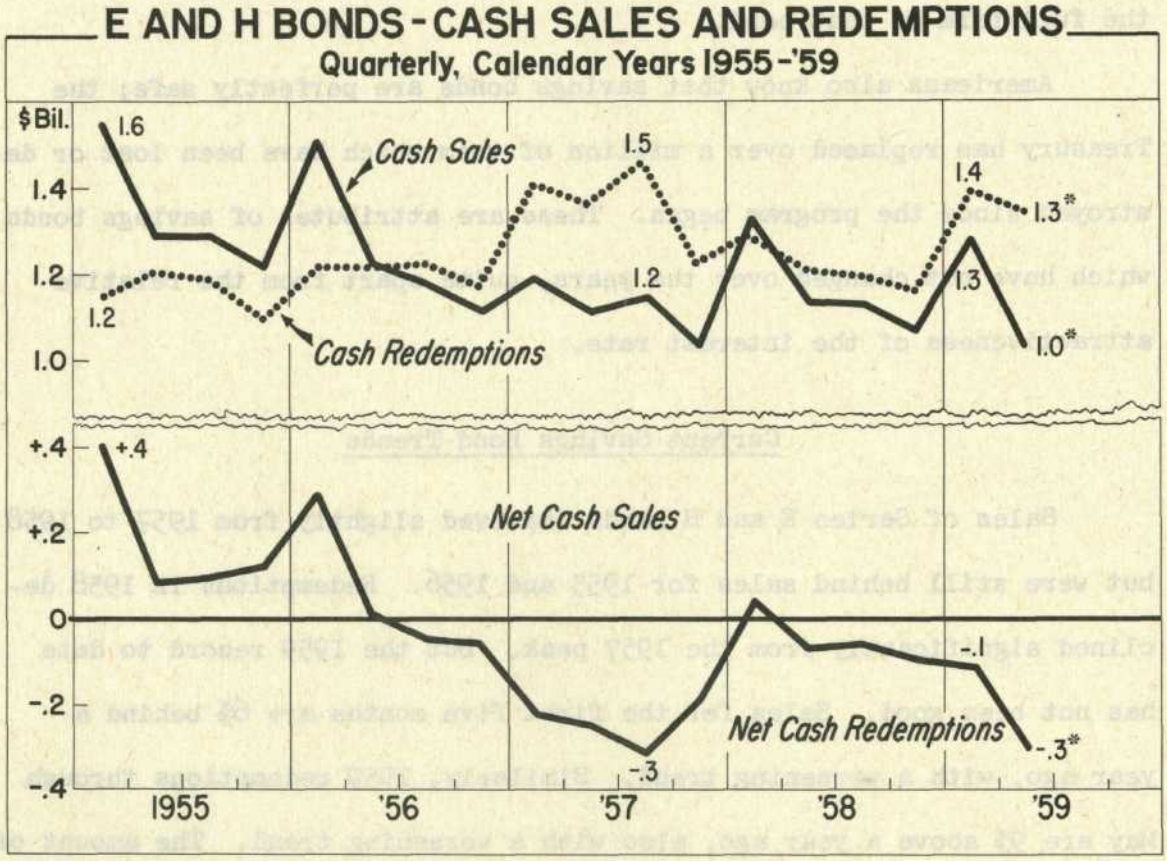
Current Savings Bond Trends

Sales of Series E and H bonds improved slightly from 1957 to 1958 but were still behind sales for 1955 and 1956. Redemptions in 1958 declined significantly from the 1957 peak. But the 1959 record to date has not been good. Sales for the first five months are 6% behind a year ago, with a worsening trend. Similarly, 1959 redemptions through May are 9% above a year ago, also with a worsening trend. The amount of E and H bonds outstanding (including accumulated interest on E bonds) declined by $36 million in April and May -- a greater decline than in any 2 month period since the autumn of 1950.

Furthermore, on a cash basis, the net drain on the Treasury of an excess of redemptions over sales of E and H bonds in the current quarter is expected to amount to approximately $300 million -- equal to the cash drain at the low point in the third quarter of 1957.

This decline will undoubtedly become much more serious as time goes on unless the present terms of these bonds are improved. Furthermore, we

Chart-3



*Estimate based on April and May 1959.

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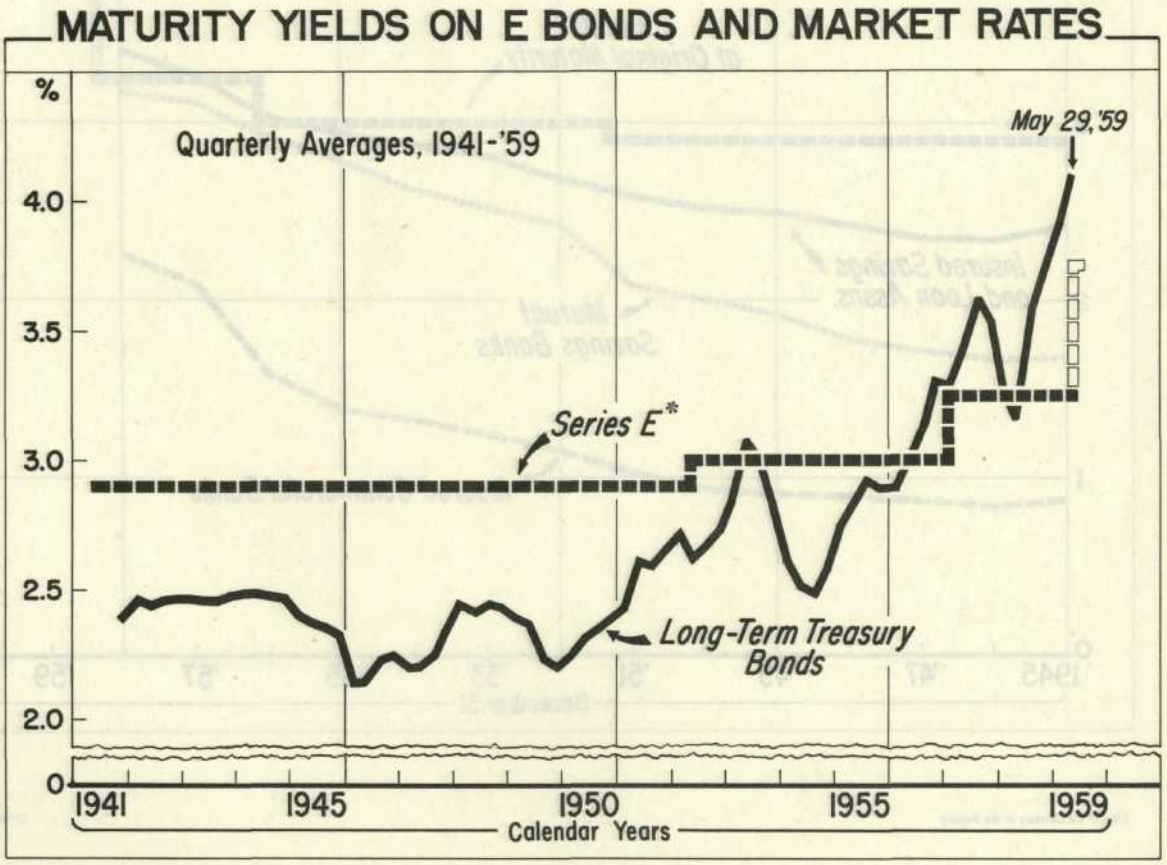
can expect enthusiastic cooperation of financial groups and employers in sponsoring the program only when they can conscientiously recommend savings bonds to themselves, to their customers, and to their employees.

The rate of interest return on E and H bonds is now much less favorable in comparison with savings accounts, as well as with other types of securities -- both Government and private -- than in earlier years.

Chart-4



*Also H bonds beginning June 1952.

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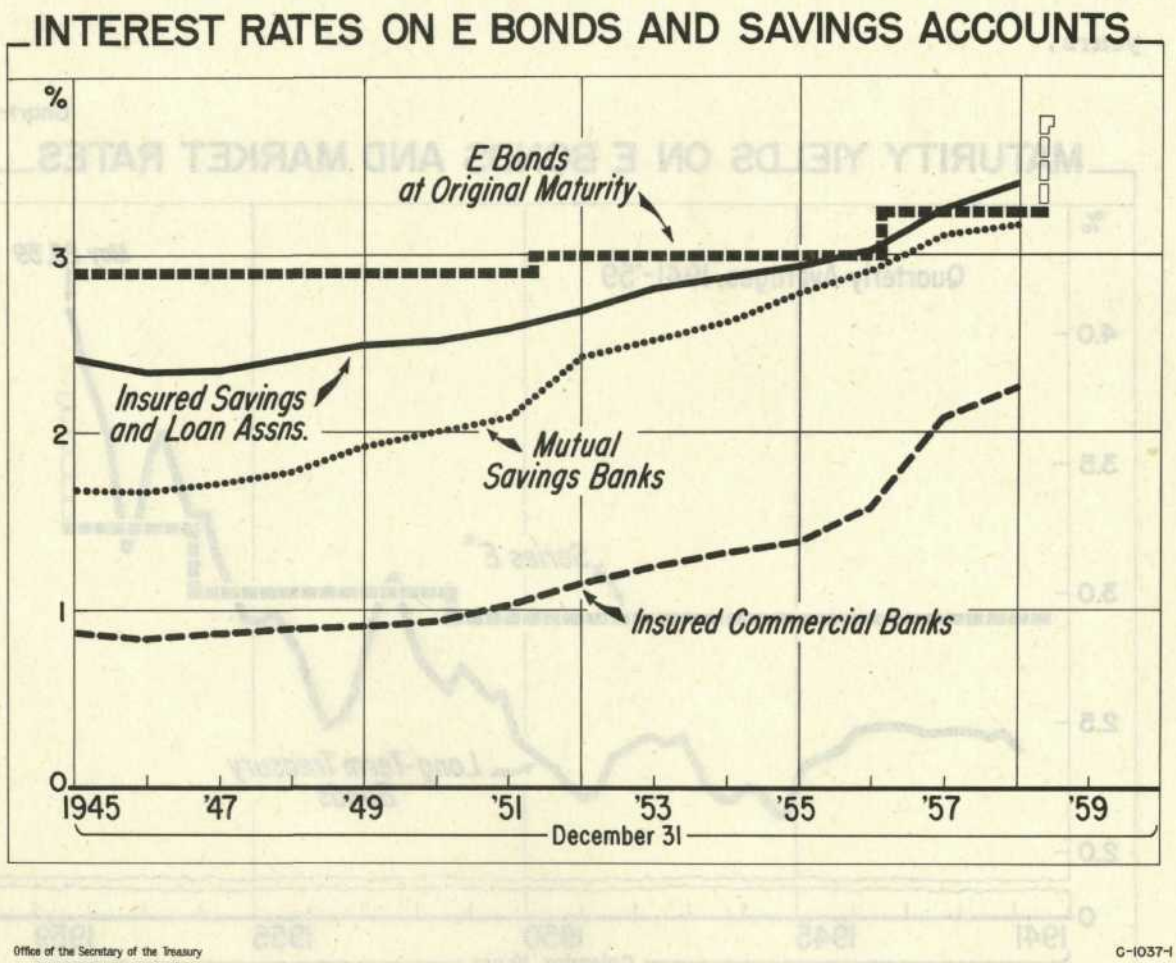
At the end of World War II Series E bonds paid 2.90% for a full 10-year term of holding, as compared with 2-1/4% on long-term maturities of marketable Government securities, an average of 2-3/8% on savings and loan shares, 1-5/8% on mutual savings bank accounts, and less than 1% on commercial bank savings deposits.

Chart-5

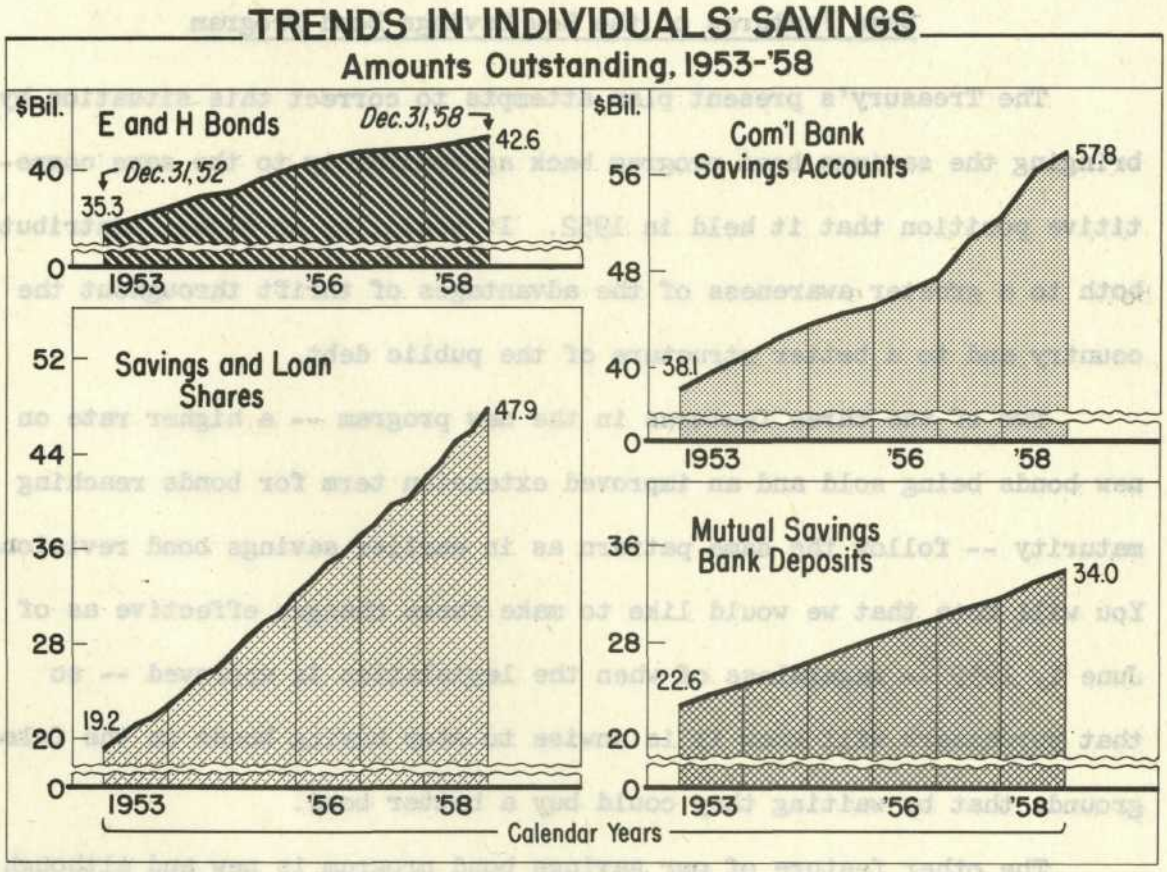


At the present time the rate on E and H bonds held to maturity is 3-1/4% as compared with more than 4% on long-term Treasury marketable securities, and average rates paid of 3-3/8% on savings and loan shares,

3-1/4% on mutual savings bank accounts, and 2-1/4% on accounts in commercial banks. Furthermore, the holder of an E bond has to wait three years to get as much as 3% on his money, whereas the applicable rates on savings accounts apply to a far shorter period of holding.

This is the principal reason, therefore, that the growth of savings bonds in recent years has been far overshadowed by the rapid expansion of savings in mutual savings banks, commercial banks, and -- particularly -- savings and loan associations.

Chart-6



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The percentage increases during the past 6 years shown on the chart are revealing: 52% for commercial bank savings, 50% for accounts in mutual savings banks, 150% for savings and loan shares, and only 21% for E and H bonds.

Overall Series E savings bond rates were improved from 2.90% to 3.00% in the spring of 1952, and from 3.00% to 3.25% early in 1957. In neither case did the increased rate make up for the increased return on competing savings since the preceding change.

Some Features of the New Savings Bond Program

The Treasury's present plan attempts to correct this situation by bringing the savings bond program back approximately to the same competitive position that it held in 1952. It would, by so doing, contribute both to a greater awareness of the advantages of thrift throughout the country and to a better structure of the public debt.

Two of the three features in the new program -- a higher rate on new bonds being sold and an improved extension term for bonds reaching maturity -- follow the same pattern as in earlier savings bond revisions. You will note that we would like to make these changes effective as of June 1, 1959 -- regardless of when the legislation is approved -- so that purchasers will know it is unwise to stop buying bonds on the false grounds that by waiting they could buy a better bond.

The other feature of our savings bond program is new and although it is rather completely described in the attachment to which I have been referring, I want to call it particularly to your attention.

We feel quite strongly that the Government has an obligation to the millions of Americans who hold E and H bonds to improve the future earnings of bonds already outstanding. We plan no additional interest on holdings of savings bonds for any period in the past. But we do feel that each holder of an outstanding bond is entitled to an increase of approximately 1/2% per annum on the future earnings of his bond if he holds it to maturity just as we are planning to pay 1/2 of 1% more to the buyers of new bonds.

Thus, present holders of E or H bonds would have little or no incentive to cash present bonds and buy new ones. Such switching operations would be costly both to the investor and to the Treasury.

The Treasury has, however, an even more important reason for taking this step -- a reason which relates to the equitable treatment of all bondholders. The Treasury has something of a trusteeship function on behalf of millions of individual savers who do not follow interest rate trends closely. They buy bonds and hold bonds with understandable faith that the Government is giving them a square deal.

The new savings bond program is expected to add $30 to $35 million to the savings bond part of the budget cost of interest on the public debt for the fiscal year 1960. Approximately $5 million of this increased cost is attributable to the higher rate on new bond sales and to improved extension terms. The remainder is accounted for by increased interest on outstanding E and H bonds.

In assessing the true cost of the new program, however, in terms of overall budget costs of interest on the public debt, allowance should

be made for some expectation of increased sales and decreased redemptions as a result of the new program in comparison with a continued deterioration of the savings bond picture if present terms are continued.

The Treasury can borrow more economically through the proposed increase in savings bond terms at the present time than it can by borrowing through marketable securities. We believe, therefore, that the net addition to next year's budget costs for interest on the public debt because of the new savings bond program may be less than $10 million, and could quite conceivably result in no net increase in all. It is realized, of course, that the gross cost on savings bonds will tend to build up in later years, but the saving in comparison with alternative borrowing would very likely continue to be a sizeable offset.

The inauguration of the new savings bond program will depend on the favorable consideration by the Congress of Section 3 of the first proposed bill. Section 3 will permit the Treasury to pay interest in excess of the present maximum interest rate of 3.26%, to pay increased interest on bonds already outstanding, and to permit future extensions of bonds for more than 10 years (the present limit) beyond their original maturity dates.

Background on the 4-1/4% Interest Rate Ceiling

I should like to consider next the 4-1/4% interest rate ceiling currently applying to all new issues of Treasury bonds, which includes all new Treasury issues maturing in more than five years. Section 1 of the first proposed bill would repeal the present limit.

The earliest of all public debt statutes, in 1790, authorized the President to borrow money on the credit of the United States for the specific purposes of payment of the foreign debt, funding of the existing domestic debt, and assumption of the debts of the several states. The President delegated this authority to the Secretary of the Treasury, Alexander Hamilton, and this pattern of responsibility continued in general until the early Civil War period. At that time (1861) the Congress directly authorized the Secretary of the Treasury to conduct the financing of the war through the issuance of bonds, 1-year notes and demand notes.

Prior to World War I, however, the Secretary of the Treasury had little discretion in the actual carrying out of the public debt operations. The acts of Congress authorizing the issuance of United States Government obligations usually specified the terms and conditions applicable to each individual issue.

World War I brought a change in this situation. Because of the large amounts of borrowing involved and the expectation that a number of loan operations would be required, Congress departed from its previous policy of specifying the terms and conditions of the obligations to be issued. Instead, in the first and succeeding Liberty Bond acts, Congress gave the Secretary of the Treasury broader authority to determine the terms and conditions of issue, conversion, redemption, maturities, payment, and the rate and time of payment of interest in respect to the several classes of obligations authorized to be issued. Interest rate ceilings on Treasury bonds were still set forth in the statutes, however; the last one was the present 4-1/4% rate ceiling.

In making these changes, Congress proceeded in several steps. In the first of the war financing operations of World War I, authorized by the first Liberty Bond Act in April 1917, Congress departed from its policy of determining the specific terms and conditions of each Treasury issue. The Secretary of the Treasury was authorized, with the approval of the President, to issue securities to the extent of $5 billion at a rate of interest on bonds issued under this authorization not to exceed 3-1/2%. The bonds were to be offered at not less than par and no commissions were to be paid; other terms were left to the discretion of the Secretary.

There was an expectation that wartime rates might move higher. It was provided, therefore, that these First Liberty Loan bonds could be converted into bonds bearing a higher rate than 3-1/2%, if any subsequent series of bonds should be issued at a higher rate before the termination of the war. It may be noted that the effective return on the new bonds was actually higher than 3-1/2% for many owners in comparison with corporate bonds or mortgages, since both principal and interest were exempt from all taxation (Federal, State and local) except estate and inheritance taxes.

In the same Act authorization was given to the Secretary of the Treasury to issue up to $2 billion of certificates of indebtedness (one year or less to maturity). The interest rate ceiling of 3-1/2% and the tax exemption privileges provided for the bonds applied also to the certificates.

The Second Liberty Bond Act in September 1917 in effect increased the Treasury's bond issuing authority under both acts to $7.5 billion and increased the interest rate ceiling on bonds to 4%. The conversion privilege was retained for the new bonds except that in this instance the privilege was to arise only once instead of each time new bonds were issued at a rate higher than 4%. In this Act and thereafter, the rate of interest payable on certificates was left to the discretion of the Secretary. Tax exemption was retained under the Second Liberty Bond Act, but to a lesser degree.

By the spring of 1918, when a third Liberty Loan was under consideration, the bonds of the previous loans were selling below par and industrial and other securities were yielding a return much in excess of the rate on Government bonds. The Third Liberty Bond Act (April 1918), therefore, authorized the issue of 4-1/4% nonconvertible bonds. The tax exemption status of the new bonds was virtually unchanged from the Second Liberty Loan.

The 4-1/4% interest rate ceiling was retained for the $7 billion of bonds issued under the Fourth Liberty Bond Act (July 1918). In order to make the rate more attractive, however, tax exemption privileges were considerably extended with respect to surtaxes, excess profits taxes and war-profits taxes payable during the war and within a fixed time after the termination of the war.

During the early months of 1919 it became clear that new financing would again be required in the near future. A complicating element in the situation was the fact that the final session of the 65th Congress

would terminate on March 4, 1919, considerably before the expected date of the new financing. Carter Glass, then Secretary of the Treasury, wrote to the Chairmen of both the House Committee on Ways and Means and the Senate Committee on Finance and presented a strong case for giving the Treasury greater leeway in setting the terms of new issues. He cited at length the difficulty under conditions then prevailing of fixing the terms of loans considerably in advance of the offering.

In a statement before the Ways and Means Committee on February 13, 1919, the Secretary made a number of specific requests in connection with the forthcoming Victory Loan, including the request that the interest rate ceiling be removed for notes and for bonds having maturities of less than 10 years. "To withhold from the Secretary of the Treasury the power to issue bonds or notes bearing such rate of interest as may be necessary to make this refunding possible [i.e., refunding the interim certificates issued between the fourth and fifth (Victory) loans] might result in a catastrophe," the Secretary stated. He added that "To specify in the act the maximum amount of interest at a figure sufficient to cover all contingencies would be costly, because the maximum would surely be taken by the public as the minimum." It may be noted that the interest rate on certificates issued in anticipation of the Third Liberty Loan had risen to 4-1/2% a year earlier (February 1918) and had remained at that figure on subsequent issues in anticipation of the fourth and Victory loans. Certificate rates later rose to 6%.

Before its adjournment, Congress responded to the Secretary's appeal in March 1919 with the Victory Liberty Loan Act. This Act granted increased discretion to the Secretary of the Treasury to enable him to deal with the situation as it might develop as far as notes were concerned, but his request on bonds was not granted.

A note issue (one of the possibilities previously suggested by the Secretary) was authorized in the amount of $7 billion "containing such terms and conditions and at such rate or rates of interest as the Secretary of the Treasury may prescribe." The notes were to run not less than one year nor more than five years from the date of issue. In April 1919, the Treasury offered $4-1/2 billion of 4-3/4% 3 - 4 year gold notes, exempt from State and local taxes (except estate and inheritance) and from normal Federal income taxes, and convertible at the option of the holder into 3-3/4% 3 - 4 year gold notes exempt from all Federal, State and local taxes (except estate and inheritance). The 4-1/4% interest rate ceiling on bonds was thus not involved in the final financing of World War I, but only because no bonds were authorized or issued.

The 4-1/4% Ceiling in Our Current Environment

Until recently, the trend of interest rates in the past 25 years has made the 4-1/4% ceiling a somewhat academic problem. Except for a short period in the early 1930's, interest rates were low all through the depression. Confidence in the future had been seriously shaken and available savings exceeded the demand for borrowed funds. In World War II interest rates were held down artificially on Federal borrowing and

the demands for borrowed funds by State and local governments, businesses and individuals were reduced to a minimum by rationing and other direct controls.

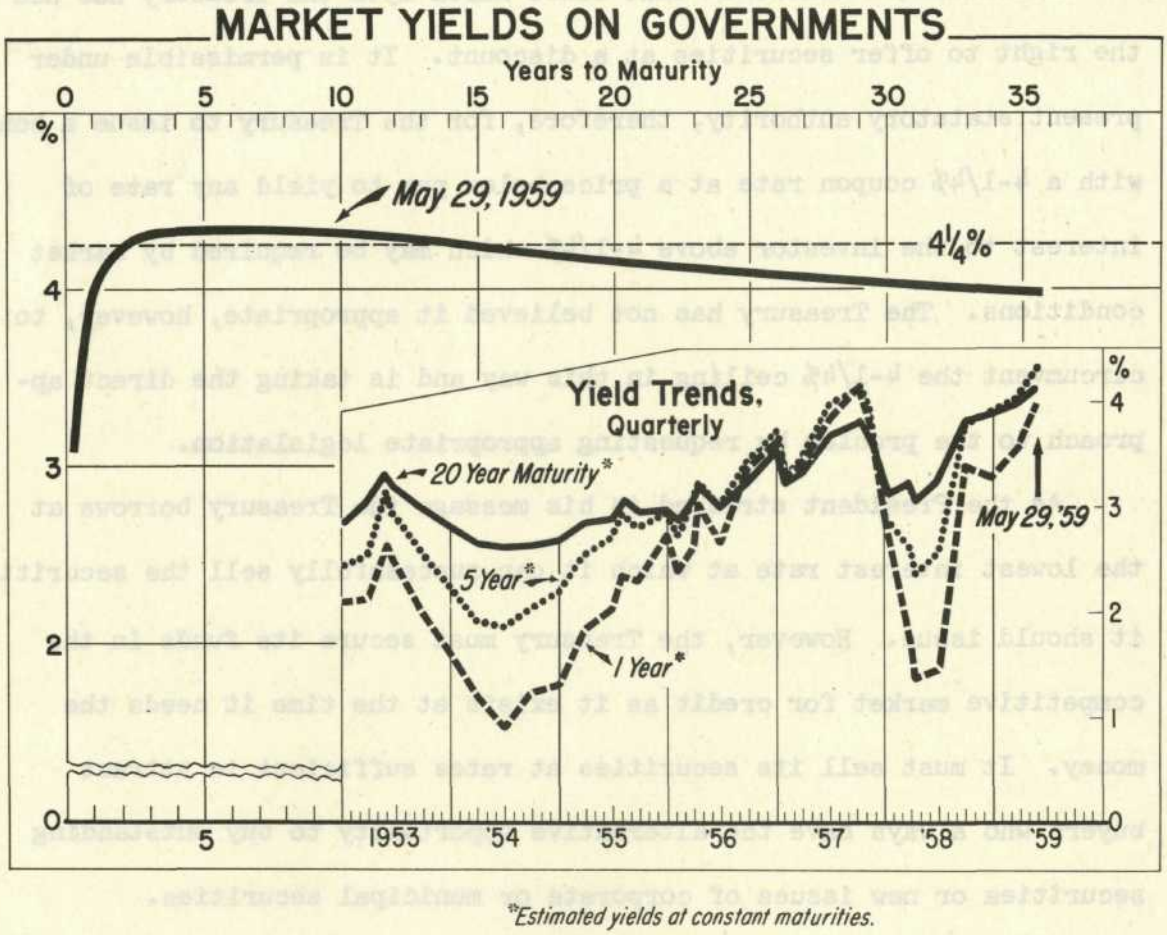
After World War II the demand for funds by non-Federal borrowers began to grow again and interest rates started to rise. This was aided by the fact that the Federal Government has not been able to reduce its debt in the postwar period as a whole. Budget surpluses in the 20's allowed the Federal Government to reduce the public debt by more than one-third (from $26 billion in 1919 to $16 billion in 1930). As a direct result, interest rates declined during a period of general prosperity.

Today, current demand for funds by businesses, home builders, State and local governments, and other borrowers continue to push heavily against a relatively modest volume of savings, and interest rates have risen further. At the present time it is extremely unlikely that the Treasury would be able to issue bonds in any volume at a rate of 4-1/4% or less. This is particularly true of the intermediate term area (5 to 10 years) where the volume of new bonds which the Treasury can sell is usually substantially larger than the more limited market for bonds in the long-term area. By the end of May 1959 a number of bonds with more than 5 years to run were selling in the market with yields above 4-1/4%.

Chart 7 on the market pattern of rates on outstanding bonds reveals that a large part of the "market curve" is above 4-1/4%. Furthermore, since the market for longer bonds is very thin (very little buying or

selling) the "market yield curve" in the longer area is low as an index of what the Treasury would have to pay for a long bond if one were to be issued today.

Chart-7



To date the Treasury has been able under the 4-1/4% ceiling to sell bonds beyond five years to maturity. Last January we sold more than three-quarters of a billion dollars of 21-year bonds to yield 4.07% and in March we sold more than half a billion dollars of 4% bonds due in 10-1/2 years. But the market has moved down further since these offerings (down in price, up in yield), and with the present level of interest rates the Treasury would be seriously restricted by the present

ceiling from taking advantage of reasonable opportunities to improve the structure of the public debt by issuing intermediate and longer-term bonds.

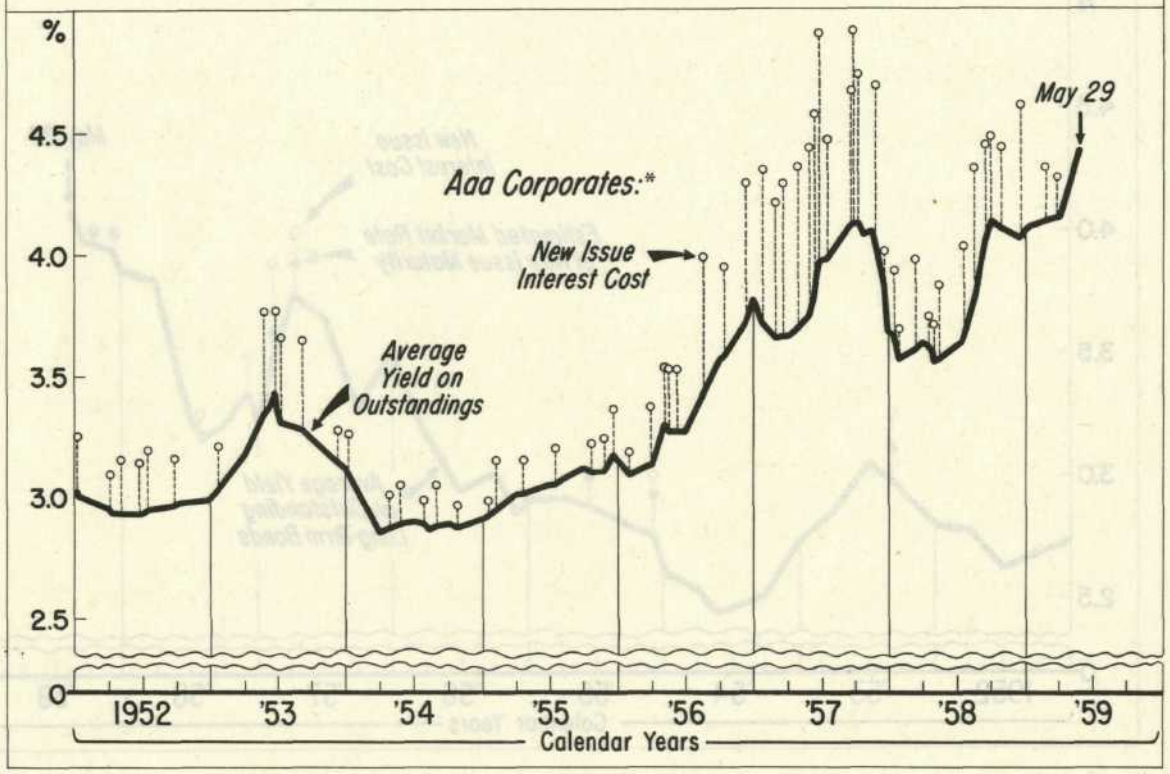
It should be mentioned that since March 1942 the Treasury has had the right to offer securities at a discount. It is permissible under present statutory authority, therefore, for the Treasury to issue a bond with a 4-1/4% coupon rate at a price below par to yield any rate of interest to the investor above 4-1/4% which may be required by market conditions. The Treasury has not believed it appropriate, however, to circumvent the 4-1/4% ceiling in this way and is taking the direct approach to the problem by requesting appropriate legislation.

As the President stressed in his message the Treasury borrows at the lowest interest rate at which it can successfully sell the securities it should issue. However, the Treasury must secure its funds in the competitive market for credit as it exists at the time it needs the money. It must sell its securities at rates sufficient to attract buyers who always have the alternative opportunity to buy outstanding securities or new issues of corporate or municipal securities.

These are conditions which are true of both government and private borrowing. Typically over recent years the average new highest grade corporate security, for example, has cost the borrower about 3/10 of 1% more than the market rate on outstanding issues. The Treasury's

Chart-8

INTEREST COST ON NEW LONG-TERM CORPORATE BONDS
And Comparable Market Yields



*Moody's Investors Service.

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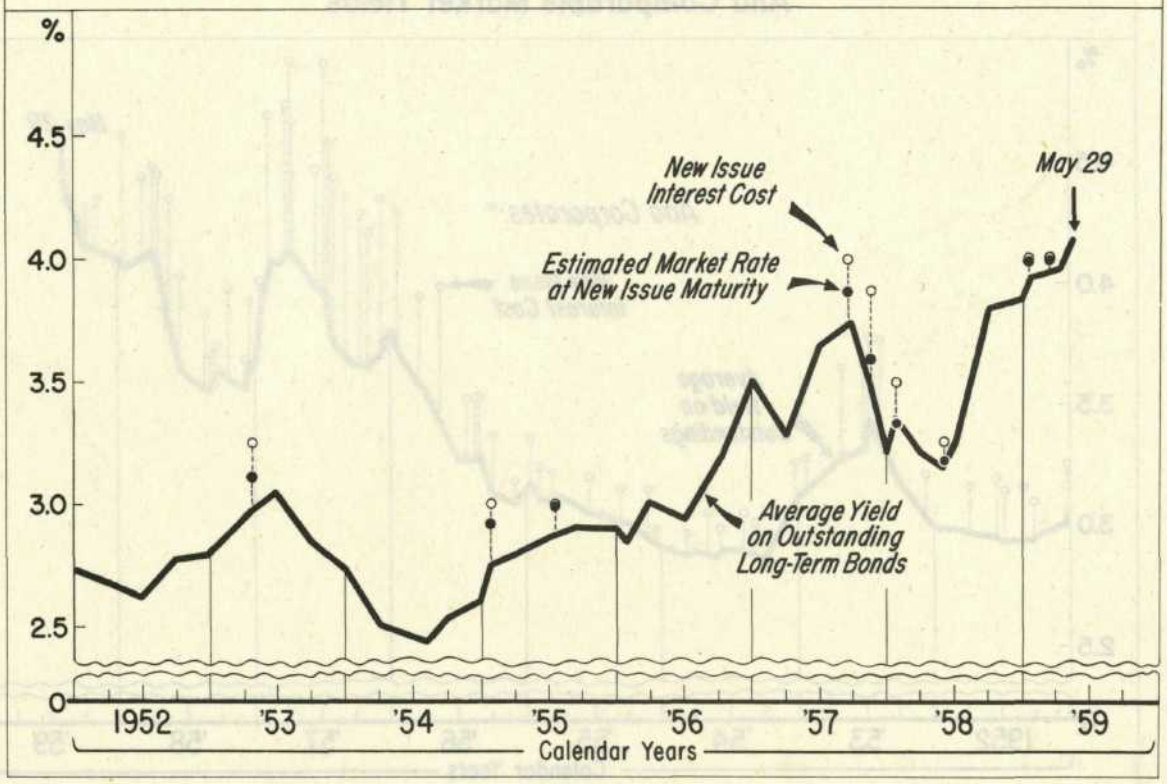
pricing of new issues has been even closer to the market pattern of rates on outstanding issues than corporate pricing, as is shown in Chart 9, in comparison between the new Treasury issue interest cost and the estimated market rates. All borrowers -- including the Treasury -- try to do their borrowing as cheaply as possible, but each new issue must be attractive or fail.

Chart-9

INTEREST COST ON NEW LONG-TERM TREASURY BONDS
And Comparable Market Yields



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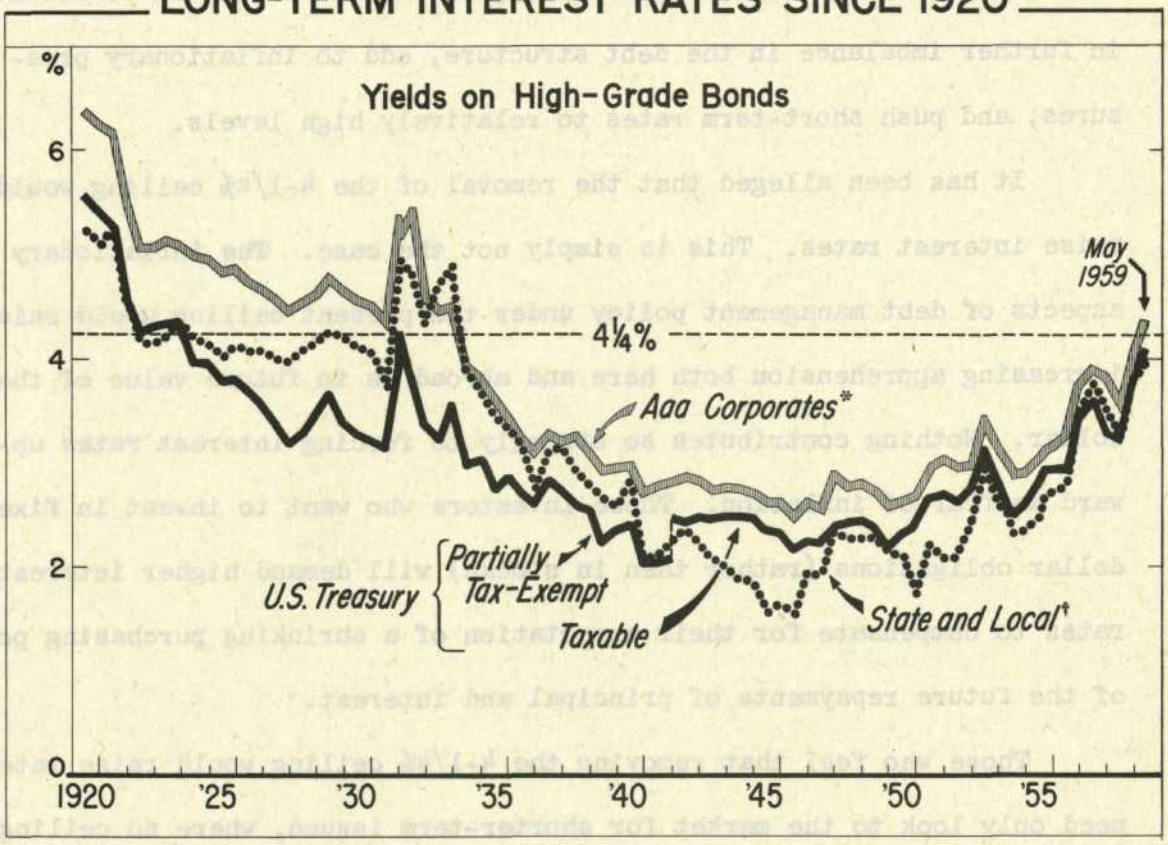
Interest yields on long-term Government securities are higher today in the United States than at any time since the 1920's except for a very brief period in the early 1930's. They are still, however, among the lowest in the world. Long-term government bond yields in Canada average approximately 5%; long-term yields in the United Kingdom are almost the same, and have been as high as 5-1/2% within the past two years.

Chart-10

LONG-TERM INTEREST RATES SINCE 1920



*Moody's Investors Service. †Standard and Poor's Municipal Average.

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Any comparison between present interest rates in the United States and the rates on Government bonds in 1918, at the time the 4-1/4% rate was originally established, should also recognize that the original 4-1/4% rate was in large part a tax-exempt rate, whereas all Treasury bonds issued since February 1941 have been fully taxable -- and at income tax rates which are substantially higher than in 1918.

The request for removal of the limit reflects an honest appraisal of market conditions for what they are -- conditions which have now made the 4-1/4% ceiling a barrier to effective debt management. Under current conditions, continuation of the 4-1/4% ceiling would not only deny

the Government the opportunity to extend debt, but also could easily increase reliance on short-term financing to such an extent as to result in further imbalance in the debt structure, add to inflationary pressures, and push short-term rates to relatively high levels.

It has been alleged that the removal of the 4-1/4% ceiling would raise interest rates. This is simply not the case. The inflationary aspects of debt management policy under the present ceiling would raise increasing apprehension both here and abroad as to future value of the dollar. Nothing contributes so strongly to forcing interest rates upward as fear of inflation. Those investors who want to invest in fixed-dollar obligations (rather than in stocks) will demand higher interest rates to compensate for their expectation of a shrinking purchasing power of the future repayments of principal and interest.

Those who feel that removing the 4-1/4% ceiling would raise rates need only look to the market for shorter-term issues, where no ceiling applies. Treasury 91-day bill rates in a competitive market have moved up and down with the business cycle -- up to almost 2-1/2% in 1953, down to 5/8 of 1% a year later, up to 3-5/8% in 1957, down to 5/8 of 1% a year ago, and up again to over 3% now. Even the 5-year rate has fluctuated from below 2% to more than 4% within the last business cycle.

The President has requested that the limit be removed not just raised to a higher figure. If the principle of flexibility has any meaning at all, it is clear that applies here. Any figure selected for a new limit would carry with it the connotation that the Government thought that is where interest rates should properly go. As Secretary Glass said in 1919 -- such a "maximum would surely be taken by the public as the minimum."

How Interest Rates Operate

Popular discussion of interest rates is often clouded by misunderstanding of their nature in a free market economy. It is often incorrectly stated that the level of rates is determined by actions of the Federal Reserve authorities, or that the Treasury determines general interest rate policy each time it issues a new security. The view is also incorrectly expressed that interest rates somehow are fixed at high levels by large financial institutions.

The rise in interest rates which has occurred since last summer -- following a rather sharp decline in the preceding eight months -- has been incorrectly attributed by some to have been the result of Federal Reserve and Treasury policies, and it is said that these policies have, in effect, cost the Treasury large sums in interest payments on the public debt. This view is followed with the suggestion that interest rates are "too high" and that something must be done to bring them down.

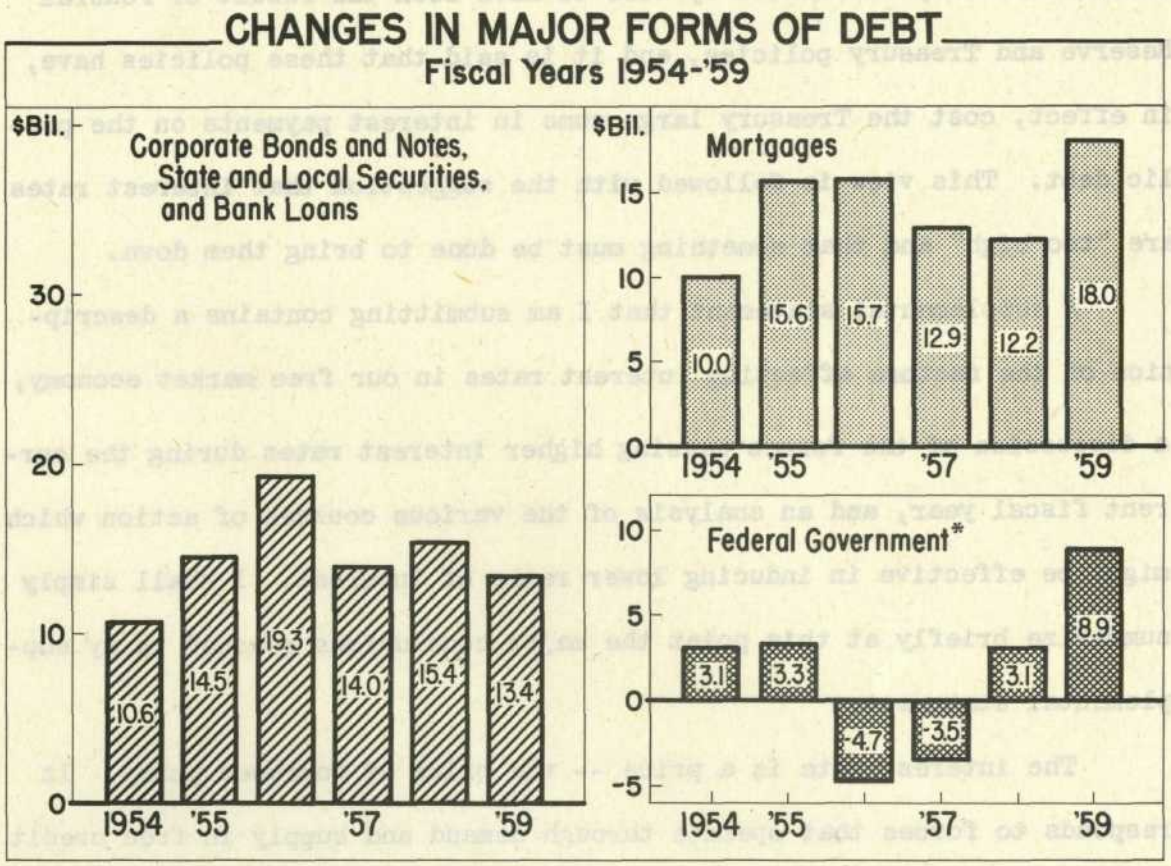
A supplemental statement that I am submitting contains a description of the factors affecting interest rates in our free market economy, a discussion of the forces causing higher interest rates during the current fiscal year, and an analysis of the various courses of action which might be effective in inducing lower rates of interest. I shall simply summarize briefly at this point the major conclusions reached in my supplemental statement.

The interest rate is a price -- the price of borrowed money. It responds to forces that operate through demand and supply in free credit markets. This being the case, the primary determinants of interest rates are the actions of millions of individuals and institutions rather

than those of the Treasury or the Federal Reserve. The rise in interest rates since the end of World War II has resulted primarily from unprecedented demands for credit on the part of individuals, businesses, and State and local governmental units. In addition, the Federal debt has expanded, rather than contracting as it did during the prosperity of the 1920's.

A major factor contributing to the rise in interest rates since last summer has been the record peacetime Federal budget deficit of approximately $13 billion. As is shown in the chart, during the current fiscal year expansion in several categories of debt -- which reflect

Chart-II



*Excluding debt held by Federal Reserve Banks and Government Investment Accounts.

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demand pressures in credit markets -- have been moderate in comparison with other recent years. Mortgage debt has increased substantially since last summer, but the total expansion in corporate bonds and notes, State and local government securities, and bank loans has been less than in any fiscal year since 1954. In addition, growth in consumer credit, except for recent months, has been moderate. On the other hand, the rise of almost $9 billion in publicly held Federal securities is in sharp contrast to the moderate increases in fiscal years 1954, 1955, and 1958 and the decrease in 1956 and 1957.

These figures support the judgment that the Federal deficit, rather than debt management or monetary policies, has been an important major factor promoting higher interest rates during this fiscal year, a fact which my supplementary statement treats in detail.

Is there, as some suggest, some practicable way of inducing lower interest rates in this country without causing great harm to our Nation?

The interest burden on the public debt -- now about $8 billion per year -- is, of course, of deep concern. Of much more concern, however, is the need to maintain freedom and flexibility in our economy and, at the same time, avoid more erosion in the purchasing power of the dollar. The causes of inflation in a highly industrialized, free market economy are many and complex. Consequently, a program of inflation control must be broad-gauged, and cannot rely on monetary and fiscal policy alone.

Nevertheless, monetary and fiscal policy are indispensable instruments in our attempts to protect the value of the dollar. Logic and experience show that attempts to maintain interest rates at artificially

low levels -- either through creation of high-powered money by the central bank or by legislative attempts to maintain artificially low interest-rate ceilings -- foster inflationary pressures. Inflation works its greatest hardships on people of modest means, whose savings are primarily in savings accounts, savings bonds, insurance policies and similar types of fixed-dollar assets. Furthermore, an inflationary upsurge is usually followed by recession -- the greatest enemy of sustained, rewarding economic growth.

Therefore, in any attempts to promote lower rates of interest, I would strongly counsel against some suggested techniques (discussed in detail in my supplemental statement) that would rely upon the ability of the Federal Reserve System to create large amounts of high-powered dollars.

This does not mean, however, that we cannot take actions which, although perhaps not leading immediately to lower levels of interest rates, would remove some of the significant pressures in the Government fiscal field that have tended to push rates higher during the past year.

In particular, we must have a clear demonstration of our willingness to maintain fiscal and monetary discipline. A period of high and rising business activity, such as the present, requires a surplus in Federal fiscal operations for debt retirement, and freedom for Federal Reserve authorities to conduct flexible credit policies. A budget surplus in the coming fiscal year can convert the Federal Government from a net borrower in credit markets to a net supplier of funds, through debt retirement. Pressures on interest rates can be considerably less than if the Treasury had to compete strongly with other borrowers for funds to finance a deficit.

As I have said before, the clearly mistaken view that inflation is somehow inevitable has tended to push interest rates higher. Inflationary expectations generate higher rates primarily because borrowers are anxious to obtain funds that they expect to repay in cheaper dollars, whereas many individuals and institutions with funds to invest prefer equities over debt obligations, or will make loans or purchase bonds only if interest rates are high enough to compensate for the expected rise in prices.

Any actions that would let borrowers and lenders know that the value of the dollar will be preserved would remove one of the pressures promoting higher interest rates. This can be done only by means of a broad-gauged attack on all of the forces and practices that stimulate inflationary pressures. I would re-emphasize, however, that under current conditions the most important single action would be a clear demonstration of our determination to maintain fiscal and monetary discipline.

Coupled with this demonstration is the need for greater flexibility in debt management, so that a better balance in the debt structure can be achieved, and so that markets will not become unsettled over such matters as an impinging interest-rate ceiling. The removal of the 4-1/4% ceiling on new issues of Treasury bonds would be an important and necessary step in this direction.

The overriding advantage of this approach to reducing pressures on interest rates stems from the fact that the actions would be consistent with the requirements of sustainable economic growth, and would also transmit effects through market forces of demand and supply rather than by means of Government decree or regulation.

By proceeding in this way, the Federal Government would be promoting "maximum employment, production, and purchasing power," as required in the Employment Act of 1946, in a manner consistent with those crucially important but often overlooked words in the Act which stipulate that such actions be carried out "in a manner calculated to foster and promote free competitive enterprise and the general welfare."

Needed Increases in the Debt Limit

I turn now to the third part of my discussion of the major elements in our public debt legislative package, namely the President's request for an increase in the public debt limit, as provided for in Section 2 of the first proposed bill.

The existence of a restrictive debt limit plays an important part in our struggle for fiscal soundness. Unlike my views on the 4-1/4% interest rate ceiling, I believe a specific dollar ceiling on the public debt serves a useful purpose and can be effective in focusing attention in a unique way on the part of the Executive Departments, the Congress, and the public to the problems of sound Government finance. Such a limit should be restrictive enough to accomplish this purpose, yet not so rigid as to impede the normal operations of the Treasury. The debt limit changes the President has requested meet this test.

Last July the President recommended enactment of legislation to increase the regular (permanent) statutory debt limit from $275 billion to $285 billion and to provide for an additional temporary increase of $3 billion to expire June 30, 1960. Instead, the Act of Congress ap-

proved September 2, 1958, increased the regular statutory debt limit to $283 billion and the temporary increase of $5 billion for the period ending June 30, 1959, provided for in the Act of February 26, 1958, was allowed to continue in effect. As a result, the statutory debt limit will revert to $283 billion on June 30, 1959, with no provision for any temporary increase in the limitation beyond that time.

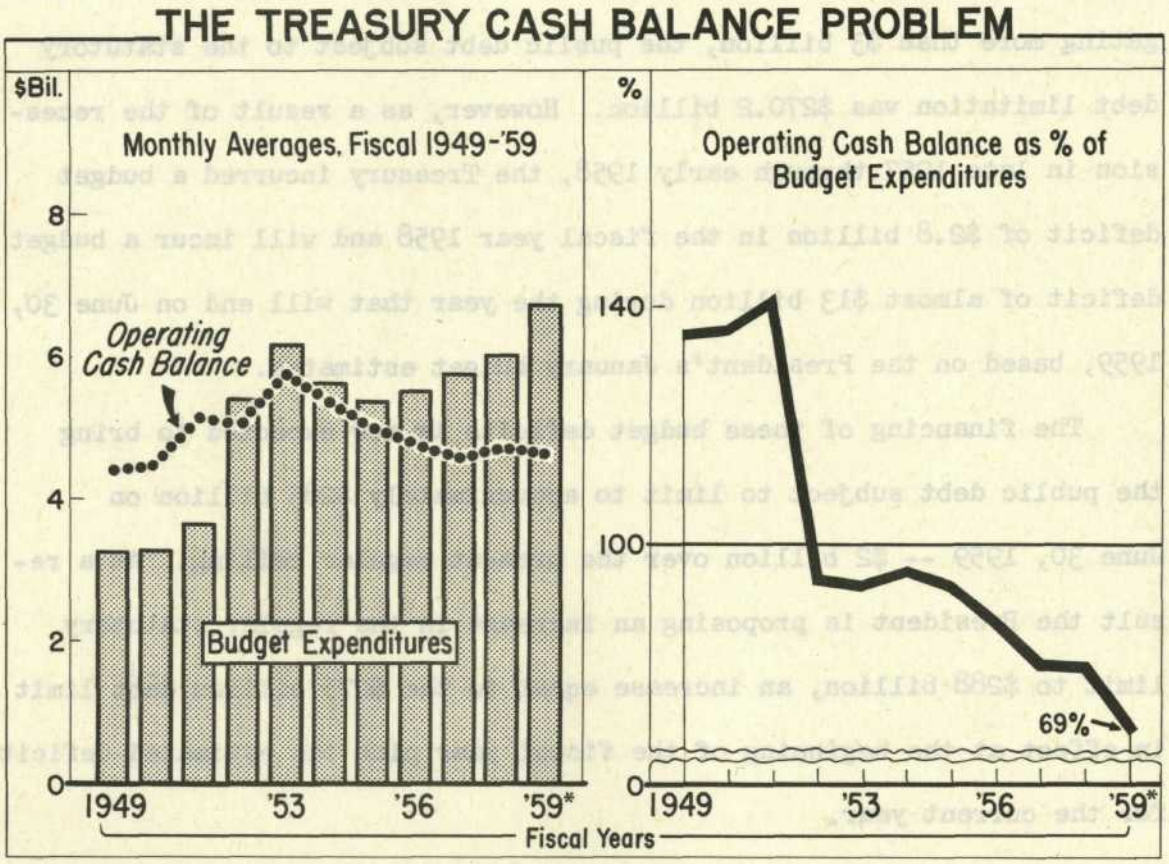
On June 30, 1957, after two fiscal years of budget surpluses aggregating more than $3 billion, the public debt subject to the statutory debt limitation was $270.2 billion. However, as a result of the recession in late 1957 through early 1958, the Treasury incurred a budget deficit of $2.8 billion in the fiscal year 1958 and will incur a budget deficit of almost $13 billion during the year that will end on June 30, 1959, based on the President's January budget estimates.

The financing of these budget deficits is now expected to bring the public debt subject to limit to approximately $285 billion on June 30, 1959 -- $2 billion over the present regular ceiling. As a result the President is proposing an increase in the regular statutory limit to $288 billion, an increase equal to the $275 billion debt limit in effect at the beginning of the fiscal year plus the estimated deficit for the current year.

This will enable the Treasury to conduct its debt operations with a margin of $3 billion to allow for flexibility in debt management operations and contingencies. A $3 billion margin is essential to proper handling of the Government's operations. The Treasury has been operating on an average cash balance of about $4-1/2 billion during each of

the last three fiscal years. This is relatively small; the average operating cash balance this year has averaged only 69% of average monthly budget expenditures -- the lowest percentage for any recent year, as is shown on the right side of the chart below. The Treasury's cash balance is no higher today than it was a decade ago, when budget spending was half its present rate.

Chart-12



The efficient use of cash balances in this way has, however, gone about as far as it can without impairing efficiency of Treasury operations. There are times when a somewhat larger cash balance would have

given the Treasury much needed flexibility in timing its borrowing operations so that it could ride out a period of market apathy for new issues, rather than forcing the Treasury to borrow in an unfavorable atmosphere because it was running out of cash.

In addition to maintaining an adequate cash balance the Treasury should also be prepared to sell new issues of securities a week or so in advance of the maturity of old securities if such action would add materially to the success of a particular financing operation. This was true, for example, of the recently completed May 1959 financing. As part of this financing the Treasury sold $2.0 billion of eleven-month Treasury bills with an issue date of May 11 to provide most of the funds necessary to pay off a $2.7 billion Treasury bill issue maturing on May 15. For the intervening four days, therefore, there was an increase in debt of $2 billion. This was possible only because the Treasury had some flexibility under the $288 billion temporary ceiling -- flexibility which we requested and which the Congress approved last summer.

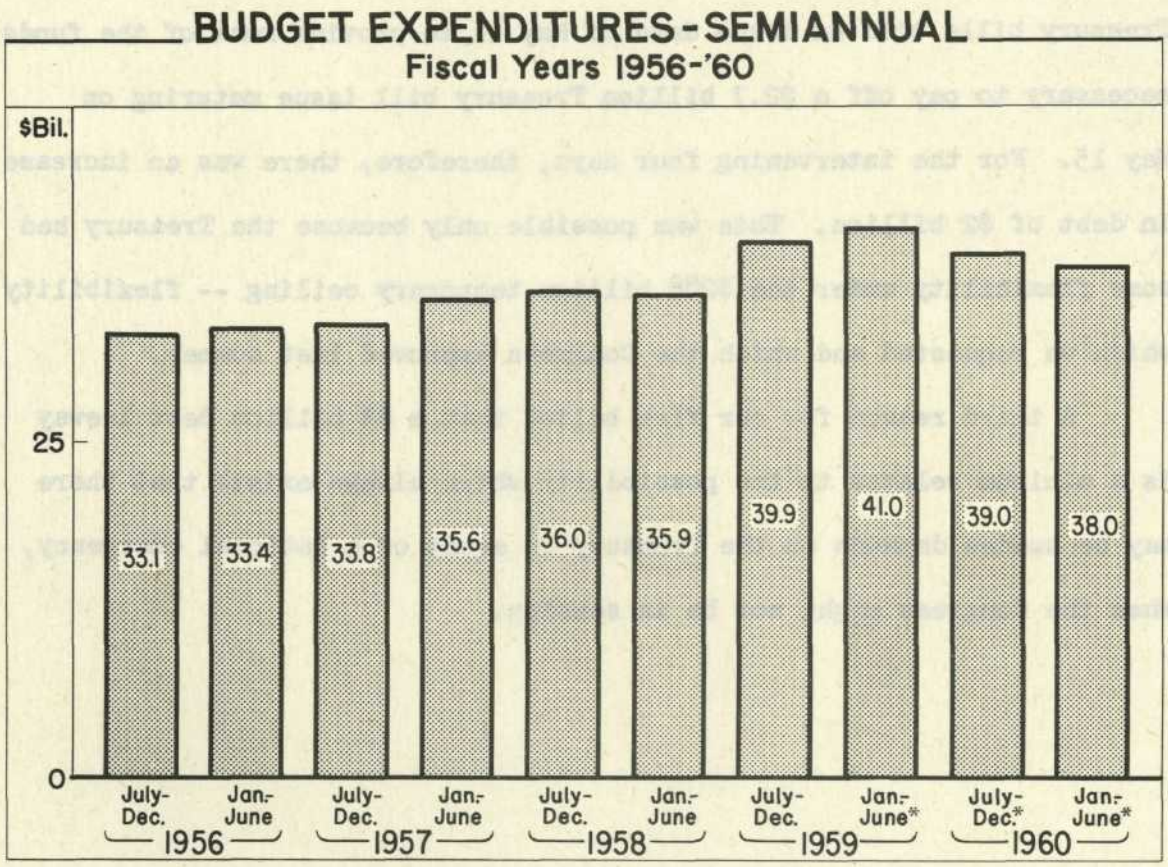
A third reason for our firm belief that a $3 billion debt leeway is a minimum relates to the possibility which always exists that there may be sudden demands on the Treasury in event of a national emergency, when the Congress might not be in session.

Our Debt Projections for Fiscal 1960

The outlook for the fiscal year beginning July 1, 1959 is for a level of budget receipts sufficient to cover budget expenditures. Even with this improvement in our fiscal outlook, however, there will still be a large seasonal deficit in the first half of the fiscal year, offset by a heavy seasonal surplus next spring.

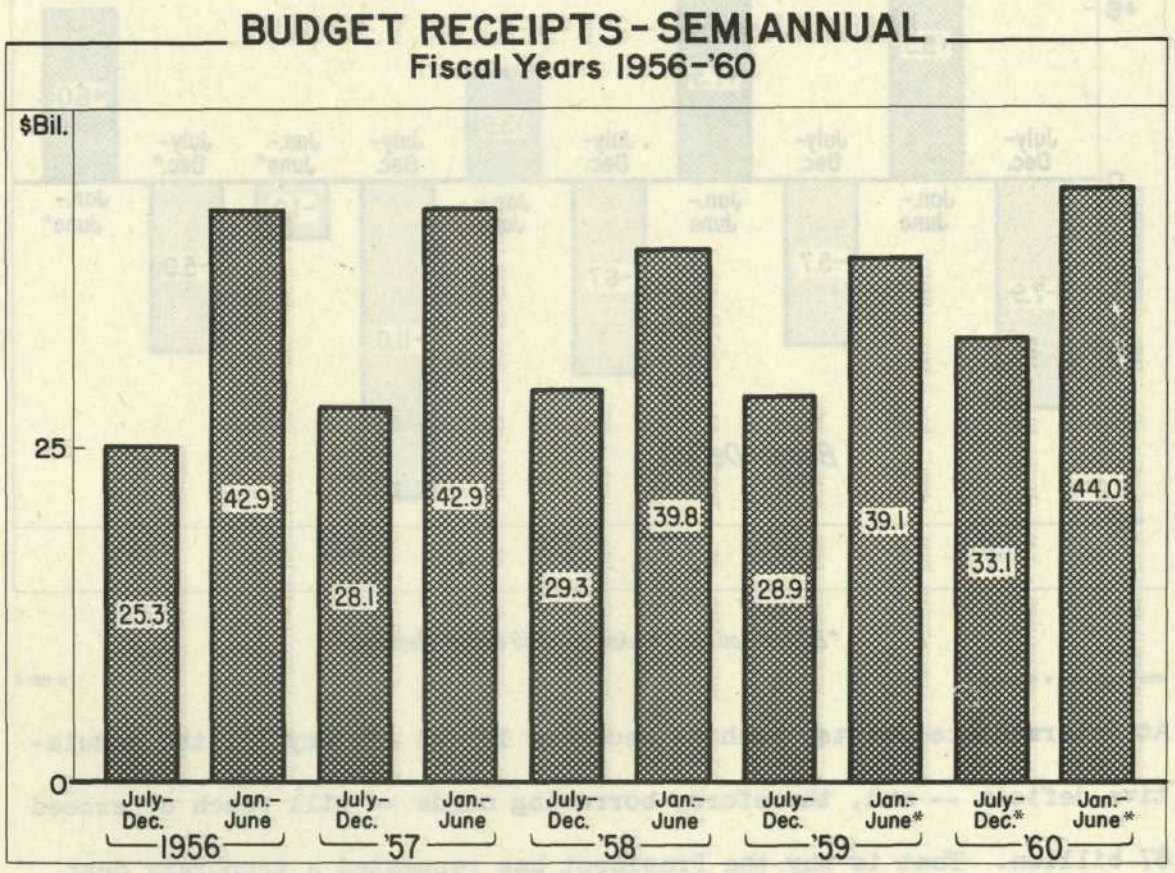
There is no distinct seasonal pattern in budget expenditures between the two halves of the year, as indicated by the chart below, which is based on the January Budget estimates.

Chart-13



On the other hand budget receipts follow a distinct seasonal pattern. Even when the speed-up in corporate tax collections, growing out of revisions in the Revenue Code of 1954, is completed there will still be a substantial seasonal disparity in tax receipts. As you know, smaller sized corporations will continue to concentrate payments in the spring which, together with the concentration of individuals' declarations and final payments, will still result in relatively high tax receipts in January-June of each year. Again, the January Budget estimates provide the basis for these figures.

Chart-14



*Estimate on basis of January 1959 Budget Message.

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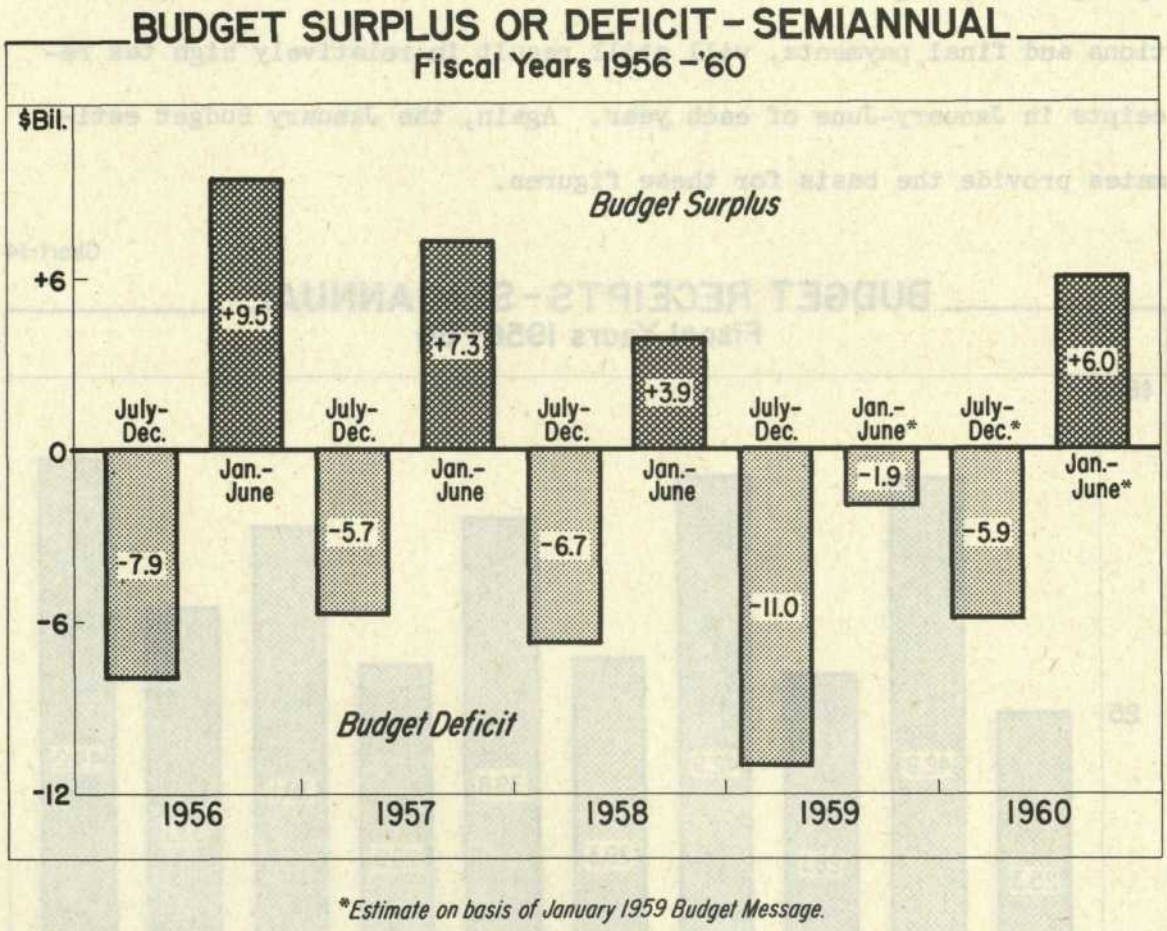
We expect, therefore, that even with a balance between expenditures and receipts for the fiscal year as a whole expenditures will exceed receipts by approximately $6 billion during the July-December half of the year. The July-December 1959 deficit will be only slightly more than half of the $11 billion deficit in July-December 1958.

Chart-15



At intermediate points, such as December 15 and January 15, the cumulative deficit -- and, therefore, borrowing needs -- will reach or exceed $7 billion. That is why the President has requested a temporary debt

ceiling of $295 billion. We are asking that this temporary limit be provided only through June 30, 1960, although a valid case can be made for a provision that would, for a longer period of time, control the debt at fiscal year ends and yet provide for seasonal requirements within the year. It is entirely appropriate for the Congress to review the debt limit situation each year, however, if it so desires.

Table 1, attached at the end of this statement, indicates in detail our current semi-monthly projection of the debt subject to the limit during the fiscal year 1960, assuming a constant $3-1/2 billion operating cash balance. 1/ The projections are stated both before and after the allowance for $3 billion flexibility. As you will note from the table and also from Chart 16 below, on December 15, for example, even the $295 billion temporary debt limit would appear to be insufficient for a few days but we will be able to operate within that limitation without undue impairment of our flexibility. Chart 16 also indicates the wide fluctuations in the amount of debt outstanding within each month during the fiscal year just ending.

The fiscal 1960 estimates on which the current request for an increase in the debt limitation is based are the same as those contained in the budget which the President submitted to you earlier this year -- budget receipts of $77.1 billion and budget expenditures of $77.0 billion. Those estimates were prepared six months ago and as the President

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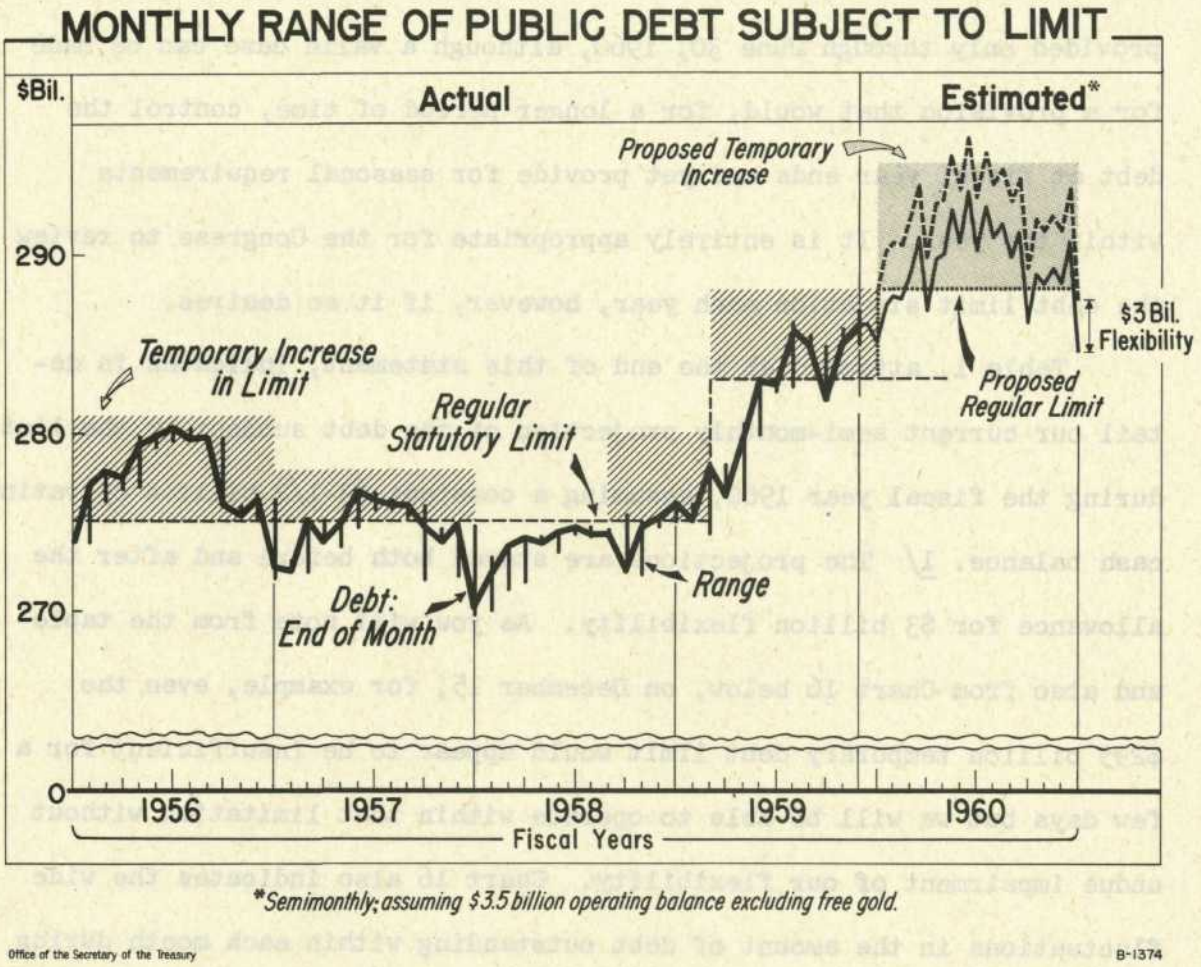
1/ Similar data for the fiscal year 1959 are shown in Table 2 at the end of the statement.

Chart-16



indicated in his message on public debt management, it now appears that interest on the public debt during the forthcoming year will amount to about $8-1/2 billion instead of the $8 billion included in the budget.

As I pointed out earlier, only a negligible amount of this half billion dollar increase (perhaps less than $5 million) represents the net additional cost of the new savings bond program. For all practical purposes the entire increase is attributable to the rise in interest rates which has taken place since the earlier estimate was made. The President also made it clear in his public debt message that the strength

of our economic recovery beyond earlier expectations has improved the revenue outlook for the fiscal year 1960 sufficiently to offset the increased interest cost.

Facilitating Exchanges of Treasury Securities

Before discussion of the remaining sections of the first proposed bill I would like to complete my statement by discussing briefly the provisions of the second proposed bill.

I have already spelled out in some detail the problem of an ever-shortening public debt and the Treasury's determination to issue intermediate and long-term bonds whenever market conditions are appropriate. Typically, new Treasury bond issues arise either from a new issue sold for cash or a new issue offered in exchange to holders of securities which are maturing within a matter of weeks. Many of these maturing securities were originally long-term bonds, bought initially by long-term investors such as individuals, personal trust accounts, life insurance companies, mutual savings banks or pension funds. When the bonds approach maturity, however, most of these longer-term investors have already liquidated their holdings and at maturity the bonds are usually held largely by commercial banks or by nonfinancial corporations or other short-term investors. Therefore, both of the traditional methods of issuing long-term securities which the Treasury uses involve a substantial amount of churning in the market as long-term investors seek

to raise the cash to pay for a new cash issue or to buy the maturing issue which gives them the right to exchange the maturing issue for the new one.

There is a third approach, however, to the problem of selling longer-term securities to long-term investors, and it is an approach which we believe would add materially to the Treasury's ability to encourage such investors to maintain investment in long-term securities. This approach may be characterized as "advance refunding." It is a technique which was used in the Canadian conversion loan operation last summer, whereby $6 billion of securities having from 6 months to 8 years yet to run to maturity were exchanged for securities with maturities ranging from 3 to 25 years -- an operation involving about 40% of that country's national debt.

Because of fundamental differences in the financial systems of the two nations, the U. S. Treasury has no intention of embarking on such an ambitious program in attempting to solve our debt problem. The basic thought behind the Canadian operation should be given careful consideration, however, as to its possible application in the United States in a much more limited way.

One of many possibilities in this direction, when and if market conditions are appropriate at some time in the future, is to offer new long-term bonds to the holders of the large amount of 2-1/2% bonds sold immediately before or during World War II. Such a new issue, or issues, would be sold on terms that would be attractive to the present holders and would permit the Treasury to do a substantial amount of debt exten-

sion on a straight exchange basis with existing holders, and, therefore, with a minimum of effect on the Government securities and capital markets. These are investors who already hold substantial amounts of Government securities. We want to keep them invested in Governments if we can.

Under present law, however, the exchange of one Federal security for another in any refunding operation requires that the gain or loss from the exchange must be recognized for tax purposes if value of the old security on the books of the investor is above or below the market value of the new issue as of the date of exchange. In practice, this type of advance refunding operation would be expected to establish a loss for tax purposes to most holders because the Treasury would be likely to engage in advance refunding only if the obligations to be exchanged are selling below par in the market. The 2-1/2% bondsreferred to, for example, were selling at prices ranging from $83 to $88 per $100 bond as of end of May. The terms of the new, longer issue would, of course, be set so that it would be worth approximately the same price in the market as the issue being turned in. Whether an investor would accept such an offer or not would be entirely his own decision. No holder can be compelled to give up his present contract rights by taking an exchange issue unless he wants to.

Under these circumstances, the present taxable character of the exchange represents an immediate tax advantage to any taxable holder since he may take a loss which he can employ for tax purposes. If he holds the new issue to maturity or sells at a higher price, he may realize a corresponding gain on the new security. He will then have to pay a tax

on this gain, but in the meantime he has had the benefit of postponing the tax on the loss deduction under present law.

Under the proposed bill postponing the recognition of gain or loss, the reason that an investor may find an exchange more attractive, despite the denial of a tax advantage, is because of his balance sheet and reserve position. So long as gain or loss on the exchange must be recognized for tax purposes many governmental authorities who supervise financial institutions require that the institution record the loss on its books. This means a corresponding reduction in earnings and in surplus, which is understandably distasteful to many investors.

If recognition of gain or loss were to be postponed until the ultimate disposition of the new security, however, it would become possible on the assumption that governmental supervisory authorities approve, for the institutional investor to carry the new securities at the same basis of valuation that he has been carrying the old ones. Thus, removal of the need to accept a book loss would make the exchange more attractive to many investors. Any investor who would benefit, under present law, from taking a tax loss could sell the old security and buy the new issue in the market.

Enactment of the second proposed bill would permit the investor to carry over the valuation basis of the bonds which are directly exchanged for the new bonds in this way. This could be done only under rules which we would prescribe for each exchange of securities so that the recognition of gain or loss for tax purposes could be deferred. There would be no

change in present provisions of law where exchanges of obligations other than U. S. Government securities are involved.

I would like to emphasize again that the practical application of this bill at the time of any such exchange -- to the extent that the bondholder is a taxpayer in the first place -- is to postpone recognition of a tax loss and therefore would tend initially to increase rather than reduce revenues. Actually, the effect on tax revenues will be small because of the character of many of the institutions involved -- pension funds, mutual savings banks, savings and loan associations, and charitable organizations.

I thank you for your patience in bearing with me through my long statement. I hope it has given you some insight into our problems and why we feel prompt enactment of both proposed bills is essential.

TABLE 1 - FORECAST OF PUBLIC DEBT OUTSTANDING, FISCAL YEAR 1960, BASED ON CONSTANT OPERATING CASH BALANCE $3.5 BILLION (excluding free gold)

(Based on 1960 Budget Document)

(In billions)

	Operating Balance Federal Reserve Banks and Depositaries (excluding free gold)	Public Debt subject to limitation	Allowance to provide flexibility in financing and for contingencies	Total public debt limitation indicated
July 15, 1959 ------	$3.5	$287.1	$3.0	$290.1
July 31 ----------	3.5	287.6	3.0	290.6
August 15 ----------	3.5	287.5	3.0	290.5
August 31 ----------	3.5	288.9	3.0	291.9
September 15 -------	3.5	290.8	3.0	293.8
September 30 -------	3.5	286.7	3.0	289.7
October 15 ---------	3.5	289.7	3.0	292.7
October 31 ---------	3.5	290.0	3.0	293.0
November 15 --------	3.5	292.5	3.0	295.5
November 30 --------	3.5	290.6	3.0	293.6
December 15 --------	3.5	293.5	3.0	296.5
December 31 --------	3.5	290.2	3.0	293.2
January 15, 1960 ---	3.5	292.6	3.0	295.6
January 31 ---------	3.5	290.9	3.0	293.9
February 15 --------	3.5	291.7	3.0	294.7
February 29 --------	3.5	289.8	3.0	292.8
March 15 ----------	3.5	291.3	3.0	294.3
March 31 ----------	3.5	286.1	3.0	289.1
April 15 ----------	3.5	288.9	3.0	291.9
April 30 ----------	3.5	288.3	3.0	291.3
May 15 ------------	3.5	289.3	3.0	292.3
May 31 ------------	3.5	288.3	3.0	291.3
June 15 -----------	3.5	290.6	3.0	293.6
June 30 -----------	3.5	284.4	3.0	287.4

NOTE: -- When the 15th of a month falls on Saturday or Sunday, the figures relate to the following business day.

TABLE 2 - ACTUAL CASH BALANCE AND PUBLIC DEBT OUTSTANDING
JULY, 1958 - MAY, 1959

(In billions)

	Operating Balance	
	Federal Reserve Banks and Depositaries (excluding free gold)	Public Debt subject to limitation
ACTUAL		
July 15, 1958 ------	$5.5	$275.2
July 31 ----------	3.9	275.1
August 15 ----------	5.3	277.8
August 31 ----------	5.3	278.2
September 15 -------	1.5	276.3
September 30 -------	3.9	276.4
October 15 ---------	4.7	280.0
October 31 ---------	3.3	279.9
November 15 --------	2.2	279.9
November 30 --------	5.3	282.7
December 15 --------	2.1	282.2
December 31 --------	3.8	282.6
January 15, 1959 ---	1.7	282.6
January 31 ---------	4.5	285.5
February 15 --------	2.8	284.8
February 28 --------	3.9	284.8
March 15 ----------	2.1	284.6
March 31 ----------	3.2	281.7
April 15 ----------	4.2	285.4
April 30 ----------	4.4	285.0
May 11 ----------	6.1	286.8
May 15 ----------	4.2	285.0
May 31 ----------	4.7	286.0

NOTE: From February 26 to September 2, 1958 the statutory debt limitation was $280,000,000,000 including a temporary increase of $5,000,000,000 which was scheduled to expire June 30, 1959. The Act approved September 2, 1958 increased the limitation to $288,000,000,000, which will revert to $283,000,000,000 on June 30, 1959.

When the 15th of a month falls on Saturday or Sunday, the figures relate to the following business day.

Supplemental Statement on Public Debt Management
by Secretary of the Treasury Robert B. Anderson before the
House Ways and Means Committee,
10:00 A.M., June 10, 1959

INTEREST RATES IN A FREE MARKET ECONOMY

As I observed in the main portion of my statement before this committee, popular discussion of interest rates is often clouded by misunderstanding of their nature in a free market economy. The purpose of this supplementary statement is to discuss in some detail the nature of interest rates - particularly the factors that cause them to rise or fall; the reasons for the increase in rates since last summer; and several alternative courses of action that might be effective in inducing a lower level of interest rates.

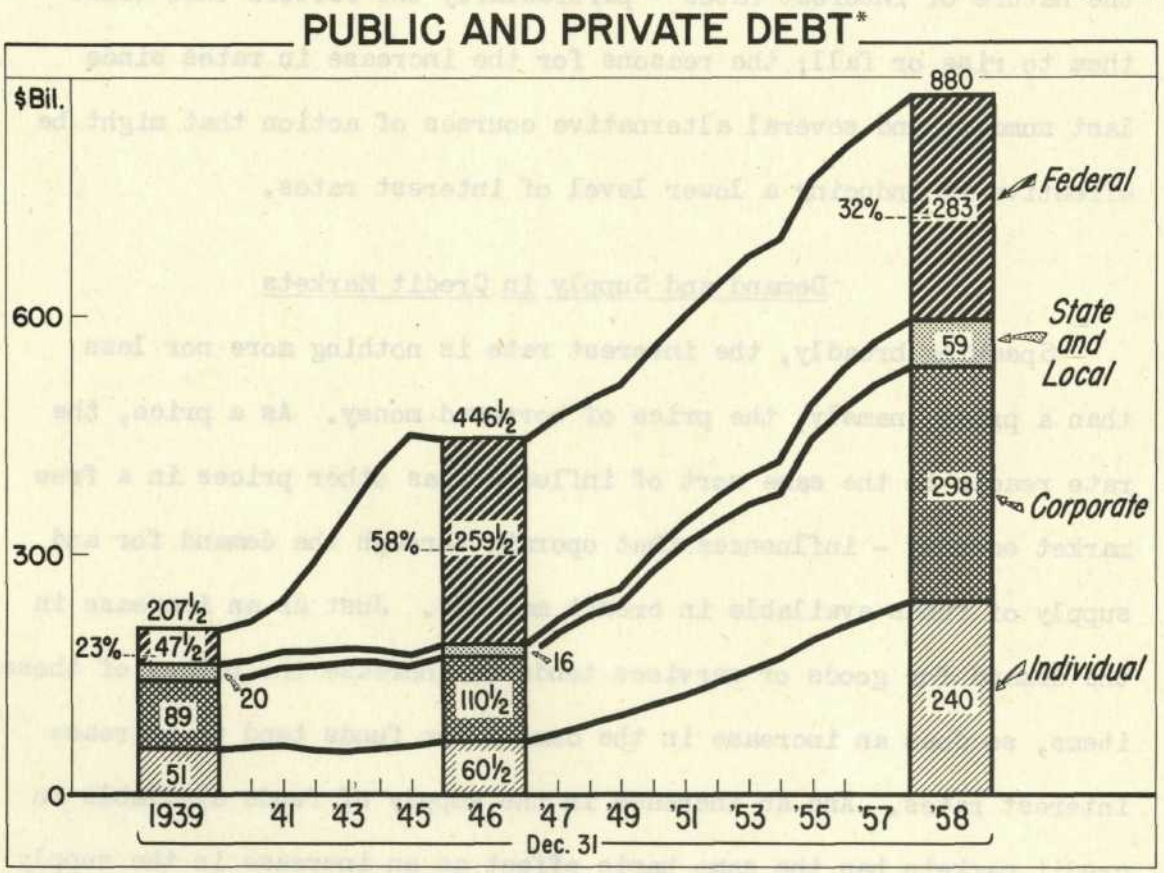
Demand and Supply in Credit Markets

Speaking broadly, the interest rate is nothing more nor less than a price, namely, the price of borrowed money. As a price, the rate reacts to the same sort of influences as other prices in a free market economy - influences that operate through the demand for and supply of funds available in credit markets. Just as an increase in the demand for goods or services tends to increase the prices of these items, so does an increase in the demand for funds tend to increase interest rates. And an increase in the supply of funds available in credit markets has the same basic effect as an increase in the supply of any good or service in any market; price tends to fall. This is

true under our present market arrangements; it will remain true so long as credit markets remain free and borrowers and lenders are permitted to manage their affairs with a minimum of interference and regulation.

From the side of demand, the principal impact on interest rates reflects the actions of four groups of borrowers: individuals, corporations, State and local governmental units, and the Federal Government. As is shown in the chart, total indebtedness of these borrowers has almost doubled since 1946.

Chart-A



*Gross debt.

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Individuals, borrowing to finance purchases of a variety of goods and services and to construct or purchase homes, increased their gross indebtedness from $60-1/2 billion to $240 billion between 1946 and 1958. The gross debt of business corporations, which seek credit to finance working capital needs and for longer-run purposes in expanding and modernizing plant and equipment, rose from $110-1/2 billion to $298 billion. State and local governmental units, confronted with growing needs for schools, highways and streets, and a variety of other facilities, have borrowed heavily in the postwar period; their gross debt expanded from $16 billion in 1946 to $59 billion in 1958. The Federal Government, the fourth major borrower in credit markets, seeks funds to meet seasonal needs and to finance a deficit. The public debt increased from $259-1/2 billion in 1946 to $283 billion in December 1958. As of the end of June, the debt is expected to total $285 billion.

The postwar pressure on interest rates arising from the demand for credit is apparent. Concomitant with the large expansion in demand, however, has been a growth in the supply of funds available in credit markets. These funds come ultimately from two sources: savings or money creation. It makes little difference to the borrower whether the ultimate source is one or the other; dollars flowing out of money creation are fully as spendable as those made available from savings. The ultimate source may be of crucial importance from the standpoint of achieving price stability and sustainable economic growth, however, simply because dollars generated through money

creation represent an increase in the total pool of dollars available for spending and, if not matched by a more or less equal increase in output of goods and services, tend to force prices up. It is no accident that consumer and wholesale prices have more than doubled during the past twenty years, in view of the fact that a fourfold increase in the active money supply was only partly matched by an approximate doubling of real production of goods and services.

There is no need to go in detail into the various forms of saving - by individuals, business firms, and governmental units - or to differentiate sharply between funds flowing from current saving and those that represent savings of earlier years that subsequently are made available to borrowers. The really important point relates to the distinction between funds obtained from existing pools of dollars and those generated by money creation.

How does money creation take place? Largely through the lending and investing activities of the more than 13,000 commercial banks in this country. Suppose that John Doe wants funds for use in his business, or to improve his home, or to meet medical or other expenses. And suppose that he applies for a loan from a commercial bank to obtain the funds. If the loan is granted, John Doe simply signs his promissory note and acquires a credit to his deposit account in the bank. This transaction represents no transfer of existing dollars; quite the contrary, John Doe has an extra $100, $1,000, or $10,000, depending on the amount of the loan, but no other individual or institution has any less money. Money creation has indeed taken place. Moreover, not only

John Doe, but thousands of business firms, many State and local governmental units, and the Federal Government also borrow, directly or indirectly, from commercial banks. Each bank credit extension of this type which is not offset by a reduction in other bank loans or investments results in an equivalent amount of new money creation.

Do commercial banks have unlimited ability to create money in this fashion? Not by any means. People borrow money primarily in order to spend, and the banker who makes such loans knows that within a relatively short period of time the newly created deposit will probably be withdrawn from his bank. This will probably take the form of a transfer to another bank, perhaps in the same city, perhaps somewhere else in the Nation. But, the important point is that the banker must be able to meet a drain of cash out of his bank; and his ability to do so depends on his cash reserve position. In other words, he cannot afford to make large extensions of credit unless he has extra cash on hand (or on deposit with his Federal Reserve Bank) to meet the resulting drains, or unless he is in a position to obtain additional cash as the drains take place.

This is where the Federal Reserve System comes into the picture. Through various devices (e.g., discount policy, open market operations, and control over member banks' reserve requirements), Federal Reserve authorities can influence the cost and availability of bank cash reserves. In so doing, the willingness and ability of commercial banks to make new loans and investments - and thus add to the flow of funds available in credit markets - is very much affected.

The resiliency of bank credit expansion and contraction can serve as an important balancing wheel in credit markets — or, it can operate as a serious destablizing factor in our attempts to achieve a stable price structure and relatively full and efficient use of our economic resources. The critical question is, of course, the rate at which bank deposits come into or go out of existence. During a period of high and rising business activity, when credit demands are especially strong, and when men, machines and materials are being used at high capacity, an excessive amount of money creation tends to add to inflationary pressures. Spending in the economy as a whole may expand rapidly but, with resources in relatively full use, the volume of goods and services that can be produced can only be increased slowly. Inflation is then the result. And judging by past experience, an inflationary upsurge is likely to be followed by readjustment and recession, so that our end objective of achieving maximum economic growth is actually impeded.

Since recession is a serious deterrent to sustained economic growth, bank credit expansion may be desirable when economic activity is lagging. Under these conditions, the men, machines and materials necessary to support increases in production are available. Greater spending by consumers and business firms is to be desired.

Consequently, sustained and rewarding economic growth — which requires reasonable price stability and relatively full and efficient use of our economic resources - can be attained only if the aggregate flow of credit is consistent with the ability of the economy to absorb

that flow, when translated into spending, at a given time. And, the Federal Reserve System, in fulfilling its statutory obligations, is constrained to employ its monetary powers flexibly. In a free market economy, an inevitable result of the interaction of demand and supply forces in credit markets - including the impact of Federal Reserve actions - is fluctuations in interest rates.

Stated simply, flexible credit policies, attuned to the business situation as it unfolds over time, can be effective only if interest rates are free to respond to the forces of demand and supply in credit markets. But it must be emphasized that the major forces affecting those rates stem from actions of free and independent lenders of funds. The law of supply and demand is a powerful and inescapable economic force; attempts to thwart it in the past have inevitably led to greater difficulties later on.

At times interest rates seem to decline faster than might be expected in view of basic trends in credit demands, savings, and the availability of bank credit. At other times they seem to rise faster than might seem warranted in view of these forces. For example, the sharp decline in rates in late 1957 and early 1958 seemed to outrun basic forces of demand and supply, and the same can be said of the sharp increase in rates in the summer of 1958.

The explanation of such sharp shifts can be found primarily in the impact of expectations on credit markets. In late 1957 it became clear that recessionary forces were gathering strength. The Federal Reserve System, consistent with its responsibility to conduct its

operations flexibly, shifted from the restrictive policy of the preceding 2-1/2 years toward a policy of monetary ease. In view of the shift in the business situation, which implied a slackening demand for funds in credit markets, and in view of the reversal of Federal Reserve policy, which implied an increase in availability of bank credit, market participants reasoned that the uptrend in interest rates that had prevailed since 1954 would be reversed, and that the outlook for some time to come was for declining rates.

Declining interest rates are synonymous with rising prices for outstanding Government and other types of bonds. Consequently, individuals and institutions with funds to invest tended to step up purchases of such instruments - the supply of funds available in credit markets expanded sharply; and individuals and institutions with bonds for sale became more reluctant to part with them - the demand for funds subsided, relatively speaking. The result: sharp declines in interest rates (or increases in bond prices), stimulated largely by expectations of lagging business and easy money.

The decline in business activity came to an end much sooner than many observers anticipated. In June 1958, the strengthening business picture gave rise to rumors that Federal Reserve policy might be in the process of shifting away from the aggressively expansive policies of preceding months. Many investors in debt instruments, including Government bonds, became anxious to dispose of the securities before interest rates rose and bond prices declined; potential buyers became less anxious to buy. The result: sharp increases in interest rates, stimulated largely by expectations.

Thus, one type of expectation is related primarily to the swings in business activity and the impact of flexible monetary policies. But at times other types of expectations exert important influences. During the past year, the increase in interest rates has been stimulated partly by a growing - but, in my judgment, mistaken - conviction that inflation is inevitable. Many investors have been reluctant to purchase debt instruments, which carry a fixed interest return and principal payment, as opposed to equities. This reluctance to purchase bonds, and the preference for equities, has contributed to relatively low bond prices (high interest rates) and high stock prices.

It is important to emphasize, however, that effects of expectations are likely to be short-lived, unless later ratified by the expected events. The sharp decline in interest rates in late 1957 and early 1958 could not have been sustained had it not been for the fact that recession did occur, credit demands did subside, and monetary policy did assume a posture of aggressive ease. Again, the sharp rise of last summer was later ratified, in part, by the vigorous expansion of business activity, with the accompanying demands for credit, and the impact of a $13 billion Federal deficit on credit markets. Finally, the impact of inflationary expectations on the level of interest rates can be minimized only when it becomes clear to participants in free credit markets that the integrity of the dollar will be preserved.

In summary, interest rates in a free market economy are influenced by a number of factors which can best be understood in terms of the forces working through demand and supply in credit markets. Of primary importance on the demand side are borrowings by individuals, businesses, State and local governmental units, and the Federal Government. The supply of funds available in credit markets is mainly a reflection of the availability of financial savings, coupled with net changes in commercial bank credit. Federal Reserve policy, by influencing reserve positions of commercial banks, affects the rate of flow of bank funds into credit markets.

Before examining the reasons for the rise in interest rates in this country since last summer, it might be worthwhile to discuss briefly two popularly held views concerning the nature of interest rates that, in my judgment, are mistaken.

One often hears the statement that increases in interest rates are necessarily inflationary, in that interest is a cost of doing business and sellers of goods tend to pass on rate increases in the form of higher prices. The people who hold this view overlook the fact that rising interest rates are indicative of pressures in credit markets growing out of strong demands for funds relative to the supply. Inasmuch as individuals and institutions borrow money primarily to facilitate spending, rising interest rates reflect an inability of all potential borrowers to obtain as much credit as they would like to have. In other words, spending is impeded, and the rise in interest rates is one measure of the degree of restriction on spending. And,

under normal circumstances, anything that tends to dampen spending when business activity is high and rising tends to diminish - not to augment - inflationary pressures.

Moreover, available figures indicate clearly that interest, as a cost of doing business, is a decidedly minor expense. In 1957, for example, net interest costs of all manufacturing corporations were only 4/10 of 1 percent of gross sales. Thus, if the cost of an article selling for $100, only 40 cents represented interest cost. Admittedly, interest expenses of wholesalers and retailers, who also must finance some of their operations by borrowing, would add slightly to total interest cost included in items bought by final consumers. Still, however, the contribution of interest expense to total cost would be small.

It has been suggested that public utility rates are influenced significantly by interest costs, since such firms rely heavily on bonded indebtedness. In this case, however, net interest expense is estimated to be less than 4-1/2 percent of gross revenues.

The evidence seems clear that an increase in interest rates exerts only a small direct effect on prices of goods and services, and that this impact is far outweighed by the restrictions on total spending stemming from limited availability of funds in credit markets.

There is also a misconception concerning the identity of the recipients of interest payments on the Federal debt. Some observers appear to believe that large financial institutions are not only the major recipients of such payments, but that their share has increased as interest rates have advanced in the postwar years.

The accompanying table, which presents estimates of the distribution of interest payments on the public debt in 1946 and 1958, indicates clearly that such is not the case. In 1946, the major financial institutions - commercial banks, mutual savings banks, and insurance companies - received an estimated $2.1 billion in interest on holdings of Government securities, or about 45 percent of the total of such payments. By 1958, the share of these institutions had declined to $2.0 billion, representing only 26 percent of total payments.

Estimated Distribution of the Interest on the Public Debt
Fiscal Years 1946 and 1958

(In billions of dollars)

	Budget Expenditures	
	1946	1958
Investor classes:		
Individuals:		
Savings bonds	.7	1.5
Other securities	.5	.4
Subtotal	1.2	1.9
Commercial banks	1.4	1.5
Mutual savings banks	.2	.2
Insurance companies	.5	.3
Nonfinancial corporations	.2	.6
State and local governments	.2	.4
Miscellaneous investors	.2	.4
Federal Reserve banks	.1	.8
Government Investment Accounts	.7	1.5
Total	4.7	7.6

Moreover, a significant portion of the interest income of banks has been passed on to customers in the form of higher rates on time and savings deposits. For example, in 1946 member bank interest payments to depositors were only 20 percent of interest income on their holdings of Treasury securities. Reflecting the sharp increase in rates paid on time and savings deposits in the past few years, member banks in 1958 paid almost 90 percent of their interest income on Governments to depositors.

Other important trends brought out by the table include an $800 million increase in interest payments on savings bonds, held mostly by individuals; a $700 million expansion in payments to Federal Reserve banks, which returned 90 percent of their net earnings to the Treasury; and an $800 million increase in payments to Government investment accounts, which are operated almost wholly for the benefit of individuals.

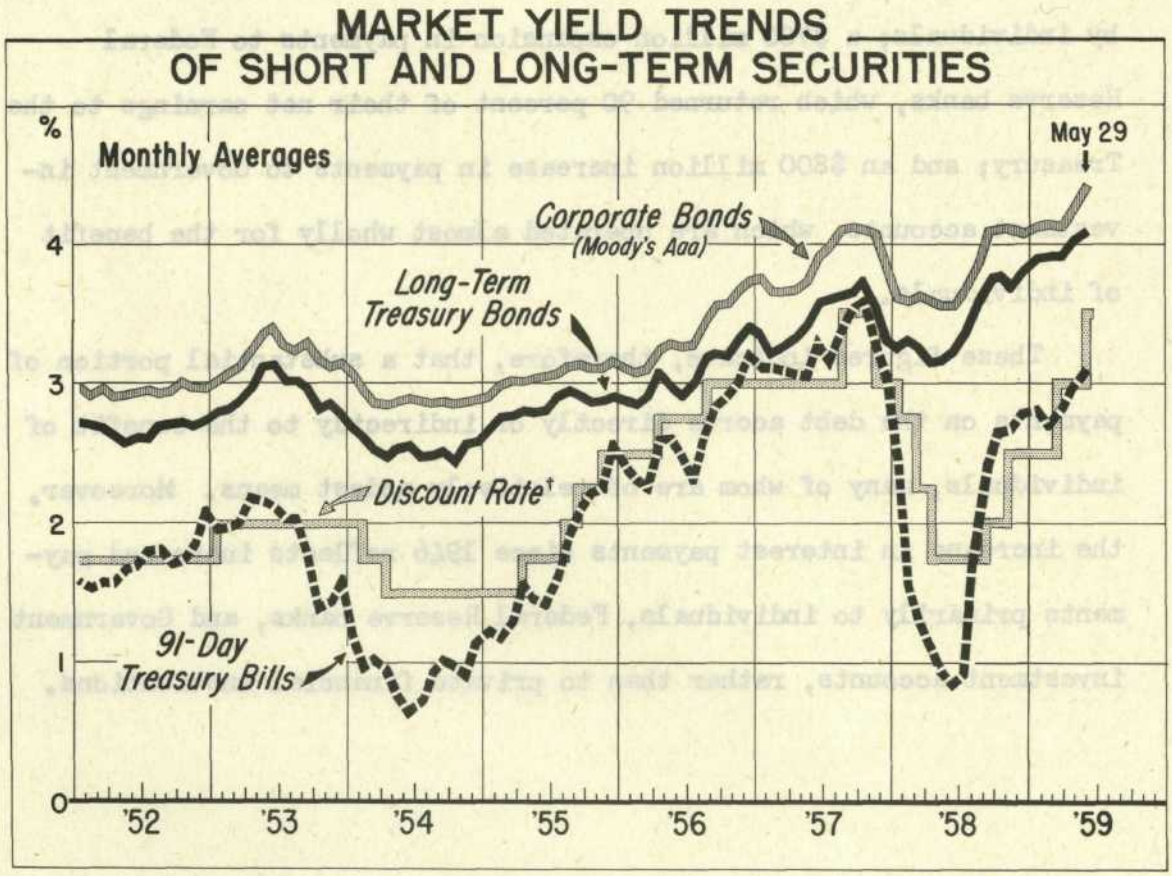
These figures indicate, therefore, that a substantial portion of payments on the debt accrue directly or indirectly to the benefit of individuals, many of whom are of relatively modest means. Moreover, the increase in interest payments since 1946 reflects increased payments primarily to individuals, Federal Reserve banks, and Government investment accounts, rather than to private financial institutions.

The Rise in Interest Rates Since Last Summer

Trends in interest rates over a period of several years, or of several months, can be understood only in terms of the major demand and supply forces at work. Accordingly, it might be worth while to examine closely the increase in rates that has occurred during the current fiscal year in order to gain an understanding of the factors underlying the advance.

Interest rates on Treasury and other securities have risen considerably from the lows reached during the recession of 1957--58.

Chart-B



†Federal Reserve Bank of New York.

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Yields on long-term Treasury bonds, which averaged 3.12 percent in April 1958, had risen to an average of 4.08 percent in May 1959. Average issuing rates on 3-month Treasury bills, which fell below 1 percent in the spring and summer of 1958, have recently risen above 3 percent. Similarly, rates on commercial paper, bankers' acceptances, prime bank loans, corporate and municipal bonds, and other debt instruments have advanced substantially during the past year.

What factors lie behind this rise in rates? First, let's look at the demand for credit.

The growth of consumer credit in the current fiscal year has been less than in most recent years. Thus, pressure on interest rates from this source has been moderate, except for the past few months, in which demand for consumer credit has risen substantially. Individuals have indeed been active borrowers of funds, primarily in the form of mortgage credit. Total real estate mortgages, consisting largely of individuals' borrowings, are expected to increase $18 billion this fiscal year, a greater rise than in any of the past five fiscal years. This increase can be viewed as having contributed to demand pressures in credit markets.

Total corporate bonds and notes, State and local government securities, and bank loans have increased less than in any fiscal year since 1954. Thus, these credit demands have not exerted significant pressures on financial markets.

Chart-C

*Excluding debt held by Federal Reserve Banks and Government Investment Accounts.

Office of the Secretary of the Treasury

B-1377

The demand for credit on the part of the Federal Government, to finance a record peacetime deficit of approximately $13 billion, has been much greater than in any of the preceding five fiscal years. The publicly held Federal debt will increase by almost $9 billion in this fiscal year, as contrasted with increases of $3.1 to $3.3 billion in fiscal years 1954, 1955, and 1958, and declines of $4.7 and $3.5

billion, respectively, in 1956 and 1957. (The difference between the $13 billion deficit and the $9 billion increase in Federal debt in this fiscal year results primarily from a reduction in the Treasury's cash balance.)

These figures demonstrate clearly that the more important demand pressures on interest rates during the past year have stemmed from the increase in mortgage debt and the record peacetime Federal deficit. However, the rise in mortgage debt, although substantial, is not much greater than in fiscal years 1955 and 1956. Thus, it appears that a major factor contributing to the sharply rising demand for credit in fiscal 1959 has been the record peacetime Federal deficit. The addition of almost $9 billion in Federal securities to what might be viewed as more or less normal aggregate credit demands could only exert strong pressure on interest rates.

As I noted earlier, however, trends in interest rates are also influenced by forces working through the supply of funds available in credit markets. While data on savings are difficult to interpret in terms of impact on credit markets, there appears to be no evidence that a shift in the availability of savings has contributed to the rise in rates during the past year.

As to the timing of the events in the summer of 1958, it is important to note that member bank reserve positions and short-term money market rates reflected a continuation of monetary ease until August - a full two months following the reversal of market rates on intermediate - and longer-term Government bonds. Thus, the market

appears to have led monetary policy and, as stated earlier, the market shift resulted primarily from radical changes in expectations. The shift in expectations resulted, in turn, from: (1) a growing comprehension that the recession had ended and that vigorous recovery was under way, with its consequent impact on demand for credit; (2) a belief that Federal Reserve credit policies, in view of the shift in the business situation, would soon move toward restraint in keeping with the requirements of flexible administration of such policies; (3) a realization that in fiscal year 1959 the Federal Government would be confronted with a deficit of $10 to $15 billion, with its strong impact on demand for credit; and (4) a growing - even if unfounded - conviction on the part of investors that further inflation would probably occur, stemming from the rigidity of prices during the recession, the impact of business recovery, and the inflationary ramifications of a record peacetime deficit during a period of rising business activity. In addition, market pressures were increased significantly by liquidation of heavy speculative holdings of Government and other securities, built up earlier in the year and in June, sometimes on relatively thin margins.

It should be emphasized again, however, that the increases in rates arising from expectations could not have been sustained had not the expectations later been ratified. And most of them were indeed ratified. Business activity has expanded vigorously; a $13 billion deficit was confirmed by official sources; and Federal Reserve credit policy did shift away from the strongly expansive policies of early

1958. The expectation of continuing inflation has not been confirmed; whether or not it will be depends in no small measure on the degree of fiscal and monetary discipline that is maintained during this period of high and rising business activity.

Furthermore, the available evidence points only to a mild degree of credit restraint since last summer. For one thing, the strong upward trend in production, employment, and income with, as yet, absence of strong inflationary pressures, indicates that credit has been sufficiently available to meet the needs of the economy. Moreover, monetary growth since last summer, as measured by the annual rate of expansion in the seasonally adjusted money supply, has been at least equal to and perhaps slightly greater than what is usually thought of as a normal rate.

All things considered, it seems to me clear that the major factor contributing to the rise in interest rates during the past year has been the $13 billion Federal deficit. It has exerted a twofold impact: first, by stimulating expectations in the summer of 1958 of strong credit demands and of a further erosion in the value of the dollar; and, second, by adding almost $9 billion in Federal securities to the demand side of credit markets.

Consequences of Various Proposals to Induce Lower Interest Rates

Are there any courses of action, open to Congress, the Executive Branch, or the Federal Reserve System, which might be successful in inducing lower interest rates? It must be emphasized that any such

actions, to be effective without leading to later difficulties, must operate through the basic forces of demand and supply. As I stated earlier, the law of supply and demand is a powerful economic force. Any attempt to hold interest rates to artificially low levels would be doomed to ultimate failure unless appropriate steps were taken to adjust demand and supply forces consistent with the selected level of rates. And even then, later difficulties may well arise. The situation is parallel to attempts to maintain price ceilings on goods and services during national emergencies; prices can be prevented from rising, if inflationary pressures are strong, only through resort to rationing, allocation of materials and labor, and so on. Similarly, interest rates can be kept from responding to the forces of demand and supply only through direct intervention in credit markets and a consequent abridgement of economic freedom. It is therefore assumed that any courses of action to be considered would involve influencing demand and supply.

With this stipulation accepted, six proposals might be mentioned. Several of these proposals, however, would so harm the Nation that responsible people would be unwilling even to consider them. They are presented solely for the purpose of bringing forward issues which apparently are often misunderstood.

(1) One approach would be for the Government, through various means, to promote recessionary pressures in the economy. Interest rates commonly decline during recessions, partly because of a slackening demand for funds on the part of individuals and businesses, partly

because of a relative increase in availability of financial savings, and partly because of greater availability of bank credit in connection with a flexible shift of monetary policy toward credit ease.

This first alternative is, of course, absurd; no responsible government would attempt to induce recession - with its accompanying loss of production and rise in unemployment - simply to produce lower rates of interest. But the introduction of this alternative highlights the fact that high and rising interest rates are a sign of expanding business. For a responsible government, the choice between high levels of business activity and employment as opposed to low interest rates is actually no choice at all. Stated differently, high interest rates are not an end in themselves; rather they are the usual accompaniment of the active credit demands that characterize expansion in production, employment, and income.

(2) It has been suggested that interest rates could be reduced if the Federal Reserve banks were directed by Congress to purchase all new issues of Government securities; this would tend to reduce pressures on interest rates, since the Federal Reserve banks would in effect create the funds necessary for the purchase of the securities. The actual process would involve credit to the Treasury's deposit balance in Federal Reserve banks in return for the newly issued Government securities.

There are at least two serious objections to this course of action. In the first place, the prohibition of direct sales of securities by the Treasury to the central bank, except under unusual

and very limited circumstances, has been an important characteristic of our financial mechanism ever since the establishment of the Federal Reserve System in 1913. As one adjunct to their primary function of influencing the flow of money and credit, the Federal Reserve banks were envisaged, by the framers of the Act, as fiscal agents for the Government — to hold Treasury working balances; to clear Treasury checks; to issue, redeem and pay interest on Government securities; and so on — not as a source of credit to finance the Government's needs. Experience in a number of foreign countries has demonstrated the dangers of easy access to central bank credit on the part of the branch of Government that has the responsibility for financing the Government's requirements. Fiscal discipline is especially difficult to preserve if the exchequer has, in effect, a "blank check" on the money—creating authority.

A second major objection to sale of new Treasury issues directly to the Federal Reserve banks arises from the fact that the transaction would provide the basis for a highly inflationary expansion of the money supply. The recipients of Treasury checks drawn on the newly created deposits at the Reserve banks would deposit most of the proceeds in Federal Reserve member banks, and the member banks in turn would send the checks to their District Reserve banks for payment. Payment would be effected in the usual way, by crediting - or increasing - the reserve balances of the banks on the books of the Reserve banks. Bank reserves would be increased by the amount of the credits; this would provide a basis for additional lending and in-

vesting by the banking system by an amount equal to about six times the increase in reserve balances. Growth in the money supply would, therefore, be strongly stimulated. Interest rate pressures would have been restrained only at the cost of highly inflationary increases in bank credit and the money supply. Moreover, as I pointed out in the main portion of my statement, strong inflationary pressures tend to promote even higher levels of interest rates.

Recognizing the objection that large-scale purchases of Government securities by the Federal Reserve banks would be highly inflationary, advocates of this course of action sometimes maintain that the inflationary growth in the money supply could be avoided simply by raising member bank reserve requirements. In other words, the new reserves created by the Federal Reserve purchases would be immobilized immediately by increasing the percentages of idle funds that member banks must hold in relation to deposits.

There is an important practical objection to this proposal. The purchase of, say, $5 billion of new Government securities by the Federal Reserve banks would result in the creation of $5 billion in new bank reserves, but these reserves would flow into the banking system, and be disseminated among individual banks, in accordance with market forces. No one could predict the ultimate distribution of the new reserves in advance. Some banks would receive a large portion, some a smaller portion; the ultimate distribution would depend primarily upon the location of the individuals and institutions who received the Government payments financed by the deficit borrowing.

An increase in member bank reserve requirements, however, affects all banks in a given classification (central reserve city, reserve city, and "country") equally in terms of percentage points of reserve requirements. Consequently, a blanket increase in reserve requirements of the magnitude required to neutralize the reserve-creating impact of large-scale Federal Reserve purchases of Governments might well lead to severe dislocations and disturbances in credit markets. Some banks would have ample reserves, others would find themselves severely pinched. It can be argued that market forces would tend to correct these imbalances, and they would -- over time. But in the short run, forces might well be set in motion leading to abrupt swings in interest rates and availability of credit; credit "droughts" in one part of the country and "surpluses" in another; and so on. And, in any event, the credit market, while highly efficient, by no means operates with complete perfection in transferring funds from areas of plenty to areas of shortage.

To this important practical objection against selling Government securities to the Reserve banks and then offsetting the inflationary impact by raising member bank reserve requirements can be added a more basic objection, if it is assumed that one purpose of the action would be to prevent interest rates from rising. As I noted earlier, purchases of $5 billion of Federal securities by the Reserve banks would result in an equivalent increase in the money supply as the recipients of the checks deposited the proceeds in their commercial banks. In the first instance, then, there would be an important

inflationary impact, resulting from the spending of the funds by the Government and the expansion in the money supply.

A large increase in reserve requirements could indeed nullify the growth in the money supply, but only by severely restricting the lending and investing activities of commercial banks. This, in turn, would exert pressure on individuals, business firms, and State and local governments, and tend to force interest rates for such borrowers to higher levels. The inflationary impact of the increase in money supply resulting from Treasury borrowing from the Reserve banks can be offset only if credit contraction occurs in other segments of the economy; the $5 billion increase in deposits held by recipients of the Treasury checks must be offset by a $5 billion decline in funds of other individuals and institutions. This can be achieved, in free credit markets, only through credit restriction, which implies additional pressure on interest rates. Thus, during a period of prosperity and a growing demand for credit, the choice is either between a somewhat higher level of interest rates, or stimulation of inflationary pressures through monetary expansion. There are no other choices.

The recommendation that Federal Reserve banks buy all or substantial portions of new issues of Treasury securities involves one other aspect that deserves discussion. Specifically, it has been recommended that the Federal Reserve banks be required to purchase only that portion of a new issue that investors other than commercial banks would not purchase; thus, the Reserve banks, in effect, would replace commercial banks as buyers of Governments. This recommenda-

tion is based partly upon the assumption that commercial banks do not perform a necessary service in buying Government obligations. Their ability to create money, it is maintained, permits them to buy these securities; but in fact the authority over money creation is constitutionally vested in Congress. Thus, it is argued that the Government should perform this function, through the Federal Reserve banks, without burdening taxpayers with interest charges.

This argument deserves several comments. In the first place, as noted earlier, purchases of Government securities directly by Federal Reserve banks would be highly inflationary. Secondly, whether or not the commercial banks perform a "necessary" service in creating money, there is little doubt that they perform an important economic function. Demand deposits in commercial banks have assumed a monetary function simply because people prefer to hold funds and make payments in that form, rather than in the form of currency. Moreover, money is essential to efficient performance of a highly industrialized market economy and, if the commercial banks did not perform the money-creating function, some other institution or agency would have to do so.

Furthermore, commercial banks do indeed perform a useful service in purchasing and holding Government securities. The business of commercial banking, in essence, is that of holding relatively illiquid assets -- principally loans and investments -- against liabilities that are largely redeemable on demand. This involves risk and, in assuming that risk, stockholders of commercial banks are entitled to

a return for a service performed. The fact that an asset is a Government security rather than a commercial loan is not germane; marketable Government securities, while devoid of risk relating to interest and principal payments, do possess risk as to the price at which they can be sold in the market. Because of the nature of their liabilities, banks must be prepared — and at times may be compelled — to liquidate assets in order to meet deposit drains. They are therefore providing an economic service by holding illiquid assets which the public does not desire to hold at the time, and in return furnishing the public with the liquidity — or money — that it desires.

There are at least two important reasons why the money-creating function should not be assigned wholly to the Federal Reserve banks. In the first place, under our institutional arrangements the money-creating function is closely allied with that of granting credit to a wide variety of borrowers. It is a cardinal principle of our type of government that private institutions should dominate credit-granting activities; otherwise, the ability to obtain credit might rest less on credit-worthiness and more on noneconomic factors.

Secondly, lodgment of the money-creating authority wholly in the Federal Reserve banks, along with expanded authority for the Reserve banks to lend directly to the Government, would permit the Government to finance its residual needs through the Reserve banks and thus by-pass the market. This would violate the basic principle set forth earlier, namely, that direct entry of the Government to the central bank for purposes of meeting fiscal requirements should be severely limited.

In many respects, the question of transferring in whole or in part the money-creating function from the commercial banks to the Federal Reserve banks is actually a question of whether the banking system should be nationalized. When it is said that "the commercial banks do not perform a necessary service in purchasing Government securities," it should be realized that there are many other services that the Government could perform for itself. It could, for example, organize its own construction crews to build the interstate highways, rather than encouraging the States to undertake this work through private contractors; it could establish its own transportation network for carrying mail and other Government property; it could set up manufacturing establishments to produce missiles, airplanes, warships, and a variety of items now purchased from private industry — it could, in short, perform many of the economic functions now performed by the private sector of the economy. The crucial question is, of course, whether it could perform those functions as efficiently as private enterprise and - of prime importance - whether the act of doing so would not ultimately destroy economic and political freedom in our Nation.

(3) A third suggestion for inducing lower interest rates would involve a Congressional directive forcing the Federal Reserve banks to "peg" prices of Government securities at some predetermined level, presumably par. Then, if market holders decided to sell Government securities, purchases by the Federal Reserve banks would provide a floor under which bond prices could not fall (interest rates on Governments could not rise).

The unfortunate experience with this technique between the end of World War II and 1951 should convince serious observers of the dangers involved; the Federal Reserve System could indeed be transformed into an "engine of inflation" rather than a responsible central bank attempting to promote sustainable economic growth. Once market yields on Governments rose to the predetermined levels, the System would be able to operate in only one direction: as a creator of bank reserves, through purchases of the securities, in whatever amounts market holders might desire. Flexible administration of credit policies would be impossible.

The dangers of this course of action, especially during a period of high and rising business activity, are obvious. Nor is it at all certain that, in the long run, the Federal Reserve banks could be successful in keeping interest rates from rising. As inflationary pressures mounted, borrowers of funds would be strongly encouraged to borrow heavily as soon as possible, in order to repay the debts in eroded dollars. Lenders would be encouraged to cut back on lending, realizing that the dollars they received in payment would be worth less in real terms. Consequently, the pressure on interest rates to increase would magnify — borrowers would be willing to pay higher rates, lenders would be willing to lend only at higher rates. In order to stem the tide, the Federal Reserve banks would have to buy more and more Governments from market holders, and thus create even more bank reserves and provide a basis for further inflationary credit expansion. The spiral could ultimately come to a halt only as a result of a crisis and subsequent readjustment.

Some observers point to experience in this country in 1947 and 1948, when the Federal Reserve was indeed pegging prices of Government securities at predetermined levels, as an illustration of an instance in which the consequences were not too bad. But it should be recalled that the Federal Government experienced a total cash surplus of almost $14 billion in calendar years 1947 and 1948. The lesson of that experience is that an inflationary monetary policy can be offset in part by large cash surpluses in Federal fiscal operations; but, if the cash surpluses had not existed, inflationary pressures would have been much more severe than they were. A disastrous spiral might well have occurred. Nowadays, advocates of System pegging of Governments most often do so because of a desire to facilitate easy Federal financing of deficits. The combination of a large Federal deficit and unbridled creation of bank reserves, in a period of high and rising business activity, could only result in the severest type of inflationary pressures, ultimate reaction and recession, and disruption of the process of economic growth.

(4) A fourth alternative that should perhaps be mentioned in passing relates to the apparent preference of some investors to purchase equities rather than debt instruments. To the extent this preference prevails, stock yields tend to be low and bond yields tend to be high. It might be, therefore, that some action which would contribute to a severe break in the stock market would in turn contribute to a shift from stocks to bonds; interest rates would tend to decline.

To suggest that a break in the stock market be induced either through Federal regulation or otherwise would, of course, be irresponsible. Moreover, to the extent that preference for equities over bonds reflects a fear of inflation, the answer to the problem is to remove the bases of the fear of inflation. As stated earlier, this would require, in part, a clear demonstration of the determination of the Government to maintain fiscal and monetary discipline. Conviction on the part of investors that the value of the dollar will be protected would do more than any other single thing to increase the attractiveness of debt instruments and thereby reduce pressures on interest rates.

(5) Inasmuch as Treasury securities occupy an important position in credit markets, interest rates could perhaps be reduced if significant progress were made in retiring part of the public debt. In this respect, there have been several proposals over the past few months to set aside a specified portion of Government revenues each fiscal year; these funds would be earmarked for debt retirement.

During a period of prosperity, retirement of some portion of our huge public debt is certainly desirable; if we cannot achieve some debt reduction when incomes are high and rising, there is serious question as to whether we shall ever be able to do so. Consequently, all proposals to establish a fixed annual percentage of debt retirement should be given serious consideration.

Many of the proposals, however, fail to drive to the heart of the problem, in that no provision is made for assuring that Government

revenues would actually exceed expenditures by an amount large enough to permit the selected percentage of debt retirement. The use of, say, $2.8 billion of tax revenues to effect a 1 percent reduction in the debt would, in the absence of a surplus in the budget, achieve nothing; additional borrowing would be necessary to supplant the tax revenues used for debt retirement. In essence, therefore, the securities retired would be replaced in the market by an equivalent amount of new securities; interest rate pressures would not be reduced. Moreover, total public debt would actually grow, instead of decline, if the revenue-tax relationship continued to reflect an over-all deficit. Again, I should like to repeat that these plans are laudable in purpose; but undue attention to them tends to obscure the hard, basic fact that meaningful debt retirement can be effected only by means of an over-all surplus of budget receipts over expenditures.

(6) There is a sixth and final alternative for reducing pressures on interest rates, although it must be admitted that success in pursuing this sixth course of action would not necessarily result in lower rates. This is because the basic trends in demand and supply in free credit markets reflect the actions of millions of individuals and institutions, and these actions might work toward higher rates even though some of the more significant pressures were reduced.

The sixth alternative can be summarized quite simply, as follows:

(a) Convert the Federal Government from a net borrower to a supplier of funds in credit markets by achieving a surplus in the budget during periods of high and rising business activity. A net

surplus permits the Treasury to retire debt, on balance; consequently, Government actions would result in a net supply of funds available for private borrowers, not a subtraction as is the case when the Federal Government borrows to finance a deficit.

(b) Convince investors that the value of the dollar will be protected, thus removing the pressures for higher interest rates stemming from a conviction that further inflation is likely to occur. This can be done only by means of attention to all of the factors and practices that stimulate inflationary pressures. But it should be re-emphasized that the most important single action would be a clear demonstration of the Government's determination to maintain fiscal and monetary discipline. During periods of high and rising business activity, fiscal and monetary discipline requires a surplus in the budget, for debt retirement, and freedom for Federal Reserve authorities to pursue flexible monetary policies.

(c) Provide the Treasury with sufficient flexibility for sound management of the public debt, so that a better balance in debt structure can be achieved - including larger amounts of longer-term securities outstanding - and so that bond markets will not become unsettled over such things as an impinging interest-rate ceiling. The Government securities market is understandably sensitive to the existence of an artificial interest-rate ceiling; this is one reason why the President has proposed that the 4-1/4 percent limit be removed completely, rather than merely raised. An increase in the limit would only act as a signal to investors that the new ceiling

is the new "normal" level as defined by Government action.

As I emphasized in the main portion of my statement, the interest burden on the public debt - now close to $8 billion - is of deep concern to me. But the alternative to sound fiscal and monetary policies - further shrinkage in the purchasing power of the dollar - concerns me even more. In the long run, no one benefits from inflation; by stimulating the excesses that develop in a period of business expansion, and thus sowing the seeds of readjustment and recession, inflation actually hinders the attainment of a high rate of economic growth. Moreover, inflation strikes hardest at those groups in our society least able to protect themselves. The man of modest means, not the rich man or the large business institution, is the primary victim of a shrinking dollar.

The overriding advantage of this sixth and final approach to reducing pressures on interest rates stems from the fact that the actions it requires would not only be directly beneficial in terms of economic growth, but would also transmit effects through market forces of demand and supply rather than by means of Government decree or regulation. And I would like to repeat that, in proceeding in this way, the Federal Government would be promoting "maximum employment, production, and purchasing power," as required in the Employment Act of 1946, in a manner consistent with those crucially important but often overlooked words in the Act which stipulate that such actions be carried out "in a manner calculated to foster and promote free competitive enterprise and the general welfare."

Statement on Technical Phases
of Proposed Debt Management Legislation
by Secretary of the Treasury Robert B. Anderson
before the House Ways and Means Committee,
10:00 A. M., June 10, 1959

Sections 1 through 3 of the first proposed bill have been discussed in the opening statement; this statement reviews sections 4 through 6.

* * *

Section 4 of the bill would amend section 22 (i) of the Second Liberty Bond Act, as amended (31 U.S.C. 757c(i)), to direct the Secretary of the Treasury to relieve any authorized agent from liability to the United States for a loss incurred in savings bonds redemptions where written notice of liability or potential liability has not been given by the United States to the agent within 10 years after the date of the payment. This limitation would be similar to the limitation upon the time within which the Government may proceed against a person who cashes a Government check upon a forged endorsement. In that case the time limit imposed upon the Government is six years.

Presently the law directs the Secretary to relieve an agent from liability only when he can determine that the loss resulted from no fault or negligence on the agent's part, regardless of the length of time between the date of payment and the date the loss is discovered. In some cases the time lapse may be considerable because the owner of the bonds may not discover their loss or theft until their maturity

or thereabouts, and would have no reason to expect that they might have been fraudulently negotiated. It should be emphasized that this proposed legislation in no way limits the time within which the real owner may make a claim upon a savings bond which was fraudulently negotiated.

Where there is a long lapse of time between the date of the payment and the date the United States discovers it has, or may have, incurred a loss resulting therefrom, it would be extremely difficult for a paying agent to prove that the loss resulted from no fault or negligence on its part. In view of this, as well as the fact that the risks involved arise from the assumption of a task which was urged upon them by the United States and which was not related to the ordinary course of their business, the Treasury Department believes that so-called "qualified" paying agents, that is, commercial, banks, trust companies, savings and loan associations, building and loan associations, and similar financial institutions, should have some limitation upon the time during which they may be liable.

Because they would have the same problem of proof, and for the sake of uniformity and orderly administration, the proposed legislation would give the same immunity to the Treasurer of the United States, the Federal Reserve Banks, and the Post Office Department or the Postal Service, which are also accountable for losses incurred by the United States in savings bond redemptions.

The proposed legislation excludes cases arising under special regulations issued by the Treasury Department which authorize qualified paying agents to pay savings bonds without obtaining the signatures of the owners on the bonds, if the agents unconditionally assume liability to the United States for any loss resulting from such payments. In making payments under these regulations, which paying agents requested for their own and their customers' convenience, they represent that they have the owners' instructions to redeem the bonds, and guarantee the validity of the transactions.

* * *

Section 5 of the bill would amend section 3701 of the Revised Statutes (31 U.S.C. 742) to clarify the exemption it accords to the interest on obligations of the United States from State and local income taxes.

Section 3701 of the Revised Statutes provides that obligations of the United States shall be exempt from taxation by or under State or local authority. The Supreme Court of the United States has held that this provision also exempts the interest on obligations of the United States from taxation by or under State or local authority (N. J. Realty Title Ins. Co. v. Div. of Tax Appeals (1950), 338 U.S. 665).

In recent years the State of Idaho has taken the position that its income tax law enacted in 1933 has required the inclusion of interest on obligations of the United States in computing gross income (from

which taxable net income was determined), and that the Federal statutes have not precluded this requirement. The Idaho statute provided that there shall be levied "upon every individual . . . a tax which shall be according to and measured by his net income." The term "gross income" (from which taxable net income was determined) was defined to include, among other items, "all interest received from federal, state, municipal or other bonds." The law elsewhere provided, however, that "all income, except . . . income not permitted to be taxed under . . . the constitution or laws of the United States, shall be included and considered in determining net income of taxpayers."

It has apparently been the position of the State of Idaho not that the Federal Government is without power to exempt the interest on its obligations from State income taxes, but rather that it has not exempted that interest from a tax such as the Idaho tax.

The reasoning of the Idaho authorities appears to have been as follows: The Federal statute has exempted the interest on Federal obligations from State taxation, and the State tax statute excluded income not permitted to be taxed by the Federal exempting statute, but the Idaho statute did not attempt to tax this income. Rather it carefully provided that there should be levied "upon every individual . . . a tax . . . measured by his net income." Apparently their position has been that this has a different effect from the State statute before 1933, which provided that there should be levied "upon the net income of every individual . . . a tax," which was therefore a tax not permitted under the Federal exempting statute.

The Treasury and the Department of Justice have felt that the position of the State of Idaho rests upon a distinction of words which is without substance. We have not, however, been able to persuade the Idaho authorities to change their position. Since this position does not rest upon a theory of lack of Congressional power to exempt interest on Federal obligations from a tax such as Idaho has had, but rather upon the theory that Congress has not exercised its power, the Treasury and the Department of Justice believe that the simplest resolution of the matter would be through Congressional action which would clarify the exemption by expressly exempting Federal obligations and the interest on them from every form of State and local income taxes. The proposed provision would accomplish that purpose.

It should be mentioned that on March 20, 1959, the State of Idaho adopted a new income tax law. The new law declares it to be its intent to impose a tax identical as far as possible to the income tax imposed by the Federal Internal Revenue Code. Since the Federal Internal Revenue Code imposes a tax "on the taxable income of every individual" it has been suggested that Idaho may no longer attempt to maintain its position that the Federal exemption statute does not extend to its income tax. We have communicated with responsible State authorities, however, and have been unable to obtain assurances that the State will discontinue requiring the inclusion of interest on obligations of the United States in computing State income taxes.

In these circumstances, we believe it to be highly desirable for the Congress to make the exemption statute more specific at this time. If positions such as Idaho has held are adopted by other States the resulting taxation could have a serious adverse effect on the sale of United States savings bonds, which are so widely held by individuals, and could have undesirable effects on Treasury financing operations in general.

* * *

Section 6 of the bill would authorize the issuance of obligations of the United States to Government trust funds at the issue price. The Congress has established some fifty Government trust funds. Portions of any of these funds not currently needed may be invested in obligations of the United States. With respect to six of these trust funds, however, the Congress has specified that Government obligations may be acquired on original issue only at par. Thus in the Act of August 14, 1935, establishing the Unemployment Trust Fund, it was provided that "such obligations may be acquired (1) on original issue at par, or (2) by purchase of outstanding obligations at the market price." Substantially identical language has been used in four other provisions dealing with five other trust funds. The trust funds and the citations to the pertinent provisions governing them are: Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund (42 U.S.C. 401(d)); the Railroad Retirement Account (45 U.S.C. 228o(b)); the special trust account for the payment of bonds of the

Philippines (22 U.S.C. 1393(g)(5)); and the Highway Trust Fund (23 U.S.C. 173(e)(2)). The reason for providing in these relatively few cases that acquisition on original issue must be at par is not known.

When the first of these provisions was enacted in 1935 the Treasury could not issue interest-bearing bonds at a discount. In 1942 the law was amended to permit issuance at a discount, but none were issued in this manner before last November. Therefore the requirement that obligations be acquired on original issue only at par has not created a problem until recently. With the possibility of more obligations being issued at a discount or at a premium in the future, however, the requirement that these six trust funds acquire obligations on original issue only at par is highly discriminatory against them. For example, the Treasury recently issued 4% bonds of 1980 at 99; the public could subscribe for these bonds at 99 and any of the trust funds other than these six could acquire them at 99, but the law prohibited any of these six trust funds from acquiring them on original issue except at 100. If the Secretary of the Treasury had issued these bonds at par on original issue for account of these funds, they would have earned interest at a lower effective rate than any of the other trust funds or any member of the public acquiring them on original issue.

There does not appear to be any sound reason for this result. It has therefore been recommended that these provisions of law be amended to authorize these trust funds to acquire obligations of the United States on original issue at the issue price, which is the price the other trust funds or the public would pay.

Draft of June 8
For Official Use Only

Supplemental Statement on Public Debt Management
by Secretary of the Treasury Robert B. Anderson before the
House Ways and Means Committee,
10:00 A.M., June 10, 1959

INTEREST RATES IN A FREE MARKET ECONOMY

As I observed in the main portion of my statement before this committee, popular discussion of interest rates is often clouded by misunderstanding of their nature in a free market economy. The purpose of this supplementary statement is to discuss in some detail the nature of interest rates - particularly the factors that cause them to rise or fall; the reasons for the increase in rates since last summer; and several alternative courses of action that might be effective in inducing a lower level of interest rates.

Demand and Supply in Credit Markets

Speaking broadly, the interest rate is nothing more nor less than a price, namely, the price of borrowed money. As a price, the rate reacts to the same sort of influences as other prices in a free market economy - influences that operate through the demand for and supply of funds available in credit markets. Just as an increase in the demand for goods or services tends to increase the prices of these items, so does an increase in the demand for funds tend to increase interest rates. And an increase in the supply of funds available in credit markets has the same basic effect as an increase in the supply of any good or service in any market; price tends to fall. This is true under our present market arrangements; it will remain true so long as credit markets remain free and borrowers and lenders are permitted to manage their affairs with a minimum of interference and regulation.

From the side of demand, the principal impact on interest rates reflects the actions of four groups of borrowers: individuals, corporations, State and local governmental units, and the Federal Government. As is shown in the chart, total indebtedness of these borrowers has

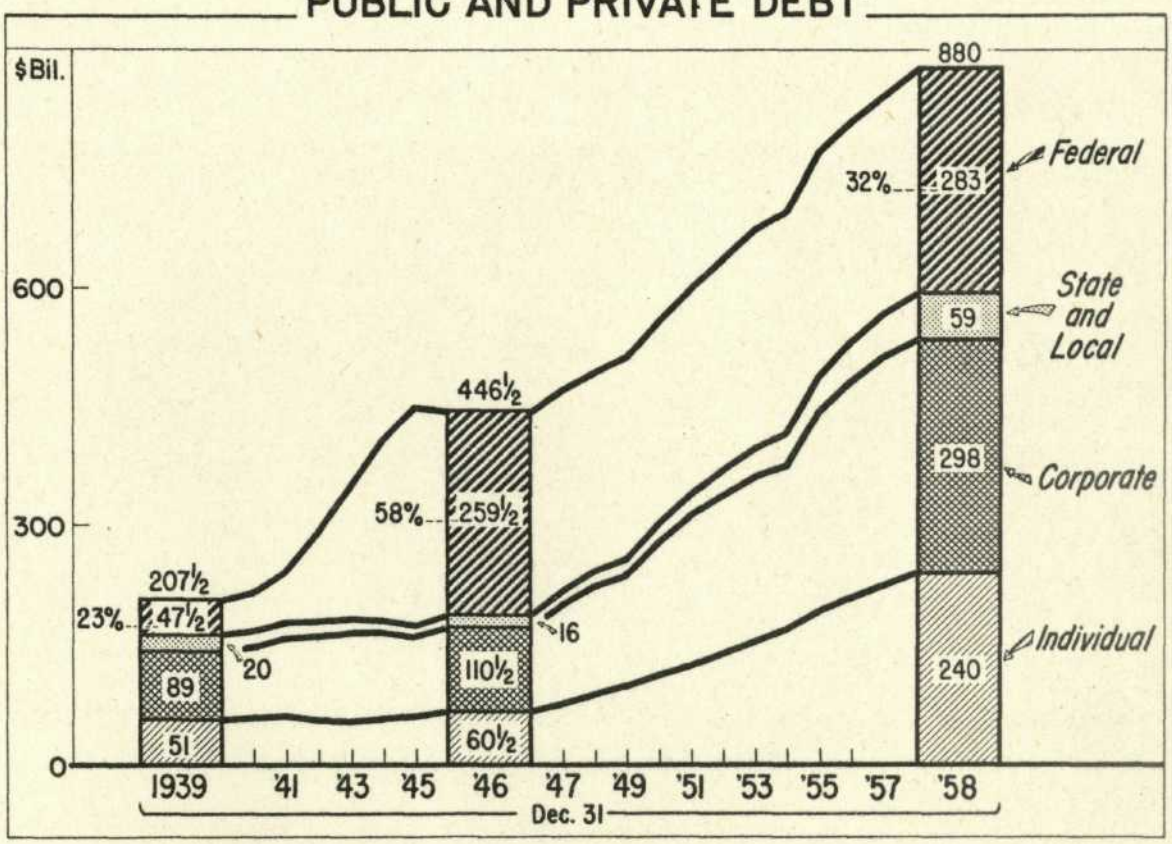
(Chart A)

expanded by $433\frac{1}{2}$ billion - almost doubling - since 1946.

Individuals, borrowing to finance purchases of a variety of goods and services and to construct or purchase homes, increased their gross indebtedness from ~~$162\frac{1}{2}$~~ $160 billion to $240 billion between 1946 and 1958. The gross debt of business corporations, which seek credit to finance

Chart - A

PUBLIC AND PRIVATE DEBT*



*Gross debt.

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working capital needs and for longer-run purposes in expanding and modernizing plant and equipment, rose from $110½ billion to $298 billion. State and local governmental units, confronted with growing needs for schools, highways and streets, and a variety of other facilities, have borrowed heavily in the postwar period; their gross debt expanded from $16 billion in 1946 to $59 billion in 1958. The Federal Government, the fourth principal borrower in credit markets, seeks funds to meet seasonal needs and to finance a deficit. The public debt increased from $259½ billion in 1946 to $283 billion in 1958. As of the end of June, the debt is expected to total $285 billion.

The postwar pressure on interest rates arising from the demand for credit is apparent. Concomitant with the large expansion in demand, however, has been a growth in the supply of funds available in credit markets. These funds come ultimately from two sources: savings or money creation. It makes little difference to the borrower whether the ultimate source is one or the other; dollars flowing out of money creation are fully as spendable as those made available from savings. The ultimate source may be of crucial importance from the standpoint of achieving sustainable economic growth, however, simply because dollars generated through money creation represent an increase in the total pool of dollars available for spending and, if not matched by a more or less equal increase in output of goods and services, tend to force prices up. It is no accident that consumer and wholesale prices have more than doubled during the past twenty years, in view of the fact that a

fourfold increase in the active money supply was only partly matched by an approximate doubling of real production of goods and services.

There is no need to go in detail into the various forms of saving - by individuals, business firms, and governmental units - or to differentiate sharply between funds flowing from current saving and those that represent savings of earlier years that subsequently are made available to borrowers. The really important point relates to the distinction between funds obtained from existing pools of dollars and those generated by money creation.

How does money creation take place? Largely through the lending and investing activities of the more than 13,000 commercial banks in this country. Suppose that John Doe desires funds for use in his business, or to improve his home, or to meet medical or other expenses. And suppose that he applies for a loan from a commercial bank to obtain the funds. If the loan is granted, John Doe simply signs his promissory note and acquires a credit to his deposit account in the bank. This transaction represents no transfer of existing dollars; quite the contrary, John Doe has an extra $100, $1,000, or $10,000, depending on the amount of the loan, but no other individual or institution has any less money. Money creation has indeed taken place. Moreover, not only John Doe, but thousands of business firms, many State and local governmental units, and the Federal Government also borrow, directly or indirectly, from commercial

banks. Each bank credit extension of this type which is not offset by a reduction in other bank loans or investments results in an equivalent amount of new money creation.

Do commercial banks have unlimited ability to create money in this fashion? Not by any means. People borrow money primarily in order to spend, and the banker who makes such loans knows that within a relatively short period of time the newly created deposit will probably be withdrawn from his bank. This will probably take the form of a transfer to another bank, perhaps in the same city, perhaps somewhere else in the Nation. But, the important point is that the banker must be able to meet a drain of cash out of his bank; and his ability to do so depends on his cash reserve position. In other words, he cannot afford to make large extensions of credit unless he has extra cash on hand (or on deposit with his Federal Reserve Bank) to meet the resulting drains, or unless he is in a position to obtain additional cash as the drains take place.

This is where the Federal Reserve System comes into the picture. Through various devices which need not be discussed here (e.g., discount policy, open market operations, and control over member banks' reserve requirements), Federal Reserve authorities can influence the cost and availability of bank cash reserves. In so doing, the willingness and ability of the more than 13,000 commercial banks to make new loans and investments - and thus add to the flow of funds available in credit markets - is very much affected.

The resiliency of bank credit expansion and contraction can serve as an important balancing wheel in credit markets - or, it can operate as a serious destabilizing factor in our attempts to achieve a stable price structure and relatively full and efficient use of our economic resources. The critical question is, of course, the rate at which bank deposits come into or go out of existence. During a period of high and rising business activity, when credit demands are especially strong, and men, machines and materials are being used close to capacity, an excessive amount of money creation tends to add to inflationary pressures. Spending may expand rapidly but, with resources in relatively full use, the volume of goods and services that can be produced can only be increased slowly. Inflation is the result. And judging by past experience, an inflationary upsurge is likely to be followed by readjustment and recession, so that our end objective of achieving maximum economic growth is actually impeded. Recession is the number one enemy of economic growth.

Since recession is in fact the primary deterrent to sustained economic growth, bank credit expansion may be desirable when economic activity is lagging. Under these conditions, the men, machines and materials necessary to support increases in production are available. Greater spending is to be desired.

Consequently, sustained and rewarding economic growth - which requires reasonable price stability and relatively full and efficient

use of our economic resources - can be attained only if the aggregate flow of credit is consistent with the ability of the economy to absorb that flow, when translated into spending, at a given time. And, the Federal Reserve System, in fulfilling its statutory obligations, is constrained to employ its monetary powers flexibly. In a free market economy, an inevitable result of the interaction of demand and supply forces in credit markets - including the impact of Federal Reserve actions - is fluctuations in interest rates.

Stated simply, flexible credit policies, attuned to the business situation as it unfolds over time, can be effective only if interest rates are free to respond to the forces of demand and supply in credit markets. But it must be emphasized that the major forces affecting those rates stem from actions of free and independent lenders of funds. The law of supply and demand is a powerful and inescapable economic force; attempts to thwart it in the past have inevitably led to greater difficulties later on.

At times interest rates seem to decline faster than might be expected in view of basic trends in credit demands, savings, and the availability of bank credit. At other times they seem to rise faster than might seem warranted in view of these forces. For example, the sharp decline in rates in late 1957 and early 1958 seemed to outrun basic forces of demand and supply, and the same can be said of the sharp increase in rates in the summer of 1958.

The explanation of such sharp shifts can be found primarily in the impact of expectations on credit markets. In late 1957 it became clear that recessionary forces were gathering strength. The Federal Reserve System, consistent with its responsibility to conduct its operations flexibly, shifted from the restrictive policy of the preceding 2½ years toward a policy of monetary ease. In view of the shift in the business situation, which implied a slackening demand for funds in credit markets, and in view of the reversal of Federal Reserve policy, which implied an increase in availability of bank credit, market participants reasoned that the uptrend in interest rates that had prevailed since 1954 would be reversed, and that the outlook for some time to come was for declining rates.

Declining interest rates are synonymous with rising prices for outstanding Government and other types of bonds. Consequently, individuals and institutions with funds to invest tended to step up purchases of such instruments - the supply of funds available in credit markets expanded sharply; and individuals and institutions with bonds for sale became more reluctant to part with them - the demand for funds subsided, relatively speaking. The result: sharp declines in interest rates (or increases in bond prices), stimulated largely by expectations of lagging business and easy money.

The decline in business activity came to an end much sooner than many observers anticipated. In June 1958, the strengthening business picture gave rise to rumors that Federal Reserve policy might be in the process of shifting away from the aggressively expansive policies of preceding months. Many investors in debt instruments, including Government bonds, became anxious to dispose of the securities before interest rates rose and bond prices declined; potential buyers became less anxious to buy. The result: sharp increases in interest rates, stimulated largely by expectations.

Thus, one type of expectation is related primarily to the swings in business activity and the impact of flexible monetary policies. But at times other types of expectations exert important influences. During the past year, the increase in interest rates has been stimulated partly by a growing - but, in my judgment, mistaken - conviction that inflation is inevitable. Many investors have been reluctant to purchase debt instruments, which carry a fixed interest return and principal payment, as opposed to equities. This reluctance to purchase bonds, and the preference for equities, has contributed to relatively low bond prices (high interest rates) and high stock prices.

It is important to emphasize, however, that effects of expectations are likely to be short-lived, unless later ratified by the expected events. The sharp decline in interest rates in late 1957 and early 1958 could not have been sustained had it not been for the fact that recession did occur, credit demands did subside, and monetary policy did assume a posture of aggressive ease. Again, the sharp rise of last summer was later ratified, in part, by the vigorous expansion of business activity, with the accompanying demands for credit, and the impact of a $13 billion Federal deficit on credit markets. Finally, the impact of inflationary expectations on the level of interest rates can be minimized only when it becomes clear to participants in free credit markets that the integrity of the dollar will be preserved.

In summary, interest rates in a free market economy are influenced by a number of factors, all of which operate through the demand for and supply of funds in credit markets.

Before examining the reasons for the rise in interest rates in this country since last summer, it might be worthwhile to discuss briefly two popularly held views concerning the nature of interest rates that, in my judgment, are mistaken.

One often hears the statement that increases in interest rates are inflationary, in that interest is a cost of doing business and sellers of goods tend to pass on rate increases in the form of higher prices. The people who hold this view overlook the fact that rising interest rates are indicative of pressures in credit markets growing out of strong demands for funds relative to a restricted supply. Inasmuch as individuals and institutions borrow money primarily to facilitate spending, rising interest rates reflect an inability of all potential borrowers to obtain as much credit as they would like to have. In other words, spending is impeded, and the rise in interest rates is one measure of the degree of restriction on spending. And, anything that tends to dampen spending when business activity is high and rising tends to diminish - not to augment - inflationary pressures.

Moreover, available figures indicate clearly that interest, as a cost of doing business, is a decidedly minor expense. In 1957, for example, net interest costs of all manufacturing corporations were less than 1/3 of 1 percent of gross sales. Thus, if the cost of an article selling for $100, less than 33 cents represented interest cost. Admittedly, interest expenses of wholesalers and retailers, who also must finance some of their operations by borrowing, would add slightly to total interest cost included in items bought by final consumers. Still, however, the contribution of interest expense to total cost would be negligible.

It has been suggested that public utility rates are influenced significantly by interest costs, since such firms rely heavily on bonded indebtedness. In this case, however, net interest expense is estimated to be less than 4 percent of gross revenues. Similarly, the Department of Agriculture estimates that only 5 percent of farmers' costs reflect interest payments.

The evidence seems clear that an increase in interest rates could exert only a minor direct effect on prices of goods and services, and that this impact is far outweighed by the restrictions on total spending stemming from limited availability of funds in credit markets.

There is also a misconception concerning the identity of the recipients of interest payments on the Federal debt. Some observers appear to believe that large financial institutions are not only the major recipients of such payments, but that their share has increased as interest rates have advanced in the postwar years.

The accompanying table, which presents estimates of the distribution of interest payments on the public debt in 1946 and 1958, indicates clearly that such is not the case. In 1946, the major financial institutions - commercial banks, mutual savings banks, and insurance companies - received an estimated $2.1 billion in interest on holdings of Government securities, or about 45 percent of the total of such payments. By 1958, the share of these institutions had declined to $2.0 billion, representing only 26 percent of total payments. Moreover, a significant portion of the interest income of banks has been passed on to customers in the form of higher rates on time and savings deposits.

Estimated Distribution of the Interest on the Public Debt
Fiscal Years 1946 and 1958

(In billions of dollars)

	Budget Expenditures	
	1946	1958
Investor classes:		
Individuals:		
Savings bonds	.7	1.5
Other securities	.5	.4
Subtotal	1.2	1.9
Commercial banks	1.4	1.5
Mutual savings banks	.2	.2
Insurance companies	.5	.3
Nonfinancial corporations	.2	.6
State and local governments	.2	.4
Miscellaneous investors	.2	.4
Federal Reserve banks	.1	.8
Government Investment Accounts	.7	1.5
Total	4.7	7.6

Office of the Secretary of the Treasury
Debt Analysis Staff

June 5, 1959

Other important trends brought out by the table include an $800-million increase in interest payments on savings bonds; a $700-million expansion in payments to Federal Reserve banks, of which almost 90-percent is returned to the Treasury in taxes; and an $800-million increase in payments to Government investment accounts, which are operated almost wholly for the benefit of individuals.

These figures seem to indicate, therefore, that a substantial portion of payments on the debt accrue directly or indirectly to the benefit of individuals, many of whom are of relatively modest means. Moreover, the increase in interest payments since 1946 reflects increased payments primarily to individuals, Federal Reserve banks, and Government investment accounts.

The Rise in Interest Rates Since Last Summer

Trends in interest rates over a period of several years, or of several months, can be understood only in terms of the major demand and supply forces at work. Accordingly, it might be worth while to examine closely the increase in rates that has occurred during the current fiscal year in order to gain an understanding of the factors underlying the advance.

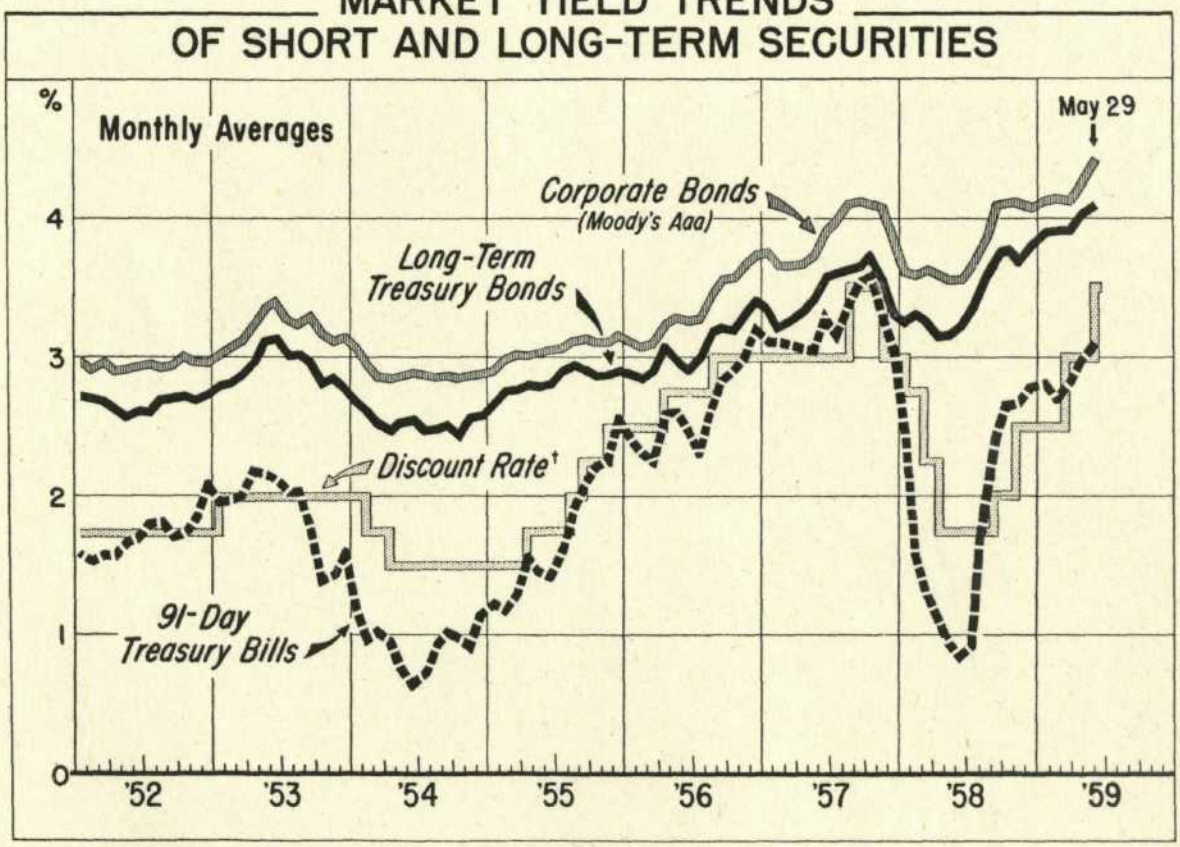
Interest rates on Treasury and other securities have risen considerably from the lows reached during the recession of 1957-58. Yields on long-term Treasury bonds, which averaged 3.12 percent in April 1958, had risen to an average of 4.08 percent in May 1959. Average issuing rates on 3-month Treasury bills, which fell below 1 percent in the spring and summer of 1958, have recently risen above 3 percent. Similarly, rates on commercial paper, bankers' acceptances, corporate and municipal bonds, and other debt instruments have risen substantially during the past year. During the past month, the prime lending rate of leading commercial banks has been increased to 4½ percent, a full point higher than the rate prevailing a year ago.

(CHART B)

What factors lie behind this rise in rates? First, let's look at the demand for credit.

Chart-B

MARKET YIELD TRENDS OF SHORT AND LONG-TERM SECURITIES



†Federal Reserve Bank of New York.

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The growth of consumer credit in the current fiscal year has been less than in most recent years. Thus, pressure on interest rates from this source has been moderate, except for the past few months, in which demand for consumer credit has risen substantially. As is indicated in the chart, however, individuals have indeed been

(CHART C)

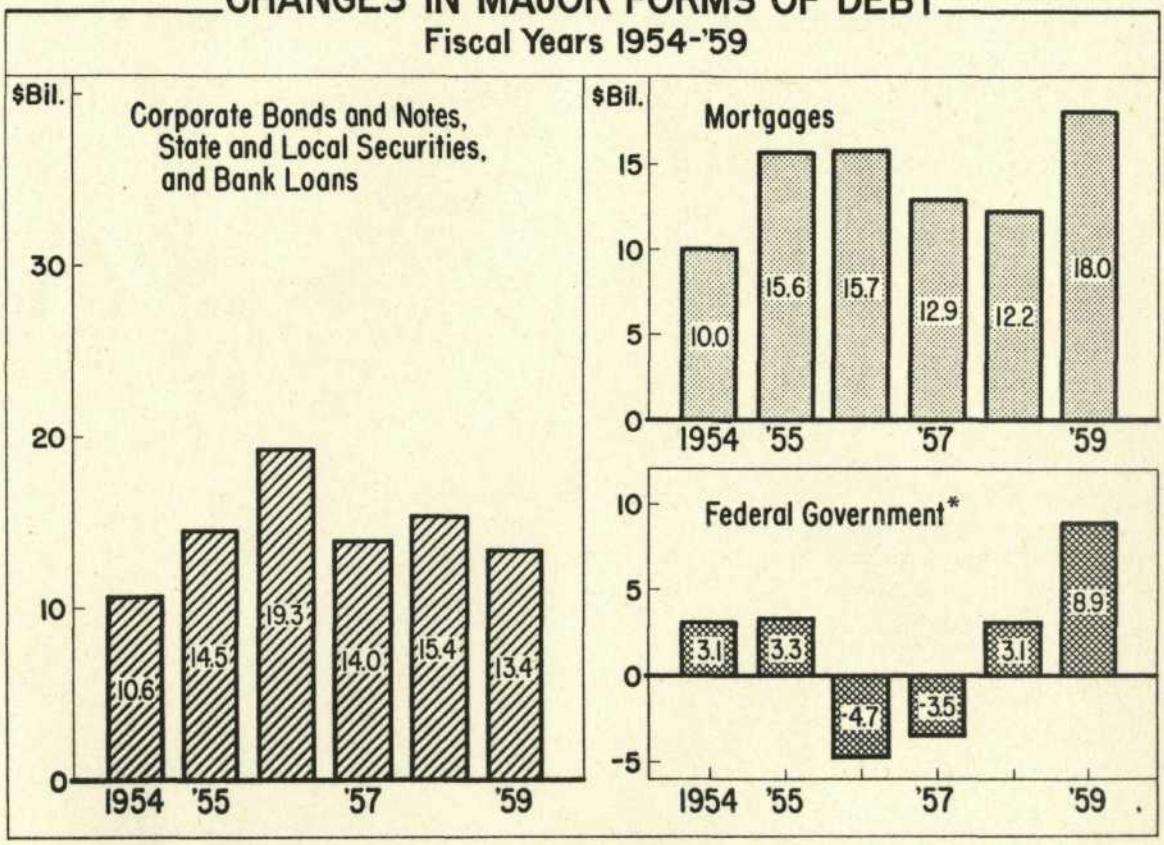
active borrowers of funds, primarily in the form of mortgage credit. Total real estate mortgages, consisting largely of individuals' borrowings, are expected to increase $18 billion this fiscal year, a greater rise than in any of the past five fiscal years. This sharp increase can be viewed as having contributed significantly to demand pressures in credit markets.

Total business financing, as reflected in bank loans and securities flotations, has been moderate, in comparison with past years. Thus, business demand for funds has not exerted undue pressure on financial markets. Moreover, net borrowings of state and local governmental units, while at a high level, are about the same as in earlier years.

Chart-C

CHANGES IN MAJOR FORMS OF DEBT

Fiscal Years 1954-'59



*Excluding debt held by Federal Reserve Banks and Government Investment Accounts.

Office of the Secretary of the Treasury

B-1377

The demand for credit on the part of the Federal Government, to finance a record peacetime deficit of approximately $13 billion, has been much greater than in any of the preceding five fiscal years. The publicly held Federal debt will increase by almost $9 billion in this fiscal year, as contrasted with increases of between $3 and $3½ billion in 1954, 1955, and 1958, and declines of $3 to $5 billion in 1956 and 1957. (The difference between the $13-billion deficit and the $9-billion increase in Federal debt in this fiscal year results primarily from a reduction in the Treasury's cash balance during the year.)

These figures demonstrate clearly that the major demand pressures on interest rates during the past year have stemmed from the sharp increase in mortgage debt and the record peacetime Federal deficit. However, the increase in mortgage debt is not much greater than in fiscal years 1955 and 1956. Thus, it appears that the single most important factor contributing to the sharply rising demand for credit in fiscal 1959 has been the record peacetime Federal deficit. The addition of almost $9 billion in Federal securities to what might be viewed as more or less normal aggregate credit demands could only have been expected to exert strong pressure on interest rates.

As I noted earlier, however, trends in interest rates are also influenced by forces working through the supply of funds available in credit markets. While data on savings are difficult to interpret in terms of impact on credit markets, there appears to be no evidence that a shortage of financial savings has contributed significantly to the rise in rates during the past year. Moreover, the statistical evidence does not support the view that the shift in rates last June resulted from a reversal of Federal Reserve credit policies, nor that credit policies since that time have impinged strongly on the supply of credit.

As to the timing of the events in the summer of 1958, it is important to note that member bank reserve positions and short-term money market rates reflected a continuation of monetary ease until August - a full two months following the reversal of market rates on intermediate- and longer-term Government bonds. Thus, the market appears to have led monetary policy and, as stated earlier, the market shift resulted primarily from radical changes in expectations. The shift in expectations resulted, in turn, from: (1) a growing comprehension that the recession had ended and that vigorous recovery was under way, with its consequent impact on demand for credit; (2) a belief that Federal Reserve credit policies, in view of the shift in the business situation, would move toward restraint in keeping with the requirements of flexible administration of such policies; (3) a realization that in fiscal year 1959 the Federal Government would be confronted with a deficit of $10 to $15 billion, with its consequent impact on demand for credit; and (4) a growing conviction on the part of investors that further inflation would probably occur,

stemming from the rigidity of prices during the recession, the impact of business recovery, and the inflationary ramifications of a record peacetime deficit during a period of rising business activity. In addition, market pressures were increased significantly by liquidation of heavy speculative holdings of Government and other securities, built up earlier in the year and in June, sometimes on relatively thin margins.

It should be emphasized again, however, that the increases in rates arising from expectations could not have been sustained had not the expectations later been ratified. And most of them were indeed ratified. Business activity has expanded vigorously; a $13 billion deficit was confirmed by official sources; and System credit policy did shift away from the strongly expansive policies of early 1958. The expectation of continuing inflation has not been confirmed; whether or not it will be depends in no small measure on the degree of fiscal and monetary discipline that is maintained during this period of high and rising business activity.

Furthermore, the available evidence points only to a mild degree of credit restraint since last summer. For one thing, the strong upward trend in production, employment, and income with, as yet, absence of strong inflationary pressures, indicates that credit has been sufficiently available to meet the needs of the economy. Moreover,

monetary growth since last summer, as measured by the annual rate of expansion in the seasonally adjusted money supply, has been at least equal to and perhaps slightly greater than what is usually thought of as a normal rate.

All things considered, it seems to me clear that the major factor contributing to the rise in interest rates during the past year has been the $13 billion Federal deficit. It has exerted a twofold impact: first, by stimulating expectations in the summer of 1958 of strong credit demands and further erosion in the value of the dollar; and, second, by adding almost $9 billion in Federal securities to the demand side of credit markets.

Alternative Courses of Action that Might Induce Lower Interest Rates

What courses of action, open to Congress, the Executive Branch, or the Federal Reserve System, might be successful in inducing lower interest rates? It must be emphasized that any such actions, to be effective without leading to later difficulties, must operate through the basic forces of demand and supply. As I stated earlier, the law of supply and demand is a powerful economic force. Any attempt to hold interest rates to artificially low levels would be doomed to ultimate failure unless appropriate steps were taken to adjust demand and supply forces consistent with the selected level of rates. And even then, later difficulties may well arise. The situation is parallel to attempts to maintain price ceilings on goods and services during national emergencies; prices can be prevented from rising, if inflationary pressures are strong, only through resort to rationing, allocation of materials and labor, and so on. Similarly, interest rates can be kept from responding to the forces of demand and supply only through direct intervention in credit markets and a consequent abridgement of economic freedom.

It is therefore assumed that any courses of action to be considered would involve influencing demand and supply. With this stipulation accepted, six alternatives might be mentioned.

(1) One approach would be for the Government, through various means, to promote recessionary pressures in the economy. Interest rates commonly decline during recessions, partly because of a slackening demand for funds on the part of individuals and businesses, partly because of a relative increase in availability of financial savings, and partly because of greater availability of bank credit in connection with a flexible shift of monetary policy toward credit ease.

This first alternative is, of course, absurd; no responsible government would attempt to induce recession - with its accompanying loss of production and rise in unemployment - simply to promote lower rates of interest. But the introduction of this alternative highlights the fact that high and rising interest rates are a sign of expanding business. For a responsible government, the choice between high levels of business activity and employment as opposed to low interest rates is actually no choice at all. Stated differently, high interest rates are not necessarily an end in themselves; rather they are the usual accompaniment of the active credit demands that characterize expansion in production, employment, and income.

(2) It has been suggested that interest rates could be reduced if the Federal Reserve banks were directed by Congress to

purchase all new issues of Government securities; this would tend to reduce pressures on interest rates, since the Federal Reserve banks would in effect create the funds necessary for the purchase of the securities. The actual process would involve credit to the Treasury's deposit balance in Federal Reserve banks in return for the newly issued Government securities.

There are at least two serious objections to this course of action. In the first place, the prohibition of direct sales of securities by the Treasury to the central bank, except under unusual and very limited circumstances, has been an important characteristic of our financial mechanism ever since the establishment of the Federal Reserve System in 1913. The Federal Reserve banks were envisaged, by the framers of the Act, as fiscal agents for the Government -- to hold Treasury working balances; to clear Treasury checks; to issue, redeem and pay interest on Government securities; and so on -- not as a source of credit to finance the Government's needs. Experience in a number of foreign countries has demonstrated the dangers of easy access to central bank credit on the part of the branch of Government that has the responsibility for financing the Government's requirements. Fiscal discipline is especially difficult to preserve if the exchequer has, in effect, a "blank check" on the money-creating authority.

A second major objection to sale of new Treasury issues directly to the Federal Reserve banks arises from the fact that the transaction would provide the basis for a highly inflationary expansion of the money supply. The recipients of Treasury checks drawn on the newly created deposits at the Reserve banks would deposit most of the proceeds in Federal Reserve member banks, and the member banks in turn would send the checks to their District Reserve banks for payment. Payment would be effected in the usual way, by crediting - or increasing - the reserve balances of the banks on the books of the Reserve banks. Bank reserves would be increased by the amount of the credits; this would provide a basis for additional lending and investing by the banking system by an amount equal to about six times the increase in reserve balances. Growth in the money supply would, therefore, be strongly stimulated. Interest rate pressures would have been restrained only at the cost of highly inflationary increases in bank credit and the money supply. Moreover, as I pointed out in the main portion of my statement, strong inflationary pressures tend to promote even higher levels of interest rates.

Recognizing the objection that large-scale purchases of Government securities by the Federal Reserve banks would be highly inflationary, advocates of this course of action sometimes maintain that the inflationary growth in the money supply could be avoided simply by raising member bank reserve requirements. In other words, the new reserves created by the Federal Reserve purchases would be immobilized immediately by

increasing the percentages of idle funds that member banks must hold in relation to deposits.

There is an important practical objection to this proposal. The purchase of, say, $5 billion of new Governments by the Federal Reserve banks would result in the creation of $5 billion in new bank reserves, but these reserves would flow into the banking system, and be disseminated among individual banks, in accordance with market forces. No one could predict the ultimate distribution of the new reserves in advance. Some banks would receive a large portion, some a smaller portion; the ultimate distribution would depend primarily upon the location of the individuals and institutions who received the Government payments financed by the deficit borrowing.

An increase in member bank reserve requirements, however, affects all banks in a given classification (central reserve city, reserve city, and "country") equally in terms of percentage points of reserve requirements. Consequently, a blanket increase in reserve requirements of the magnitude required to neutralize the reserve-creating impact of large-scale Federal Reserve purchases of Governments might well lead to severe dislocations and disturbances in credit markets. Some banks would have ample reserves, others would find themselves

severely pinches. It can be argued that market forces would tend to correct these imbalances, and they would -- over time. But in the short run, forces might well be set in motion leading to abrupt swings in interest rates and availability of credit; credit "droughts" in one part of the country and "surpluses" in another; and so on. And, in any event, the credit market, while efficient, by no means operates perfectly in transferring funds from areas of plenty to areas of shortage.

To this important practical objection against selling Government securities to the Reserve banks and then offsetting the inflationary impact by raising member bank reserve requirements can be added a more basic objection, if it is assumed that one purpose of the action would be to prevent interest rates from rising. As I noted earlier, purchases of $5 billion of Federal securities by the Reserve banks would result in an equivalent increase in the money supply as the recipients of the checks deposited the proceeds in their commercial banks. In the first instance, then, there would be an important inflationary impact, resulting from the spending of the funds by the Government and the expansion in the money supply. An increase in reserve requirements could indeed nullify the growth in the money supply, but only by forcing commercial banks to restrict their lending and investing activities, largely to private borrowers in business and agriculture, and to consumers. If the full impact of growth in money supply stemming from the sales of Governments to Reserve

banks were to be offset, interest rates would tend to rise. An increase in reserve requirements can be effective in restraining growth in the money supply only if it restricts credit; in a free credit market, such restriction exerts pressure on interest rates. Thus, during a period of active business and a growing demand for credit, the choice is between a somewhat higher level of interest rates, on the one hand, and, on the other hand, stimulation of inflationary pressures. There are no other alternatives.

The recommendation that Federal Reserve banks buy all or substantial portions of new issues of Treasury securities involves one other aspect that deserves discussion. Specifically, it has been recommended that the Federal Reserve banks be required to purchase only that portion of a new issue that investors other than commercial banks would not purchase; thus, the Reserve banks, in effect, would replace commercial banks as buyers of Governments. This recommendation is based partly upon the assumption that commercial banks "perform no necessary service whatever in buying Government securities." Their ability to create money, it is maintained, permits them to buy these securities; but in fact the authority over money creation is constitutionally vested in Congress. Thus, it is argued that the Government should perform this function, through the Federal Reserve banks, without burdening taxpayers with interest charges.

This argument deserves several comments. In the first place, as noted earlier, purchases of Government securities directly by Federal Reserve banks would be highly inflationary. Secondly, whether or not the commercial banks perform a "necessary" service in creating money, there is little doubt that they perform an economic function. Demand deposits in commercial banks have assumed a monetary function simply because people prefer to hold funds and make payments in that form, rather than in the form of currency. Moreover, money is essential to efficient performance of a highly industrialized market economy and, if the commercial banks did not perform the money-creating function, some other institution or agency would have to do so.

Furthermore, commercial banks do indeed perform a useful service in purchasing and holding Government securities. The business of commercial banking, in essence, is that of holding relatively illiquid assets - principally loans and investments - against liabilities that are largely redeemable on demand. This involves risk and, in assuming that risk, stockholders of commercial banks are entitled to a return for a service performed. The fact that an asset is a Government security rather than a commercial loan is not germane; marketable Government securities, while devoid of risk relating to interest and principal payments, do possess risk as to the price at which they can be sold in the market. Because of the nature of their liabilities, banks must be prepared -- and at times may be compelled -- to liquidate assets in order to meet deposit drains. They are therefore providing an

economic service by holding illiquid assets which the public does not desire to hold at the time, and in return furnishing the public with the liquidity -- or money -- that it desires.

There are at least two important reasons why the money-creating function should not be assigned wholly to the Federal Reserve banks. In the first place, under our institutional arrangements the money-creating function is closely allied with that of granting credit to a wide variety of borrowers. It is a cardinal principle of our type of government that private institutions should dominate credit-granting activities; otherwise, the ability to obtain credit might rest less on credit-worthiness and more on noneconomic factors.

Secondly, lodgment of the money-creating authority solely in the Federal Reserve banks would permit the Government to finance its residual needs through the Reserve banks rather than, as is now the case, through the market. This would violate the basic principle set forth earlier, namely, that direct entry of the Government to the central bank for purposes of meeting fiscal requirements should be severely limited.

In many respects, the question of transferring in whole or in part the money-creating function from the commercial banks to the Federal Reserve banks is actually a question of whether the banking system should be nationalized. When it is said that "the commercial banks perform no necessary service whatever in buying Government securities," it should be realized that there are many other services that the Government could perform for itself. It could, for example, organize

its own construction crews to build the interstate highways, rather than utilizing private contractors; it could establish its own transportation network for carrying mail and other Government property; it could set up manufacturing establishments to produce missiles, airplanes, warships, and a variety of items now purchased from private industry -- it could, in short, perform any economic function now performed by the private sector of the economy. The crucial question is, of course, whether it could perform those functions as efficiently as private enterprise and - of prime importance - whether the act of doing so would ultimately destroy economic and political freedom in our Nation.

(3) A third suggestion for inducing lower interest rates would involve a Congressional directive forcing the Federal Reserve banks to "peg" prices of Government securities at some predetermined level, presumably par. Then, if market holders decided to sell Government securities, purchases by the Federal Reserve banks would provide a floor under which bond prices could not fall (interest rates on Governments could not rise).

The unfortunate experience with this technique between the end of World War II and 1951 should convince serious observers of the dangers involved; the Federal Reserve System could indeed be transformed into an "engine of inflation" rather than a responsible central bank attempting to promote sustainable economic growth. Once market yields on Government rose to the predetermined levels, the System would be able to operate in only one direction: as a creator of bank reserves, through purchases of the securities, in whatever amounts market holders might desire. Flexible administration of credit policies would be impossible.

The dangers of this course of action, especially during a period of high and rising business activity, are obvious. Nor is it at all certain that, in the long run, the Federal Reserve banks could be successful in keeping interest rates from rising. As inflationary pressures mounted, borrowers of funds would be strongly encouraged to borrow heavily as soon as possible, in order to repay the debts in eroded dollars. Lenders would be encouraged to cut back on lending, realizing that the dollars they received in payment would be worth less in real terms. Consequently, the pressure on interest rates to increase would magnify -- borrowers would be willing to pay higher rates, lenders would be willing to lend only at higher rates. In order to stem the tide, the Federal Reserve banks would have to buy more and more Governments from market holders, and thus create even more bank reserves and provide a basis for further inflationary credit expansion. The spiral could ultimately come to a halt only as a result of a crisis and subsequent readjustment.

Some observers point to experience in this country in 1947 and 1948, when the Federal Reserve was indeed pegging prices of Government securities at predetermined levels, as an illustration of an instance in which the consequences were not too bad. But it should be recalled that the Federal Government experienced a total cash surplus of almost $14 billion in calendar years 1947 and 1948.

The lesson of that experience is that an inflationary monetary policy can be offset in part by large fiscal cash surpluses; but, if the cash surpluses had not existed, inflationary pressures would have been much more severe than they were. A disastrous spiral might well have occurred. Nowadays, advocates of System pegging of Governments most often do so because of a desire to facilitate easy Federal financing of deficits. The combination of a large Federal deficit and unbridled creation of bank reserves, in a period of high and rising business activity, could only result in the severest type of inflationary pressures, ultimate reaction and recession, and disruption of the process of economic growth.

(4) A fourth alternative that should perhaps be mentioned in passing relates to the public's preference for investment in equities as opposed to debt instruments. To the extent this preference prevails, stock yields tend to be low and bond yields tend to be high. It might be, therefore, that some action which would contribute to a severe break in the stock market would in turn contribute to a shift from stocks to bonds; interest rates would tend to decline.

To suggest that a break in the stock market be induced either through Federal regulation or otherwise would, of course, be irresponsible. Moreover, to the extent that preference for equities

over bonds reflects a fear of inflation, the answer to the problem is to remove the bases of the fear of inflation. As stated earlier, this would require, in part, a clear demonstration of the determination of the Government to maintain fiscal and monetary discipline. Conviction on the part of investors that the value of the dollar will be protected would do more than any other single thing to increase the attractiveness of debt instruments and thereby reduce pressures on interest rates.

(5) Inasmuch as Treasury securities occupy an important position in credit markets, interest rates could perhaps be reduced if significant progress were made in retiring part of the public debt. In this respect, there have been several proposals over the past few months to set aside a specified portion of Government revenues each fiscal year; these funds would be earmarked for debt retirement.

While laudable in purpose, most of these proposals fail to drive to the heart of the problem, in that no provision is made for assuring that Government revenues would actually exceed expenditures by an amount large enough to permit the selected percentage of debt retirement. The use of, say, $2.8 billion of tax revenues to effect a 1-percent reduction in the debt would, in the absence of a surplus in the budget, achieve nothing; additional borrowing would be necessary to supplant the tax revenues used for debt retirement. In essence, therefore, the securities retired would be replaced in the market by an equivalent amount of new securities; interest rate pressures would not be reduced. Moreover, total public debt would actually grow, instead of decline, if the revenue-tax relationship continued to reflect an over-all deficit. Again, I should like to repeat that these plans are laudable in purpose; but undue attention to them tends to obscure the hard, basic fact that meaningful debt retirement can be effected only by means of an over-all surplus of budget receipts over expenditures.

(6) There is a sixth and final alternative for reducing pressures on interest rates, although it must be admitted that success in pursuing this sixth course of action would not necessarily result in lower rates. This is because the basic trends in demand and supply in free credit markets reflect the actions of millions of individuals and institutions, and these actions might work toward higher rates even though some of the more significant pressures were reduced.

The sixth alternative can be summarized quite simply, as follows:

(a) Convert the Federal Government from a net borrower to a supplier of funds in credit markets by achieving a surplus in the budget during periods of high and rising business activity. A net surplus permits the Treasury to retire debt, on balance; consequently, Government actions would result in a net supply of funds available for private borrowers, not a subtraction as is the case when the Federal Government must borrow to finance a deficit.

(b) Convince investors that the value of the dollar will be protected, thus removing the pressures for higher interest rates stemming from a conviction that further inflation is likely to occur. This can be done only be means of a broad-gauged attack on all of the

factors and practices that stimulate inflationary pressures. But it should be re-emphasized that the most important single action would be a clear demonstration of the Government's determination to maintain fiscal and monetary discipline. During periods of high and rising business activity, fiscal and monetary discipline requires a surplus in the budget, for debt retirement, and freedom for Federal Reserve authorities to pursue flexible monetary policies.

(c) Provide the Treasury with sufficient flexibility for sound management of the public debt, so that a better balance in debt structure can be achieved - including larger amounts of longer-term securities outstanding - and bond markets will not become unsettled over such things as an impinging interest-rate ceiling. The Government securities market is understandably sensitive to the existence of an artificial interest-rate ceiling; this is one reason why the President has proposed that the 4¼-percent limit be removed completely, rather than merely raised. An increase in the limit would only act as a signal to investors that the new ceiling is the new "normal" level as defined by Government action.

As I emphasized in the main portion of my statement, the interest burden on the public debt - now close to $8 billion - is of deep concern to me. But the alternative to sound fiscal and monetary policies - further shrinkage in the purchasing power of the dollar - concerns me even more. In the long run, no one benefits from inflation; by stimulating the excesses that develop in a period of business expansion, and thus sowing the seeds of readjustment and recession, inflation actually hinders the attainment of a high rate of economic growth. Moreover, inflation strikes hardest at those groups in our society least able to protect themselves. The man of modest means, not the rich man or the large business institution, is the primary victim of a shrinking dollar.

The overriding advantage of this sixth and final approach to reducing pressures on interest rates stems from the fact that the actions it requires would not only be directly beneficial in terms of economic growth, but would also transmit effects through market forces of demand and supply rather than by means of Government decree or regulation. And I would like to repeat that, in proceeding in this way, the Federal Government would be promoting "maximum employment, production, and purchasing power," as required in the Employment Act of 1946, in a manner consistent with those crucially important but often overlooked words in the Act which stipulate that such actions be carried out "in a manner calculated to foster and promote free competitive enterprise and the general welfare."