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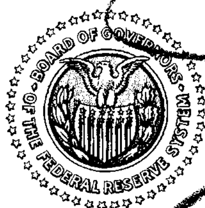

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

JAMES K. VARDAMAN, JR.
MEMBER OF THE BOARD

November 1, 1950

Personal

Dear John:

The attached letter from Dean G. L. Bach of the School of Economics of the Carnegie Institute of Technology to Mr. Grover Ensley of the Joint Committee on the Economic Report dated October 10 is self-explanatory.

You will probably find it interesting as a theoretical presentation and suggested solution of the problem you were good enough to discuss with me on October 10.

The one weak spot in Dean Bach's presentation is the theoretical advisability of letting long time governments break par at this time. I do not think that is advisable and there is certainly no intention on the part of the Board in the present circumstances to do so. I think such action at this time would be disastrous economically as well as politically.

Dean Bach's letter is not for general distribution and it would be appreciated if you would treat it as confidential.

Sincerely,

JK

Honorable John R. Steelman
Assistant to the President
The White House
Washington, D. C.

Attachment

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October 10, 1950

Mr. Grover Ensley, Acting Staff Director
Joint Committee on the Economic Report
United States Congress
Washington, D. C.

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x229

Dear Grover:

These comments are in reply to your letter of September 22, suggesting that I state briefly my views with respect to recent changes in short-term interest rates and the current problem of monetary policy. I have tried to arrange my comments in a series of consecutive paragraphs, which comprise in effect an analysis of the current situation and a set of suggested policies. I hope this kind of statement will be useful to you. You are free to quote any part of it, so long, of course, as nothing is stated out of context in a way that would distort the overall meaning I am aiming at.

(1) The evidence seems to me clear that large changes in employment, national output, and the price level are almost invariably accompanied by large changes in the same direction in the volume of currency and bank deposits per capita. Moreover, significant changes in direction in the volume of overall output and employment are almost invariably preceded or immediately accompanied by changes in the same direction of the per capita money supply. These patterns have been so consistent, and the analytical reasons for believing that a significant causal relationship exists between changes in the per capita money supply and the volume of overall employment and output are so convincing, that I believe we must consider the per capita money supply a significant factor among the determinants of the level of overall economic activity.

This proposition holds, although the exact chain of relationships from changing money supply to economic activity has not been indisputably established. The major connections appear to be through the interest rate, involving both cost element and changes in capital values of assets, and, probably more importantly, through the direct impact of changing liquidity and availability of loan funds for the public on individual and business spending. Fortunately, it is not necessary to weight these two channels exactly, since most monetary policy measures work through both in the same direction at the same time. In this connection, it is important to recognize that, however we assess the evidence on the effectiveness of easy money in inducing revival, there is clear evidence that tight money has repeatedly been important in checking inflationary booms.

(2) Since this is true, and since the problem of business fluctuations is still a very significant one in our economy, it follows that governmental (Treasury and Federal Reserve) control over the supply of money is an important weapon in our small, and somewhat untried, arsenal against economic fluctuations. It also follows that it is important to have the flexible use of monetary policy against these fluctuations, in contrast to the present arrangements where monetary policy is largely hamstrung under the Federal Reserve policy of essentially guaranteeing maintenance of U. S. bond prices above par. Current Federal Reserve policy has essentially negated flexible monetary policy, even though the stability of interest rates per se may be relatively unimportant compared to the general liquidity (availability of funds) factor.

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(3) I believe that the evidence points toward moderate to strong inflationary pressure over the several years ahead. Current inflationary pressures appear to be strong. I see no reason to expect this situation to change markedly, short of a significant change in the overall international situation or U. S. attitudes toward it.

(4) Under these circumstances, I believe that monetary policy should be re-activated and brought to bear against inflationary pressures much more strongly than has been true in the recent past. In particular, I believe that two steps should be taken:

(a) Short term interest rates on government securities, and on private loans in so far as they are affected, should be permitted to rise, and to rise substantially. Given the high degree of overall liquidity of the economy and the easy money situation guaranteed by Federal Reserve support of long securities, such a rise in short rates could not be expected to exert major anti-inflationary pressure. It would, however, in my judgment have the following important values.

First, it should have a moderate and general tightening effect on bank loan policies and on general money market psychology, thus affecting to some extent the availability of loan funds. Second, higher rates would exercise some effect through the cost side. In a very strong inflationary situation this would probably not be a very important factor, but in a more moderate situation such as appears ahead it may be a significant deterrent in marginal cases. Third, and perhaps most important, flexible upward adjustment of short rates would serve as notice to the money market that a gradual re-establishment of effective monetary policy is under way, and that the market should adjust itself to the gradual removal of rigidity in the price of long-term governments at or above par. Such notice by the federal authorities seems essential to avoid the danger of drifting again into dangerous easy-money policies for the long defense period apparently ahead, just as we drifted into dangerous easy-money policies without seriously considering the consequences during the early days of World War II.

(b) Federal Reserve authorities should immediately lower the effective support price for long-term government securities to slightly below par, letting the market know informally but clearly that the Reserve intends to take this action and, for the current defense crisis, to support long issues moderately below par if such support becomes necessary. This action would have the important effect of raising long rates moderately. More important, it would remove the strong standing invitation to holders of long issues to convert into money on very advantageous terms at any time. It would at the same time retain the essential protection of capital of any distress sellers of long securities. This compromise action would fall considerably short of a completely flexible and strongly anti-inflationary monetary policy, but it would mark a real advance in concrete terms, and in announcement value, away from the completely easy money arrangements which have so far blocked significant monetary policy against the war and post-war inflation.

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(5) The question of the cost of such a policy to the treasury needs analysis. Here clear recognition of fundamentals is required, in contrast to acceptance of the superficial appearance of the problem.

(a) The Treasury is only an agent of the American public, and interest costs on the public debt are merely transfer payments from one segment of the public to another. Thus, "cost" to the treasury is fundamentally a meaningless and useless concept, unless it is used to connote primarily a problem of redistribution of income among the various groups of the population involved in payments to and from the Treasury. The problem here is sound Congressional distribution of the tax burden and proper handling of Treasury policy in selling government securities.

(b) Against this transfer problem arising from an increase of interest payments must be set the convincing evidence of the importance of a tightening money supply and liquidity situation in restraining inflationary pressures. In my judgment, even a very substantial increase in Treasury interest costs would bulk small compared to the advantages of restraining inflationary developments in the present quasi-war economy.

(c) Even from a "Treasury" viewpoint, there is an important advantage in paying higher interest rates on the national debt if inflation can be restrained. First, there is already clear-cut evidence of growing public awareness of the impact of inflation on holders of fixed dollar value government securities. Over the past decade, $1000 invested in the highest yield government securities (U. S. Savings Bonds) would now buy only about $750 worth of consumers goods (B.L.S. price index), even after the large interest accumulation is added onto the principal. This elementary fact is increasingly obvious. Heavy stock market investments and recurring upward pressure on prices of inflation-hedge assets point clearly to Treasury difficulties in peacetime or quasi-war borrowing from the public on a voluntary basis unless the inflation is checked. Second, with huge government expenditures ahead on defense, even a very small restraint on inflation will save far more in total government spending than the billion or two of increased interest charged involved in increases in short and long-term rates. In my judgment, under these circumstances, excessive concern over <u>nominal</u> savings in Treasury interest cost is likely to go down in history as a classic example of fiscal short-sightedness.

(d) Treasury concern lest the market for governments be "unsettled" is legitimate in face of the huge volume of refundings and possible new money issues that will have to be handled. While it is important to keep the market from a panic condition, excessive preoccupation with market "confidence" and "stability" is shortsighted. The erosion of the value of the dollar under continued inflation seems to me much more likely to create a huge barrier to Treasury borrowing <u>from the public</u> than any temporary "unsettling" involved in moving toward higher and more flexible rates.

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There seems to me to have been considerable loose talk on this point, involving confusion between purchases by the public and by the banks. The Treasury with the cooperation of the Federal Reserve can always sell securities to the banks at any given rate by pumping in enough excess reserves to make the banks highly liquid. This, however, is a perversion of proper Treasury borrowing policies in an inflationary period, and main emphasis should be placed on sales to the public. For such sales on a voluntary basis, continued inflation promises to become a major barrier. Under these cirucmstances, an informal Reserve support price for long issues moderately below par for some time, perhaps later giving way to a still lower support price, seems to provide a reasonable compromise between keeping the market "settled" and trying to freeze at least part of the outstanding issues into a lower level of liquidity than they now possess.

(6) These monetary steps alone cannot be counted upon to check the current inflationary pressure. Large increases in taxes, beyond the rises currently being contemplated, must provide the backbone of any realistic anti-inflation program when inflationary pressures are strong. Coupled with such an aggressive tax policy, the monetary restrictions suggested above should constitute an important supplement, even though they cannot carry a major share of the task as long as the long rate is held down and liquidity assured by a support policy of the Federal Reserve, even moderately below par. Reliance on partial direct controls over individual prices and wages seems to me quite unrealistic under present circumstances. History demonstrates that to be effective partial direct controls need to be rapidly expanded to complete controls over prices and wages if the inflationary pressures are strong. I cannot believe that the American public will be prepared to accept effective overall direct controls unless we become involved in a large-scale, all-out war. To believe that the public will accept even partial direct controls at points where the controls really bite also seems to me to be politically unrealistic in the defense situation into which we appear headed. My conclusion is that for the type of period ahead any effective control must come through fiscal-monetary measures.

(7) Concerning the allocation of monetary-fiscal-debt powers between the Treasury and Federal Reserve, I strongly support the approach advocated by the Douglas sub-committee on the following points: (a) Up-grading the status of a smaller, strengthened Federal Reserve Board of Governors; (b) Joint and co-equal consultative status between the Federal Reserve and the Treasury in debt-monetary policy making; (c) Clearer allocation of monetary policy responsibility to the Federal Reserve through Congressional directive. I support these steps not because I believe the Federal Reserve should really be vigorously "independent", since such vigorous "independence" seems to me to be quite unrealistic in the current setting. I support them rather as firm steps toward assuring more equal status for the traditional central bank anti-easy money attitude in inflation period governmental policy formation. While minor differences between the Federal Reserve and Treasury, such as those of recent months, do no great harm, fundamentally the nation's monetary-fiscal-debt policy must be unified and free of strong inner conflicts. To be most useful to the nation, this unification must come on the basis of careful consideration

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of the points of view advocated by operating Treasury officials and by central bank officials, in a framework where the parties are considered, and consider each other, as roughly co-equal.

(8) In handling refundings and new money issues over the period ahead, I urge reconsideration of current Treasury policy to convert the debt predominantly to short issues. This policy has the illusory advantage of minimizing interest charges, but at the very real expense of decreasing the government's flexibility in adjusting debt policy to overall economic conditions. In particular, this inflexibility takes the form of guaranteeing the short term liquidity of the public debt to the public, regardless of Federal Reserve and Treasury feelings about the desirability of tight or easy money.

Sincerely yours,

G. L. Bach
Dean

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