

F. R. 13.

In this critical period of international disturbance, it is imperative that we have unified action on the entire defense front, including the financial front. I am, therefore, issuing today an Executive Order which requires that the Federal Reserve System's open market operations in Government securities be made with the approval of the President of the United States. I am at the same time making this statement public so that my reasons for issuing the Executive Order will be clear. When the Congress reconvenes, I shall suggest that it consider the advisability of enacting specific legislation incorporating this requirement.

On Friday, August 18, in accordance with the provisions of the laws of the United States -- which require that the President approve each issue of United States Government securities maturing in more than one year before the offering of such securities can lawfully be made to the public -- I approved the offering by the Secretary of the Treasury of two issues of 13-month, 1-1/4 percent Treasury notes in exchange for \$13-1/2 billion of Treasury bonds and certificates of indebtedness, maturing or called for redemption on September 15 and October 1. When the market opened on the following Monday morning, August 21, the Open Market Committee of the Federal Reserve System, through its open market operations, proceeded to establish a pattern of prices on various short-term issues of Government securities which resulted in higher short-term interest rates, wholly inconsistent and incompatible with a 1-1/4 percent rate on Treasury notes of the type offered in connection with the refunding.

I immediately sent a letter to Chairman McCabe of the Board of Governors of the Federal Reserve System, in which I pointed out that when I approved the 13-month, 1-1/4 percent issues on August 18, outstanding United States Government securities were selling at yields which would make the new issues attractive. I asked that the operations and actions of the System relating to the market for Government securities be adjusted so that this situation would again prevail. This would insure the complete success of the refunding operation.

Chairman McCabe personally assured me that, during this critical period, the Federal Reserve System would make its operations consistent with the financial policies of the Government. Nevertheless, the Federal Open Market Committee -- which is comprised of the seven members of the Board of Governors of the Federal Reserve System and five presidents of Federal Reserve Banks -- ignored my request entirely.

As a result of the open market operations of the Federal Open Market Committee, the Government security market has been unsettled during the past two months and unfavorable circumstances were created for the Treasury's September-October refunding operation. The Federal Reserve System sold Government securities at prices which gave purchasers a higher rate of return than they would receive on the new issues offered by the Government. Obviously, most of the holders of the refunded issues did not choose to exchange them for the new issues. They either did their own refunding through the Federal Reserve System or turned in the matured issues to the Treasury for cash.

Now, in a letter dated October 16, Chairman McCabe has informed the Secretary of the Treasury that the Federal Reserve System has decided to proceed with further increases in short-term rates. This would create additional disturbance and unsettlement in the Government security market.

Officials of the Federal Reserve System have stated that the purpose in raising short-term interest rates is to combat inflationary pressures by restraining credit expansion. In his October 16 letter to the Secretary of the Treasury, as justification for the actions taken by the Federal Open Market Committee, Chairman McCabe quoted a paragraph from my Midyear Economic Report which begins by stating that "for the immediate situation, we should rely in major degree upon fiscal and credit measures" in restraining inflationary pressures. The Federal Reserve knows that I did not have in mind, in this connection, raising short-term interest rates on Government securities. I spelled out the fiscal and credit measures which I thought appropriate in my July 19 message to the Congress, in which I asked for increased taxes and for selective credit controls. I made it clear to the Federal Reserve before their August 18 action was taken, and again in my letter to Chairman McCabe, that I did not want interest rates on short-term Government securities to be increased.

Credit expansion must be restrained; but this cannot be done by small fractional increases in short-term interest rates. Such increases are not effective in combating inflationary pressures. The use of such ineffective measures is extremely dangerous, moreover, in that they give the country a false sense of security that the job is being done. For example,

the increase in short-term interest rates has had no noticeable restrictive effect on bank loans. On the contrary, business loans of weekly reporting member banks increased nearly 11 percent in the seven weeks ending October 4. This is an extremely rapid rise; in fact, in one week, the rise was the sharpest ever recorded. In addition, the uncertainty created in the market as a result of the recent increase in short-term interest rates caused large sales of marketable Government securities to the Federal Reserve Banks.

The rapid expansion in credit can and should be controlled and we have effective measures for this purpose. But events in our own economic past have shown that the urge to borrow is not restrained by moderate increases in short-term rates. In 1919-1920, rates on 3- to 6-month Treasury issues reached nearly 6 percent, and the call money rate went as high as 30 percent. In 1929, rates on 3- to 6-month Treasury issues exceeded 5 percent, and the call money rate went to 20 percent. How effective even these high rates were in restraining credit expansion is debatable; but, it is clear, that increases in short-term rates large enough to result in effective discouragement of loans would represent a crude application of economic laws that is out of harmony with enlightened economic policy. It would be on a par with driving civilian users of essential defense materials -- such as steel -- out of the market by means of excessive price rises. This is a course of action which in any area of our economic life is both unjust in its effects and extremely dangerous to the healthy functioning of the economy.

Obviously, in order to be effective in the areas of special inflationary pressures which we wish to restrain, increases in interest rates would need to be so large that they would have a stringently repressive effect upon every area of the economy. This we must avoid since it would slow down the production of vital defense materials and weaken our economy in these critical times. It is essential to control the volume of credit; but it is also necessary that this be done without unduly restricting its use where additional credit facilities are needed to finance military production.

For this purpose, economic controls of a selective nature are required. I asked for these; and Congress has provided them in the Defense Production Act of 1950. The Board of Governors of the Federal Reserve System was given power to control consumer credit; and I have delegated to the Board the authority to curb privately financed real estate credit. It is extremely important that these selective measures be used to the best possible advantage.

The most effective over-all fiscal-monetary measure in combating inflationary pressures is a balanced budget or better. The Revenue Act of 1950 is a step in that direction; and I might also note that so far this fiscal year the Federal budget is operating with only a very small deficit -- amounting to about \$125 million through October 16 -- compared with a deficit of \$2,350 million for the same period last year. In the absence of further tax increases, however, the deficit will grow as our expenditures

for defense are stepped up. I am extremely anxious that during its next session Congress will enact further legislation which will enable us to meet our expanded defense requirements on a pay-as-you-go basis.

The Defense Production Act also authorizes the President to consult with representatives of industry, business, finance, agriculture, labor, and other interests, with a view to encouraging voluntary agreements and programs to further the objectives of the Act. In order to facilitate voluntary agreements of this nature, I asked the Congress -- and Congress agreed -- to exempt such arrangements from the prohibitions of the antitrust laws and of the Federal Trade Commission Act of the United States.

I am of the opinion that a program of voluntary credit restraint on the part of banks would, with the proper guidance and encouragement by the Federal Reserve System, provide another effective means of withholding credit that would put needless inflationary strains on the economy, while at the same time meeting the legitimate credit needs of a mobilization economy. The commercial banks of the country have indicated a willingness to cooperate in such a program. The voluntary credit control program of the American Bankers Association early in 1948 received splendid cooperation.

In this critical period, it is particularly important not to lose sight of the fact that individual initiative, which is the mainspring of our

free enterprise system, can operate effectively only in an atmosphere in which orderly economic conditions are taken for granted. The independence of our private banking system, just as truly as the independence of our small business concerns and of our individual investors, depends on continuing confidence that the commitments which are made will not be disrupted by fundamental disturbances in the economy. The necessity of gearing our economy to the needs of defense must not lead us to overlook the importance of protecting the environment in which free enterprise can function effectively.

It is the policy of this Administration to do everything possible to maintain the financial system of this country in the soundest possible condition. With this end in view, I intend to give the people of this country maximum assurance that their financial decisions can be made in full confidence that their Government has both the ability and the determination to keep the economy strong.

As a result of the necessities of financing World War II, the public debt of the United States now amounts to well over \$250 billion. Both the size of the public debt and its importance in the financial life of the Nation are unprecedented in our history. In consequence, operations in the Government security market have repercussions which are felt throughout the entire economy. They affect the investments of millions of our citizens and of many thousands of business concerns and financial institutions throughout the country.

It is clear that investments of this magnitude and importance in the life of the Nation require that orderly and stable conditions be maintained in the financial markets where Government securities are bought and sold. It is of primary importance to every investor and to every citizen that transactions in this market take place in such a way as to enhance the strength of the Government's credit. It is a principal responsibility of the Government and a principal objective of Government financial policy to see that this goal is achieved. It is obvious that the central bank of a country must work in close cooperation with the Government of that country; and that it is untenable for a central bank to pursue policies which contravene the financial policies of its Government.

These financial policies of the Government have provided a record of debt management the importance of which must not be overlooked. Private nonbank investors added over \$5 billion to their holdings of Government securities from the beginning of the year through August -- primarily through purchases of savings bonds by long-term investors and of short-term marketable securities and savings notes by corporations. Private nonbank holdings of Government securities reached an all-time peak -- higher even than at the end of the Victory Loan. At the same time that this was being accomplished, the Government security holdings of the commercial banking system were being reduced to very close to their postwar lows.

There is another consideration of vital concern to every taxpayer which calls for a stable price and interest structure in the market for Government securities. This is the fact that unsettled conditions in the market for

Government issues would seriously impair the ability of the Government to finance the debt on the basis of the lowest interest cost consistent with the well-being of the economy.

During the fiscal year 1950, the interest cost of the debt comprised about 14 percent of the Federal budget; and it is estimated that the interest on the Federal debt will amount to \$5.6 billion in the fiscal year ending on June 30, 1951. Even a relatively small increase in the average interest rate on the debt would add a substantial amount to the total annual interest cost. To use the taxpayers' money to pay increased interest on the public debt in an ineffectual attempt to control inflation is clearly unjustifiable.

EXECUTIVE ORDER

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REGULATION BY THE PRESIDENT OF OPEN MARKET
OPERATIONS OF THE FEDERAL RESERVE BANKS

By virtue of the authority vested in me by the Constitution and Laws of the United States, particularly section 5(b) of the Act of October 6, 1917, as amended, it is ordered as follows:

The purchases and sales of paper described in section 14 of the Federal Reserve Act, as amended, as eligible for open market operations shall be made with the approval of the President of the United States.

THE WHITE HOUSE