TREASURY DEPARTMENT

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TO THE SECRETARY:

In Chairman McCabe's letter of October 13, it was suggested that the Treasury continue to draw on its war loan balances to retire securities held by the Federal Reserve as rapidly as the Treasury's cash position permits.

He suggests (a) that bills be retired at the rate of $100 million a week for a number of weeks and (b) that available trust funds could be used to purchase marketable securities.

He also suggests (a) that we refund the December 15 bonds amounting to $571 million (because they are held outside the Federal Reserve), (b) that we reduce our war loan balances as low as $500 million (they are now $1.9 billion), and (c) that we could let our Federal Reserve balances go below the present $1.7 billion (because of the heavy tax receipts in the first quarter of 1949).

On the basis of the President's estimates of receipts and expenditures for the fiscal year ending June 30, 1949, it appears that we will have available for retirement of marketable debt between this date and June 30 next, about $2,300 million, allowing for a cash balance at the end of the year amounting to $3.3 billion.

It looks as though the deficit for the balance of the year will be taken care of largely by a reduction in the cash balance. There will be about $3,200 million from trust funds and savings bonds, of which about $900 million will be needed for Bretton Woods, savings notes, and other items, a net of about $2,300 million.

Of this $2,300 million, approximately $1,500 million will be needed for attrition on the marketable maturities through June 30, 1949. This would leave about $800 million available for either (a) retirement of bills held by Federal Reserve, or (b) purchase of securities on the market for trust accounts.

The purpose of this memorandum is to suggest that instead of using the extra cash for bill retirements that you consider an aggressive purchase of long-term 2-1/2's for account of the Old-Age and Survivors Trust Fund amounting to $800 million in an effort to turn the market around. I have a feeling that it is worth a trial.

E. H. Bartelt

Fiscal Assistant Secretary

A Statement on the Policy of
Maintaining Stability in the Government Bond Market

When I came into the Treasury in June 1946, the war had been over less than a year. War financing had only recently been completed, and the country was in the process of transition from a wartime to a peacetime economy. No one knew how rapidly or how smoothly that transition could be achieved. There were many who felt that its achievement would occur only after the country had been rocked by unemployment and economic dislocation. Government and business, farmers and labor were all worried about many factors on the economic scene.

Not the least of these was the size of the public debt -- which had been multiplied by more than five times in the few short years since 1940. It was difficult at the time to forecast how so large a debt might be handled. The size was unprecedented, both in terms of the dollar amount involved and of the debt's relation to the economy of the country.

I felt when I came to the Treasury in 1946 that stability in the Government bond market during the transition period would be of tremendous importance to the country. Stability would contribute to the underlying strength of the country's financial system, and would ease reconversion, not only for the Government, but also for the industrial and business enterprises of the country. Stability would encourage the capital expansion necessary for maximum production in a peacetime economy.

In the 2-1/4 years since June 1946, the Government has bent its best efforts to maintain stability in the bond market. These efforts have been in both directions -- toward keeping bond prices from going up too high and too fast and toward keeping them from going down too sharply. Commencing in the spring of 1947 we took actions to control an incipient boom in the bond market — selling long-term bonds from some of the Government investment accounts, offering the Investment Series of bonds to institutional investors, and increasing short-term rates. All of these operations combined to take upward pressure off the market. When conditions changed, and a downward pressure on bond prices developed, we stabilized the bond market through purchases of long-term bonds. All of our actions have been taken with a view toward promoting business confidence and of attaining a high level of employment and production.

The country today is enjoying the greatest prosperity in its history. Its financial structure is in good shape. Except for the upward pressure on prices which we have experienced, the situation is satisfactory on all counts. Business optimism is nation-wide. There is no doubt that the successful management of the public debt since the war and the maintenance of a continued period of stability in the bond market have contributed materially to this situation.

My feelings of June 1946, with respect to the desirability of stability in the Government bond market during a period of transition from a wartime economy, repeat themselves as I look at the world situation today. This is so because, since the war, the financial, economic, and political planning of the whole world on this side of the Iron Curtain has been founded upon and is being built upon the financial strength of the United States. The credit of the United States Government has become the keystone upon which rests the economic structure of the world. Prices of Government securities in the market are looked upon as a barometer of confidence in the Nation's well-being. Stability in Government securities becomes essential, therefore, because so much of the future of the world depends upon the financial condition of our country.

I do not feel that I exaggerate when I emphasize these matters. I think that they are of tremendous importance. It is unfortunate, I feel, that they are generally overlooked in most of the statements, discussions, and speeches that reach the public press.

There are, of course, other important reasons for the maintenance of stability in the Government bond market, with a continuation of the 2-1/2 percent rate on long-term bonds.

A public debt of the magnitude of $250 billion is a new thing in our economy. You will recall that, when we embarked upon a war-financing program which was going to require a large increase in the public debt, there were people who were concerned with the ability of the country to stand a heavy Federal debt -- say, even of the magnitude of $100 billion. The financial thinking of the times had to be revised. We had to take bold new steps in financial planning. One of the important decisions that was made early in the war was to sell as many securities as possible to nonbank purchasers. In order to do this, the securities sold by the Government were fitted to the needs of the various types of investors.

As we look back on this decision, we know that it was the best one that could have been made. At the same time, we must recognize that, when that decision was made, it had tremendous implications for the future of our debt-management policies. For example, a part of that decision involved the sale to individuals of nontransferable savings bonds, redeemable upon demand. Those bonds bore interest rates of from 2-1/2 percent to 2.9 percent to maturity. Their very issuance to tens of millions of individuals in the amount of $50 billion laid the groundwork for a considerable period of stability in the bond market. Their widespread ownership and their redeemable nature made a decline in long-term bond prices impractical for a long period of time.

This is because a decline in long-term bond prices to points below par would be a wholesale invitation to the holders of the $50 billion of savings bonds to cash them in at their earliest opportunity. Bondholders across the Nation would believe something had been done to the value of their savings bonds. Confidence built up over a period of years would be undermined. Once again, there would be removed from the Government securities market the millions of investors who were so laboriously brought into that market.

This was done once before — after World War I, when Liberty bonds were allowed to drop to 82. It has taken years of financial planning, plus tremendous quantities of promotion and aggressive selling, to bring nonbank buyers, particularly individuals and small corporations, back into the Government securities market.

We may not have years to rebuild our army of bondholders the next time we need them. The international situation is sufficiently unsettled to place deficit financing -- as a result of a preparedness program -- within the realm of possibility in a relatively short time.

The budget for the fiscal year 1949 already calls for a $1-1/2 billion deficit because of increased expenditures for national defense and foreign aid, coupled with untimely tax reduction. No one knows, nor is any one in a position to reasonably forecast, what the Government's requirements will be in 1950 and 1951. It may be necessary to raise substantial amounts of money sooner than we now expect. It would be extremely improvident for the Treasury, under the circumstances, to do anything which would impair the confidence of its bondholding public.

Another example of how decisions early in the war are important with respect to current debt-management activities involves the concentration of the securities sold to banks in issues maturing within a relatively short period of time. This was a good decision; and it has kept the banking system in a liquid condition throughout the ups and downs of war and postwar financing. It requires, however, a large volume of refunding every year — about $50 billion. Refunding of $50 billion of securities in a year is a tremendous task. It exceeds the total of all security refunding engaged in by all other borrowers in the country during the entire past 25 years. The magnitude of the figure foretold the small limits within which short-term rates could change, and the considerable period of time over which such changes would have to take place.

There are other examples that could be pointed out. For instance, fitting securities to the needs of investors meant that more marketable securities, based on a long-term rate of 2-1/2 percent, could be sold during the war to nonbank investors. This rate has now been integrated into the financial structure of the Nation. The well-being of financial institutions, as well as that of their depositors, policyholders, and shareholders, is, therefore, tied up with factors that relate to the public debt.

Savings banks, for example, have about 60 percent of their assets invested in Government securities. Their holdings of these securities are six times larger than their capital funds. A similar situation exists in the case of life insurance companies. A decline in the market value of Government bonds incident to a rise in longer-term interest rates -- which, because of the integration of the financial markets, would be accompanied by a decline in the value of corporate and municipal securities -- would create a book loss in the assets held by many such institutions equal to or in excess of the total of their capital and capital reserves. While such book losses would not actually be sustained, the existence of market-value shrinkage in large proportions might threaten the security of many institutions.

It is clear from the foregoing, it seems to me, that the stability of the Government bond market is inevitably necessary for the proper management of the public debt. No one is more jealous of the freedoms of private enterprise than I am, but the hard facts are that there must be firm control of public debt management so long as the public debt remains such a dominant factor in the financial and economic life of the Nation.

There is one other point that might be mentioned. That is, the burden on the budget from increasing interest costs would be tremendous if the bond market declined and there was a substantial change in the long-term interest rate. The interest cost of the public debt is already $5.3 billion a year. It is likely to grow over a period of time in the absence of substantial debt reduction, because the rate on savings bonds increases as the bonds are held to maturity and because an increasingly large proportion of the debt represents the accumulation of trust funds invested at rates set forth in the law, which are higher than the present average interest rate on the debt. A further rise in the budget charge for interest payments would come about as the result of a general rise in the long-term rate of interest. This would be of nation-wide importance, and it would affect every taxpayer. For example, a rise in the average interest rate of the public debt by as little as 1/2 of 1 percent would cost the American taxpayers approximately a billion dollars a year.

The Treasury must concern itself -- as it has in the past -- with saving the taxpayers' money. The Treasury was able to finance the last war at an average borrowing cost of less than one-half the borrowing cost of World War I. If this had not been done, the interest charge at the present time would have been more than $10 billion a year instead of $5 billion a year. It is clearly evident that at the present time this $5 billion annual saving in the taxpayers' money is a highly important factor in the budget picture of the Federal Government.

I have outlined in some detail the reasons why the Government is maintaining a stable bond market because I feel that an understanding of Government policy is essential. Government, as you know, is just as much your business as it is the business of those actively engaged in it. The job of running government in our American democracy is the job of 146 million people. The kind of government we have here is the kind of government that you and the 146 million other people make it. This requires a free and open, intelligent discussion of the important problems of the day, whether they be political, or on the international scene, or whether they involve such technical problems as debt management.

The course of action which must be taken by the American people on a wide variety of problems lies in uncharted fields. This is true of debt management. The problems are new and varied, because the debt is so new and so large, both in absolute amounts and proportion to the economy. Policy decisions are not crystal clear as to their rightness or wrongness. There are opinions on both sides of important questions, and these are maintained sincerely by informed people in the financial field.

The maintenance of stability in the Government bond market has, as you know, brought out a widespread discussion in recent months, because, in the execution of that policy, the Federal Reserve has had to buy $3 billion of long-term Government securities since early July. It is argued that lowering support prices for Governments below par would stop sales of these securities to the Federal Reserve. I do not believe this. There is, in fact, a strong case for the opposing argument that such action, because it would impair confidence in the Government bond market, would result in much more substantial sales to Federal.

It is also argued that supporting the market is inflationary, and that we are paying too high a price in order to gain the benefits of bond market stability which I have outlined above.

The control of inflation has been one of the most important domestic issues before the country for many months. There are many weapons that could be employed which we do not have. The President has asked Congress for them a number of times, but Congress has refused to act. Some weapons are more effective than others; some have greater applicability in specific areas, some for the economy as a whole.

Anti-inflation weapons of a fiscal nature operate against inflation by cutting down the total spending power of the country. They are, therefore, indispensable in a period of general price rise. By far the most useful of these weapons is a substantial surplus in the Federal budget. Other fiscal weapons must of necessity play a lesser role on the inflation scene. All of these weapons, however, have only limited effectiveness, since they operate in an over-all fashion by cutting down the total purchasing power of the country. High prices in special areas can be dealt with most effectively by specific measures applied directly to those areas. A curtailment of general spending power which would be drastic enough to bring such prices into line would curtail the total income of the country so severely as to disrupt the whole economy.

When I came to the Treasury in June 1946, I stated that we should make every effort to achieve a balanced Federal budget -- or better. It has been gratifying, therefore, that in each of the past two fiscal years we have had budget surpluses, which we could use in our attack upon the problem of inflation. Unfortunately, in the current fiscal year, we no longer have a budget surplus with which to continue the debt-reduction program carried on since the end of war financing. Because of the untimely tax-reduction bill -- which took away $5 billion of revenues for the fiscal year 1949 -- and because of increased expenditures for national defense and foreign aid, the Budget Bureau has estimated that we will have an operating deficit of approximately $1-1/2 billion this year, as compared with an operating surplus of $8-1/2 billion last year. Thus, the Treasury has been deprived of its most important anti-inflationary weapon. The Government's deficit will, in fact, contribute toward increasing inflationary pressures this year.

Moreover, no one can say that the Government's budget situation during the fiscal years 1950 or 1951 will be much better. We have just embarked upon a program of expanded national defense and of international cooperation. It is a confident man, indeed, who can visualize the international situation as improving so rapidly as to allow expenditures a year or two ahead to follow a declining trend from present levels.

I have mentioned these things because I feel that a surplus in the Federal budget is the only really important anti-inflationary fiscal weapon of the Federal Government; and that, in the absence of such a surplus, we should avoid measures, such as dropping bond prices, which have an unproved value in solving the inflation problem, on the one hand; and which are likely to cause tremendous disturbances in our financial community, on the other.

I feel that I can go even a step further and say that, if we let the bond market get out of control, there is a real possibility that we may have more inflation to contend with, rather than less inflation.

Our problem at the present time is a slow upward movement of prices. There is none of the panicky inflation situation which existed in Germany and France, for example, after World War I, or in China recently; nor is there any indication whatever that such a situation will develop. We do not need to worry about the underlying strength of our monetary system. There is no flight from money to goods. People are not jumping out of liquid assets. This is shown by the continuance of tremendous volumes of liquid assets in the hands of individuals; there has, in fact, been an increase in these holdings since the end of the war.

We are in a dynamic economy, however, in which the public debt is a tremendous factor. A drop in the price of long-term bonds resulting from an abandonment of the policy of bond market stability might cause such a shock to the economy that a flight from money to goods might result. Our experiences in the 1929 crash indicated how quickly public psychology could change. In a few months, investments which had been in great demand went into disrepute. They were jettisoned wholesale by thousands and thousands of people. What happened was a change in public confidence in the financial future.

The removal of confidence from the financial scene makes a tremendous difference. Doing so at the present time by unpegging the long-term rate and abandoning bond market stability might change the picture rapidly. Instead of finding itself facing an upward pressure on prices, the country might find itself in the middle of a financial crisis. This should not, and must not, happen.