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September 19, 1950

TO THE SECRETARY:

~~CONFIDENTIAL~~

This is in response to your request for a careful review of the document relating to Treasury-Federal Reserve relations. The document as submitted has 5 sections as follows: (1) Developments in the Government Security Market since January 1, 1950, (2) What kind of Federal Security Market is Needed to Finance a War, (3) Responsibilities of the Secretary of the Treasury as the Chief Fiscal Officer of the Government, (4) Background of Federal Reserve-Treasury Relationship, and (5) The Record of the Federal Reserve System. In addition to the foregoing, I furnished you with a memorandum under date of September 11, 1950 relating to this subject with particular reference to the effect of the Federal Reserve's action on the September 15 and October 1 financing operations.

I think the document discussed in your office on Friday, September 15, is an excellent justification of the position maintained by the Treasury in its relations with the Federal Reserve. I do have a question with respect to the section entitled "Developments in the Government Security Market since January 1, 1950." It is my feeling that certain statements contained in this memorandum, particularly in paragraphs 1 and 2 would impair what otherwise would be a very fine document in support of the Treasury's position. In the first place, I doubt very seriously whether certain statements could be substantiated, or at least I don't believe they would be convincing as far as the general public is concerned. It would be my advice to eliminate from the first paragraph any claims that the Treasury was responsible for reducing bank holdings of Government securities and increasing nonbank holdings. Specifically I would eliminate from the third line of the first paragraph the words "by the Treasury." I would also eliminate the third sentence of the same paragraph reading: "By providing the types of securities needed to meet the situation as it existed, the Treasury was able to reduce bank holdings of Government securities by \$3 billion and to increase holdings of private nonbank investors by nearly \$5 billion." I would also eliminate the last two lines, reading: ". . . and, without any fanfare, accomplished an extremely satisfactory anti-inflationary debt rearrangement program."

The other thought I have with respect to this section of the document is that I believe that the effect would be much better if there would be no direct criticism of the Federal Reserve on points which may be highly controversial and which rest largely on individual opinion or suspicion of motives.

Whether it is true or not I have an idea that many investors sincerely believe that the open market operations of the Federal Reserve in the long and intermediate areas have on the whole been wisely conducted and that some of their actions were necessary because of the pressure on the long market. The criticism is on the way they have handled the bills and the short market.

For your ready reference I have circled in red the parts of the memorandum that I would question.

Developments in the Government Security Market
Since January 1, 1950

During the first seven months of this calendar year, there were two dynamic developments in the Government security market. On the one hand, there was the attempt by the Treasury to reduce bank holdings of Government securities and to increase nonbank holdings to the greatest extent possible consistent with the requirements of the economy. By providing the types of securities needed to meet the situation as it existed, the Treasury was able to reduce bank holdings of Government securities by \$3 billion and to increase holdings of private nonbank investors by nearly \$5 billion. This was the greatest increase in holdings by private nonbank investors in such a short period of time since the end of war financing. The Treasury, it is clear, was highly successful in its debt management program, and, without any fanfare, accomplished an extremely satisfactory anti-inflationary debt rearrangement program.

The other dynamic factor that occurred during the period from January 1 through July 31, 1950, was the sale by the Federal Reserve of \$2 billion of long-term restricted bonds to a market which was not receptive to such issues, as each small offering resulted in a price decline. By forcing these issues on the market, the Federal Reserve knocked down the price of long-term Victory bonds from 103-27/32 at the beginning of the year to 101-1/32 on July 31; and encouraged long-term investors in Government securities to switch out of issues they already owned in order to buy the issues offered to the market by the Open Market Account. The Federal Reserve action succeeded only in deteriorating market psychology and keeping the market in a weakened condition. That the market did not entirely understand the Federal Reserve actions during this period was pointed out by Mr. Paul Heffernan in an article in the New York Times on August 20, 1950. He stated that:

"For most of this year the central bank, in an operation not completely understood by the private market, has been selling Victory 2-1/2 per cent bonds at declining prices -- a move which tended to contract bank reserve balances and keep long-term gilt-edge yields at artificially high levels. . . ."

Notwithstanding repeated requests from the Federal Reserve during the winter and spring, the Secretary refused to go along with the Open Market Committee in its market weakening program. He refused to offer new issues of long-term bonds to the market because, it was clear then, as it is now through hindsight, that long-term investors were not increasing their portfolios of Government bonds. The high level of building activity and the great investment in plant and equipment caused more home mortgages and corporate bonds to come on the market than there were funds available. As a result, many long-term investors, particularly life insurance companies, had to sell marketable issues of Government securities in order to meet the needs of our private enterprise economy.

This was clearly a reflection of the fact that private business was in a healthy condition. It was a good sign. The Secretary felt that there

Don't believe this is the cause of the market

was no point, therefore, in offering competition to a good business outlook by the issuance of long-term Government securities. The economic development of our country, he felt, required new plant and equipment expenditures in significant volume, if jobs were to be provided for the expanding labor force and there was to be a prosperous economy in the years ahead. The Secretary felt that our economic happiness required new housing for the people of this country who have been poorly housed for a long time, and for the rapidly expanding population which is growing by 2-1/2 million persons a year. He felt that if long-term investors purchased the corporate bonds and mortgages resulting from new capital goods, they would be contributing to the economic development of the Nation. This feeling was in close harmony with the Secretary's repeated assertion that his broad objective was to manage the public debt in the way which would promote the financial well-being of the country.

During this period, the Secretary recognized, however, that the absence of long-term investment funds in the market was accompanied by a plethora of short-term funds in the hands of industrial, manufacturing, mercantile, and commercial corporations, State and local governments, and foreign investment accounts. With this in mind, the Secretary kept the market supplied with an adequate volume of short-term Treasury securities in the form of Treasury bills, short-term notes, and savings notes.

The position of each of the various investor classes was the controlling factor in the Secretary's financing decisions throughout the first seven months of the calendar year. His decisions were made after many consultations with financial experts outside of the Treasury and after exhaustive analysis of the market situation. Federal Reserve policy from the beginning of the year was one that called for higher interest rates. In connection therewith, the Federal Reserve kept the market continually in a weakened condition. Government security holders at the short end were forced to watch quotations decline on all issues. On New issues of notes, quotations were at discounts soon after the issues came on the market. The money market was kept very tight, and rumors flooded the market that rates were going up immediately after each refunding was over. As a result, as everyone observed, a large volume of the maturing issues and the securities offered to refund them flowed into the Federal Reserve portfolio. The Federal Reserve sold the idea that it had to purchase short-term issues in order to support Treasury refunding operations. Actually, Treasury refunding offerings would not have needed support, had it not been for the adverse Federal Reserve open-market operations and the continued rumors that the Federal Reserve was going to force higher rates. OK

At the long end, bondholders were continually discouraged by the down-trend of prices. For a long time, the Victory loan 2-1/2's dropped 1/32 a day on the average -- a decline that was far in excess of the interest return and sufficient, therefore, to eliminate the possibility of earning even a nominal return from a long-term bond.

The outbreak of the Korean crisis made it clear to the Secretary that the outlook for future Government financing had been changed entirely. It meant that a whole new psychology would have to be developed in the market -- a psychology which would permit the Government to raise large amounts of new money and to refund maturing issues under circumstances essentially different from those existing prior to the crisis situation. It meant that confidence in the Government security market must be maintained and that stability was essential.

The Secretary made this clear to the Federal Reserve during the last week in June and in a letter to Chairman McCabe, dated July 17. (A copy of this letter is attached.) He made it clear to the Chairman that with a Federal debt of \$257 billion, everything possible should be done to maintain a basically strong position in the Government bond market during the period of international disturbance. The Federal Reserve ignored the Secretary's opinion, and proceeded further with its program of trying to raise interest rates generally.

Despite all of the actions which the Federal Reserve had taken throughout the year to churn up the market and deteriorate its psychology, the situation in the Government security market on August 18, when the Secretary announced the September-October refunding, was such that a 13-month, 1-1/4 percent security was an attractive offering unless the market was informed that rates were going to be increased. However, the Federal Reserve raised its rediscount rate and established a pattern of prices in the market on short-term issues of Government securities which was wholly inconsistent and incompatible with the new Treasury issue, despite the fact that the President, as required by law, had approved the refinancing operation.

The Federal Reserve offered to buy in the maturing Treasury issues at par; but psychology had deteriorated so greatly that holders of \$1.4 billion of the September 15 maturity -- nearly 20 percent of the issue -- held their securities for a cash pay-off. In the past two years, on the other hand, comparable refunding operations have involved cash pay-offs of 3 to 7 percent.

To the extent that holders of maturing issues refunded them via the Federal Reserve, the result was a sale of a large Treasury issue to the central bank, against the wishes of the Secretary of the Treasury. The operation meant also that as soon as the refunding was completed, the new issues would be selling at a discount in the market.

The actions of the Federal Reserve since the first of the year have, it is clear, jeopardized the entire financing program that may result from the Korean crisis. The Secretary has indicated on many occasions that small fractional changes in interest rates are of very limited effectiveness in combating inflationary pressures. They operate against inflation

in an over-all fashion; but, in order to be effective in areas of special inflationary pressures, interest rate increases would need to be so large that they would have a stringently repressive effect on the entire economy. In the present situation, a strong economy is required and a certain amount of expansion is necessary in order to provide for the heavier military output which we are now undertaking. It is essential, under the circumstances, that nothing be done which would depress the economy to such an extent that production of essential materials is slowed down.

It was with this in mind that the President recommended to Congress that in addition to the tax measures which he proposed, the Congress incorporate in the Defense Production Act of 1950 such selective controls as priorities and allocations of essential materials, products and services, and the control of consumer credit and privately financed real estate credit. It was felt that these measures would be sufficient to handle the inflationary situation for some time to come. Events since the President's message have not changed this conclusion. It is, in fact, reinforced by a study of the Federal budget outlook which indicates that, because of the normal delays in the new expenditure programs which have been developed as a result of the Korean crisis, net spending by the Government during the fiscal year 1951 is unlikely to be an important inflationary factor.

The Secretary had a definite and tangible reason for the actions which he proposed after the Korean crisis developed. He did not wish to change rates while the international situation was unsettled. The volume of financing that might be required was unknown, as were the timing and the circumstances under which financing might have to be conducted. But the Secretary was aware, as was the Federal Reserve, that an interest rate increase would be a tip-off to the market as to the fact that financing of military requirements was likely to be conducted on an ascending scale of interest rates and, therefore, declining prices in the Government security market. This would be an impossible situation.

The operations of the Federal Reserve, if continued along the lines followed up to now, are untenable because they can force the market failure of future Treasury financing offers, except at rising interest rates. This matter is one of most serious import because it aims directly at the matter of maintaining confidence in the financial structure of the United States Government. Confidence, both at home and abroad, in our financial structure and bond market stability is of prime importance. No uneasiness about the management of the public debt should be allowed to occur because it could result in wholesale liquidations of Government securities, particularly savings bonds, by nonbank investors. Years have been spent in building up confidence in the financial structure of the United States Government. The financing of the Korean crisis and whatever else may be required of us depends upon maintaining that confidence. It depends, moreover, upon the

complete ability of the Secretary of the Treasury to manage the public debt in the manner best designed for the well being of the economy.

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The table and the charts which follow cover some of the statistical points described above.

Attachments