The Fiftieth Anniversary of the Treasury-Fed Accord

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**From 1971 through 1977, Ralph Leach was Chairman of the Executive Committee of J. P. Morgan and Morgan Guaranty Trust. Before joining the Guaranty Trust Co. in 1953, he was Chief of the Government Finance Section at the Board of Governors of the Federal Reserve System. This article contains his reminisces about the Treasury-Federal Reserve Accord. The authors gratefully acknowledge conversations with C. Richard Youngdahl and Donald B. Riefler.

The fiftieth anniversary of Federal Reserve Independence Day is March 4, 2001. After the end of World War II, the Fed had continued to peg interest rates. The Treasury-Fed Accord announced March 4, 1951, freed the Fed from that obligation. Below, we chronicle the story of the Accord.

The initial part of the chronicle provides background on the views of policymakers after World War II. The body of the story tells of the dramatic confrontation between the Fed and the White House. The final part provides some explanation for why the Accord marks the birth of the modern Fed. Reminisces are from Ralph Leach who participated in these events as a staff economist at the Board of Governors.

I. The initial debate

Inflation soared with the end of wartime price controls. For the twelve-month intervals ending June 1946 and June 1947, CPI inflation was 17.6 and 9.5 percent, respectively. Why did the United States not free the Fed at that time from its obligation to peg interest rates? The answer lies in the prevailing understanding of the nature of inflation. Contemporary views on inflation still reflected views formed during the experience with a commodity monetary standard, which had been the norm since the colonization of America. Policymakers and the public believed that inflation arose from private rather than central bank behavior.

The main manifestation of that view was the prevalent belief about the price level that "what goes up must come down." In particular, before World War II, policymakers believed in the real bills view that inflation arose from speculative behavior by investors (see Humphrey 2001 and Hetzel 2001). In hearings on the 1945 *Full Employment Act*, Sen. Robert A. Taft (R. Ohio) said, "My definition of inflation has always been an activity which is artificially built up to an extent that we cannot permanently maintain" (cited in Goodwin and Herren 1975, p. 17). The real bills view held that, inevitably, deflation followed inflation as asset bubbles burst.

The economy then had to go through a period of forced inventory and asset liquidation and debt reduction. Policymakers had to let the accompanying economic recession run its course. People looked back to the recession that followed the post-World War I inflation. They also looked back to the stock market crash and Depression that followed the perceived asset price inflation in the twenties.

The deflation of the Depression and the inflation of World War II began to change these views. After the Depression, as expressed in the 1946 *Employment Act*, policymakers recognized a government responsibility to offset declines in private expenditure. The wartime and postwar inflation also changed attitudes. That inflation clearly arose from excessive aggregate demand, not asset speculation. As FOMC chairman Marriner S. Eccles (Board *Minutes*, 11/18/47, p. 1575) reasoned, "Even loans for productive purposes are inflationary if they increase the demand for labor and material that are already in short supply."

However, much of the earlier attitudes remained. Goodwin and Herren (1976, p. 44) cite a 1947 report written by prominent economists including John Kenneth Galbraith and Seymour E. Harris "For a very dramatic expression that unrestrained inflation would lead to a very serious depression." In a 1946 radio address, President Truman declared, "The inflationary pressures now at work can bring an inflation and a crash that will be much more serious than 1920" (cited in Goodwin and Herren, 1976, p. 27). In 1947, in an open letter recommending the veto of a bill reducing taxes, the Board of Governors (*Minutes*, 6/5/47, p. 849) wrote:

The longer inflationary pressures are sustained and

> readjustment deferred, the more serious the inevitable reaction will be. . . .the magnitude of which will depend largely upon how long inflationary forces are sustained.

That attitude, of course, heightened concern for inflation. However, the prevailing view that the central bank neither caused nor could control inflation negated its influence on monetary policy. Before the war, the Fed had denied responsibility for the behavior of the price level. In April 1939, an article in the *Federal Reserve Bulletin* (p. 258) criticized bills before Congress that would require the Fed to stabilize the price level: "[E]xperience has shown that prices do not depend primarily on the volume or the cost of money; that the Board's control over the volume of money is not and cannot be made complete."

After the war, the view continued that the Fed is impotent to control the price level. Policymakers saw the price level as determined by many powerful, nonmonetary factors with the central bank one, relatively minor influence. In a letter to the Board of the Philadelphia Fed scolding its members for a plea to restrain inflation through central bank action, the Board of Governors (Board *Minutes*, 5/28/47, p. 811) concluded:

> It would be most unfortunate if responsible people in the Federal Reserve System were to create the impression publicly that the System itself could at this late hour materially diminish inflationary forces. The problem is not so simple that it could be dealt with effectively by monetary policy. Outside of the monetary cranks, no one at all informed on the subject would suggest that in the great complex of economic forces there is some simple

monetary device that could preserve or restore economic equilibrium.

In steps taken from August 1947 through October 1948, the Fed and the Treasury agreed to raise the interest rate peg on short-term government debt. The major impetus for the change was the incompatibility of the 3/8 percent peg on 3-month Treasury bills with the 7/8 percent peg on one-year certificates was not viable. Banks sold short-term debt to buy the longer-term debt, which was just as liquid given the rate peg. The Fed then held almost all short-term government securities. Although the short-term peg was clearly untenable, no one questioned the sacrosanct 2-1/2 percent ceiling on long-term government bonds.

The Fed chafed at its inability to move short-term interest rates. (See the history of Fed-Treasury relations in U.S. Treasury, 1951 *Annual Report*, pp. 258ff.) However, the combination of the personal views of Fed policymakers and the political environment precluded an open challenge to Treasury dominance. Marriner Eccles, chairman of the Board of Governors until 1948, held the common belief that the post-war inflation arose from the government deficits incurred in World War II. To control inflation, he urged Congress to run large surpluses to extinguish government debt (see Eccles' [1947] congressional testimony). He also wanted the power to prevent banks from making loans that would add to the stock of debt. He concentrated on an ultimately futile effort to persuade

Congress to impose a supplementary reserve requirement on banks.

In an essay written before the Korean War, Allan Sproul (1951, p. 315), president of the New York Fed, expressed the common view that monetary policy could not affect inflation significantly without an unacceptable "contraction of employment and income." Sproul (1951, p. 298) wrote that the renewal of recession following the Fed's increase in reserve requirements in 1936 and 1937 made it "doubtful that credit policy would thereafter be used vigorously and drastically to restrain inflationary pressures." Sproul also expressed the common view that, because of the large amount of government debt outstanding, the Fed had to support the sale of government securities to avoid a "bottomless market" (U.S. Treasury, 1951 *Annual Report*, p. 261).

Regardless of the views of Fed policymakers, the Fed could not have won a political contest with the Treasury. By the end of the war, the war effort was consuming about 40 percent of national output. The fear that reconversion to a peacetime economy would bring a return to economic depression shaped political views. The Board of Governors expressed its unwillingness to challenge the status quo in a letter to the directors of the Philadelphia Fed, who had urged actions to control the "spiral of expanding credit." Such a course, the Board (Board *Minutes*, 5/28/47, p. 811) argued,

> would increase enormously the charge on the budget for servicing the debt. If the Secretary of the Treasury were confronted with any such consequences . . . he would no doubt take the issue directly to the President who, in turn, would take it to the Congress. . . There can hardly be any doubt as to what the result would be. The "System's freedom of action" would in all probability be promptly terminated.

By 1949, inflation had turned to deflation and the issue of inflation lapsed temporarily. However, because of the long-run contradiction between an interest rate peg and expectations implicitly assuming a gold standard, inevitably, the Fed would have to deal with inflation again. On the one hand, past experience with the gold standard still shaped the expectations of the public about the nature of inflation. A testament to the continuing influence of the gold standard experience is the fact that during this time no one ever argued that inflation raised bond rates by raising expected inflation.

On the other hand, the frozen pattern of interest rates was ultimately incompatible with monetary stability. For a while, the uncertainty created by the prevalent expectation that the Depression would reappear with the end of wartime spending created a demand for liquidity that validated the low level of the Fed's interest rate peg. The Korean War would force a change from this unsustainable situation. In doing so, it would give birth to the modern Fed.

II. Dramatis personae

Fed economists played an essential role in achieving the

Accord. They did so by articulating for policymakers the changes in the post-war intellectual environment. To make its case for an independent monetary policy directed toward economic stabilization, policymakers had to rely on the persuasiveness of their ideas.

The role of the economists was all the more important because of the atrophy of the federal character of the Federal Reserve System. The FOMC comprised all the Board governors and the five regional Bank Governors who were voting members. Because New York always voted, only four of the regional bank presidents attended FOMC meetings. The FOMC issued the Directive as a guide to monetary policy. However, the Directive changed only infrequently. Its language reflected the phase of the business cycle and accordingly stated whether the primary goal of monetary policy was to restrain inflation or to encourage economic activity.

The full FOMC left the interpretation of the Directive to the Executive Committee, which actually made monetary policy. It comprised the Board chairman, two governors, the President of the New York Fed, and a regional Bank president. The FOMC met about 5 times a year and the Executive Committee met about once a month. Allan Sproul and Marriner Eccles dominated the Executive Committee.

Allan Sproul was one of the giants of central banking. Sproul joined the San Francisco Fed in 1920. As Secretary of the Bank, he traveled to Washington for meetings on monetary policy. His abilities attracted the attention of Benjamin Strong, the legendary first head of the New York Fed, and George Harrison, who succeeded Strong. Harrison succeeded in bringing Sproul to New York in early 1930. Sproul became Harrison's assistant and later managed open market operations for the New York Desk. He became president of the New York Fed in 1941 (see Ritter, Chapter 1).

In the twenties, the New York Fed had functioned as the central bank of the United States. Allan Sproul wanted to reestablish the earlier dominant position of the New York Fed. In 1946, he turned down an offer to head the newly formed World Bank because of the importance he assigned to reviving monetary policy (Ritter 1980, p. 11). Sproul was the preeminent central banker within the Fed. He could articulate ideas and was the first FOMC member to bring to the FOMC table the idea that became a rallying point for the Fed it its effort to end the interest rate peg. He articulated the idea that the Fed should control bank reserves and let the market determine the interest rate.

Sproul valued highly his conversations with John H. Williams. Williams was both an officer of the New York Bank and a professor at Harvard. (He trained many of the next generation of Fed policymakers.) He was a renowned expert in international finance and became president of the American

Economic Association in 1952. Williams (FOMC *Minutes*, 8/18/50, p. 144) said at the August 1951 FOMC meeting that "[T]he basic question was how far the committee would be willing to see interest rates rise in order to curb monetary inflation and everything else would be ineffective unless there was a rise in interest rates."

Like other Fed economists, in response to the policy problems of the post-war period, Williams own views tempered the Keynesian views of academia. Contrary to expectations, the most important policy problem after the war was inflation rather than depression. The problem was not how to stimulate aggregate demand, but rather how to restrain it. In his presidential address to the American Economics Association, Williams (1952, p. 8) criticized Keynes. "Keynes' emphasis on the demand side - his principle of effective demand - sins quite as much in its taking for granted the adaptability of supply as the classical economists did in their reverse emphasis. This has interested me particularly in connection with problems of international trade adjustment." (The last comment refers to work on the overvalued British pound.) Fed economists recognized the importance of monetary policy and its relation to inflation some 20 years before the economics profession began to debate seriously that possibility.

President Roosevelt had appointed Marriner Eccles chairman (then called "Governor") of the Board of Governors effective November 15, 1934. First Roosevelt and then Truman reappointed him to successive four-year terms as chairman. However, when his term expired January 29, 1948, in a move that surprised Eccles, Truman declined to reappoint him (see "Knifed" in Hyman 1976).

Truman gave no reason. Although Eccles never learned the reason, he considered two possibilities (Hyman 1976, p. 339). Treasury Secretary Snyder may have wanted to get rid of him as an "abrasive adversary." Alternatively, in a presidential election year, Eccles was a political liability to him in California. Eccles was a fierce opponent of the attempt by A. P. Giannini to use the holding company Transamerica to expand the branch bank network of the Bank of America in California. Eccles' term as Board governor did not expire until 1958. Although no longer Board chairman, he remained on the Board of Governors. (He retired in July 1951.)

Eccles had believed that the government should use fiscal policy (what he called compensatory finance) to stabilize the economy. Only gradually did he come to believe that the Fed should control reserve creation by allowing the market determination of interest rates. Once converted to that view, he provoked the ultimate confrontation with the White House.

Thomas B. McCabe, chairman of Scott Paper Company, replaced Eccles as chairman of the Board of Governors. McCabe had been chairman of the Philadelphia Fed's Board of

Directors, which had written the 1947 letter cited above. McCabe made the Accord possible through the professional, honest way that he presented the case for monetary independence to the Executive Branch and Congress.

McCabe came to Washington on the condition that Winfield B. Riefler would accompany him as personal adviser. Riefler was an extraordinary individual with an exceptional background. He dominated discussion through the forcefulness of his intellect. No one could best him in an argument because he had all the facts and institutional background at his command.

In the twenties, Riefler had worked at the Board in Washington. While there, he developed the table in the *Federal Reserve Bulletin* currently called "Reserves of Depository Institutions and Reserve Bank Credit," which provided a consolidated Treasury-Fed accounting of the factors that supply and absorb bank reserves and currency. In a thesis originally written at the Brookings Institution and later published as a book, Riefler (1930) showed how Fed actions that affect bank reserves influence short-term interest rates.

In the early thirties, Riefler left the Fed for the Roosevelt administration, where he helped write the *Federal Housing Act*. He conceived and developed the idea of the self-amortizing home mortgage. Before then, home mortgages had matured in five years and required full payment of the principal at the end. After leaving government, Riefler joined Institute for Advanced Studies at Princeton.

Riefler wanted to re-establish Fed independence and to reorient monetary policy to the goal of economic stabilization. He realized that goal would require a free market in government securities. Not only would the Fed have to abandon its bond support program, but also it would have to allow and encourage the market to set government bond prices. It is hard to imagine now but there was no free market in government securities.

The New York Fed ran the market with an iron fist. A government securities dealer who wanted to change the price of a government bond by even a minuscule fractional amount would call Robert G. Rouse (head of the New York trading desk). And Rouse would probably say no. With the exception of a few academics at places like the University of Chicago, people could not imagine the Treasury placing the huge amount of debt created during the war without the assistance of the Fed. Riefler, however, realized that the only way to avoid continued pressure by the Treasury on the Fed would be to make completely clear that the Fed would not intervene to control bond prices.

The Board staff economists who advocated a free market in government securities included also the long-time Fed economists Woodlief Thomas and Ralph Young. A younger economist, Richard Youngdahl had received a Ph.D from the University of Minnesota, where he studied with George Stigler and Arthur W. Marget.

In contrast to the views in the Fed, President Harry S. Truman and Treasury Secretary John Snyder held strong populist views. Both felt that government had a moral obligation to protect the value of the war bonds purchased by patriotic citizens. Truman talked about how in World War I he had purchased Liberty Bonds, only to see their value fall after the war.

III. The challenge to the Treasury

Leach joined the Fed right before the storm. After serving in World War II in the South Pacific, Leach managed the Treasury portfolios of two moderately sized banks, first, in Chicago and later in Phoenix. In both cases, Leach was an active trader of government securities. Leach developed a telephone acquaintance with all the major Treasury dealers and joined them in the daily routine of guessing the actions of the Fed's New York trading Desk.

In spring 1950, the Federal Reserve Board decided to add someone with market experience to its Washington staff. Some of my associates recommended Leach. After talking with Winfield Riefler and Woodlief Thomas, Leach accepted the position of Chief of the Government Securities Section of the

Research Division.

The Korean War broke out the day before Leach started his new job. Both Riefler and Thomas came to my office to say they felt they had done me a disservice. War meant the continued pegging of the government securities market rather than the development of a free market that would permit an independent monetary policy. In fact, the opposite occurred.

At its August 1951 meeting, the FOMC issued its first public challenge to Treasury domination of monetary policy. Particularly since its June 13, 1950, meeting, the FOMC had chafed at the straitjacket imposed by the rigid regime of rate pegging. Since the trough of the business cycle in October 1949, the economy had recovered strongly. At the June meeting, Sproul had recommended raising short-term rates by 1/8 percent. The sacred cow of the rate peg was the 2-1/2 percent rate on long-term bonds. Although long-term bonds were selling above par (yielding less than the 2-1/2 percent ceiling), everyone knew that the Fed's Rubicon would be a rise in short-term rates incompatible with this 2-1/2 percent wartime ceiling. Sproul commented, "[I]f we are faced with the decision whether to let long-term bonds go below par, I would let them go below par" (FOMC *Minutes*, 6/13/5, p. 87).

At the August meeting, the FOMC decided to challenge Treasury Secretary Snyder's unwillingness to allow any rise in rates, short-term or long-term. Later, President Sproul expressed the frustration the Committee had experienced in dealing with the Secretary (FOMC *Minutes*, 2/6/51, p. 69):

> [W]e had been discussing these problems with him for more than a year . . . he had discussed them with us little or not all . . . he had usually turned to an associate and usually asked if they had any comment to make and then said that he would let us know what he was going to do . . . that had usually been followed by an announcement by him, often anticipating far in advance his needs, of the financing program which had differed almost completely from our recommendations and which had had the effect of freezing our position.

These one-way conversations reflected the Treasury's view of the Fed as a subordinate organization. Just before the August FOMC meeting, Chairman McCabe and the System Open Market Account Manager, Robert Rouse, had met with Secretary Snyder to urge him to issue a nonmarketable long-term bond to remove the marketable bonds from the market. As Rouse put it, "[T]here ensued a spirited discussion" and "an impasse" (FOMC *Minutes*, 8/18/50, p. 131).[1]

A less significant, but still telling, example occurred on the day of the August FOMC meeting. At the Treasury's invitation, after lunch, members of the FOMC went to the Treasury to see a chart show on the distribution of Treasury securities by class of investor. However, before they went, a Mr. Haas called and informed them "that, while he would be glad to show the slides to members of the Committee and the staff, he and the staff could not spare the time for a discussion of the figures" (FOMC *Minutes*, 8/18/50, p. 133).

At the August meeting, Sproul raised the challenge. He referred to the fruitless discussions with the Treasury and said, "We have marched up the hill several times and then marched down again. This time I think we should act on the basis of our unwillingness to continue to supply reserves to the market by supporting the existing rate structure and should advise the Treasury that this is what we intend to do--not seek instructions" (FOMC *Minutes*, 8/18/50, p. 137).

Governor Eccles agreed with Sproul that if the System "expected to survive as an agency with any independence whatsoever [it] should exercise some independence" (FOMC *Minutes*, 8/18/50, p. 137). Despite concern about the Treasury refunding of the September 1-1/4 percent certificates maturing in two weeks, the FOMC agreed to raise the interest rate on one-year Treasury securities from 1-1/4 to 1-3/8 percent. The members of the Board of Governors also decided to approve the recommendation of the New York Fed to increase the discount rate from 1-1/2 to 1-3/4 percent. Chairman McCabe and Vice Chairman Sproul then prepared to go to the Treasury to inform Secretary Snyder of the FOMC's decision.

First, however, the Board staff asked what should the FOMC do if the Treasury were to attempt to forestall its action by immediately announcing a refunding of the one-year securities at a 1-1/4 percent rate. At this point, Leach asked Chairman McCabe if I could make a comment on the market. He replied, "We don't have opinions on the market down here-we rely on New York for those opinions." After an awkward silence, Sproul turned to me and said, "I would like to hear your comment." My suggestion was to announce the discount rate change after the market closed, but with no comment.

Monday morning, as soon as the market opened and trading began, Leach argued that the New York Desk should put out a par bid for all of the new Treasury issue. The result would be that the New York Desk would purchase the Treasury issue at the ("high") price consistent with the current rate peg. However, as the Desk bought the new issue, it would sell other short-term issues at the ("low") prices consistent with the desired rise in interest rates. That action would prevent failure of the refunding because the Fed would buy the Treasury issues. At the same time, it would raise short-term interest rates.

Sproul asked for a short recess, during which he, Rouse, and Leach discussed the probable market response. Sproul then endorsed the plan and the FOMC approved it. The Board of Governors approved the discount rate increase, which it announced without comment after the market closed. McCabe and Sproul then made the five-minute drive to the Treasury.

When told that the Fed planned to raise short-term interest rates, Snyder reacted angrily. With the President's support, Secretary Snyder immediately announced the refunding of the 13-month Treasury issues maturing not only in September but also in October. He rolled them both into 13-month notes at the pegged rate of 1-1/4 percent. Snyder assumed, incorrectly as it turned out, that his action would force the Fed into maintaining the old pegged rate. Dealers immediately understood the implications of the Desk's par bid for the new Treasury issue. At the opening of the market, they dropped their offering prices (raising rates) on other short-term issues. In the next few days, several billion dollars in securities traded at the higher rates (and the corresponding lower prices).

At the beginning of the August 1950 FOMC meeting, Eccles had argued that that the Fed could act only with Treasury acquiescence. During the lunch break, other staff members and Leach explained to him that buying the new issue at par would mute the challenge to the Treasury. After the meeting resumed, Eccles then argued that the proposed action would be a good way to get the debate into the open. As Woody Thomas told me after the meeting, "We walked him up one side of Constitution Avenue and down the other, and it turned out well." However, Woody also told me that Marriner wanted to see me in his private office. Eccles gave me quite a dressing down for having been too forward at the meeting.

Newspapers were full of stories of the Fed challenge to the Treasury. Fed critics claimed that the Fed had taken over management of the federal debt. Fed supporters countered that the Treasury should price its offerings at interest rates that would attract investors to buy and hold them.

At the September 27, 1950, meeting of the Executive Committee, Sproul and staff economists Williams and Riefler argued for another rise in short-term rates. Eccles demurred. He argued that no significant increase in short-term rates would be possible without an increase in the long-term rate. Before that could happen, Eccles said, the Fed should "present the matter to Congress with a clear explanation of the problems and the alternatives available" (FOMC *Minutes*, 9/27/50, p. 167). The success of MacArthur's September 15 Inchon landing, 200 miles behind enemy lines, made the viability of the 2-1/2 bond rate peg less problematic.

Over the objections of Treasury Secretary Snyder, at its meeting on October 11, the FOMC decided to raise the one-year Treasury bill rate to 1-1/2 percent. On October 16, the Board of Governors sent a letter to Secretary Snyder explaining its actions. It stated, "We can assure you that these actions will not affect the maintenance of the 2-1/2 percent rate for the outstanding long-term government bonds."

Within the FOMC, Truman had an ally who used newspaper leaks to discredit Chairman McCabe. The first internal conflict occurred over leaks to the *American Banker* of FOMC debate. Those leaks incorrectly portrayed FOMC participants as divided in their challenge to the Treasury. Suspicion focused on Governor James K. (Jake) Vardaman, who had been a close friend of President Truman from Truman's early days as a machine politician in Kansas City, Missouri. Truman had appointed him to the Board in 1946. Leach recalls that at a Board meeting, Board Vice Chairman M. S. (Matt) Szymczak declared that the leaks were disgraceful and that he was not responsible for them. One by one, the governors repeated Governor Szymczak's statement. Vardaman could see the sentiment moving around the table toward him. Before it reached him, he rose from the table and left the room stating, "I don't have to put up with this."

Throughout the fall, Chairman McCabe and Vice Chairman Sproul attempted to persuade Treasury Secretary Snyder directly and, indirectly through him, President Truman of the need to raise interest rates. However, the chasm that existed was unbridgeable. Truman was a populist. He believed that banks, not the market forces of supply and demand, set interest rates. Truman wrote Russell C. Leffingwell, Chairman of J. P. Morgan, "I can't understand why the bankers would want to upset the credit of the nation in the midst of a terrible national emergency. That seems to be what they want to do and if I can prevent it they are not going to do it" (Donovan 1982, p. 329). Snyder believed that "Sproul and New York bankers and brokers were trying to recapture the primacy in fiscal and monetary affairs that had been lost to

Washington during the New Deal" (Donovan 1982, p. 328).

Although the Fed continued its attempt to convince the Treasury of the need for a rise in interest rates, it never considered unilateral abandonment of the 2-1/2 percent bond rate peg. However, and this was the sticking point, it would not publicly commit to the indefinite maintenance of the peg. The Treasury wanted the Fed to commit publicly to maintaining the existing interest rate structure for the duration of hostilities in Korea. On December 4, Truman wrote McCabe (FOMC *Minutes*, 1/31/51, p. 9):

> [T]he Federal Reserve Board should make it perfectly plain . . . to the New York Bankers that the peg is stabilized. . . . I hope the Board will . . . not allow the bottom to drop from under our securities. If that happens that is exactly what Mr. Stalin wants.

IV. From stalemate to confrontation

The formally correct but strained relationship between the Fed and the Treasury fell apart with the intensification of the war in Korea. On November 25 and 26, the Chinese army, 300,000 strong, crossed the Yalu River. Suddenly, the United States faced the possibility of a war with China and, if the Soviet Union came to the aid of its ally, World War III. As the communists pushed Allied forces back down the Korean peninsula, Washington wondered whether General MacArthur could stop the communist advance at the 38th parallel. MacArthur requested authority to involve the Nationalist troops of Chiang Kai-shek, and Truman at a press conference left the impression that MacArthur could use atomic weapons. On world markets, commodity prices soared. Anticipating the reimposition of wartime controls and shortages, consumers rushed out to buy consumer durables. For the three-month period from December 1950 through February 1951, CPI inflation was at an annualized rate of 21 percent.

The working relationship between the Fed and the Treasury then began to unravel. At the November 27 FOMC meeting, Sproul argued that "[W]e must look toward unfreezing the long end of the rate pattern as well as the short end." Eccles countered that the Fed should "present the matter to Congress and that the Congress should decide" (FOMC *Minutes*, 11/27/50, p. 236). However, he made an additional suggestion. Throughout 1950, the 2-1/2 percent ceiling on bond rates had not been binding. The New York Desk had kept the price of long-term bonds above par (their interest rate below to 2-1/2 percent), and the desk still had to *sell* bonds. Eccles advocated that their price be allowed to fall somewhat so that they traded just below 2-1/2 percent.

That fall in the bond price would still leave in place the sacrosanct 2-1/2 percent rate peg. However, it would address an immediate problem. The threat of a major, protracted war created the real possibility that the bond rate would rise to its 2-1/2 percent ceiling, and possibly above. Life insurance companies, which held the bonds, then had an incentive to sell them immediately to avoid a capital loss. The Fed did not want to monetize an avalanche of bond sales. For that reason, it wanted to eliminate the above par price on the bonds. The Treasury, in contrast, saw the problem as the Fed's own creation. If the Fed would only publicly commit to maintaining indefinitely the current price of bonds, it believed, the insurance companies would no longer have an incentive to sell.

These conflicting views collided over a routine Treasury refunding. On November 13, Secretary Snyder had written Chairman McCabe requesting FOMC views on the appropriate yields to offer on a December 15 refunding. The Treasury accepted Fed advice and priced its issues in a way that reflected the Fed's recent increase in short-term rates. However, the refunding went poorly. Snyder believed that the Fed had reneged on a pledge of full cooperation. Why?

Between the pricing of the new issues and bringing them to market, the Chinese had entered the war and routed American forces. For the reason given above, the FOMC then reduced slightly its buying price for long-term bonds. Secretary Snyder saw that action as creating a fear of capital loss that hindered the success of the refunding. On December 9, McCabe had written President Truman that the Fed would give its full support to the refunding. Snyder believed that the FOMC had reneged on that promise.[2]

McCabe and Sproul met with Snyder January 3, 1951. Sproul argued that the inflation following World War II had come from too low a rate peg. He accepted that the possibility of large future government deficits might necessitate maintaining a rate peg. However, in anticipation of that eventuality, the Fed should allow a higher level of the peg. He also added, "If present inflationary advances in the credit sector continue . . . further action to restrict the availability of bank reserves would be in order" (FOMC *Minutes*, 1/31/51, p. 5).

On January 17, 1951, McCabe met with Truman and Snyder at the White House. Upon his return, McCabe dictated a memorandum of the conversation. (See FOMC *Minutes*, 1/31/51, pp. 12-13.) At the meeting, he made the point that "the purchase of these bonds resulted in the creation of reserves in the banks, which were very inflationary." Truman and Snyder reiterated their desire for the Fed to make a public commitment to the 2-1/2 percent bond peg. Snyder argued that investors would stop selling their bonds if the Fed were to reassure them that it would maintain their price.

On the next day, January 18, 1951, Secretary Snyder addressed the New York Board of Trade. There he announced that Chairman McCabe had agreed that future Treasury "issues will be financed within the pattern of that [2-1/2 percent] rate" (U.S. Treasury, 1951, p. 616). In his memoirs, Eccles

(1951, p., 485) expressed his feelings by quoting commentary contained in the *New York Times*. "[L]ast Thursday constituted the first occasion in history on which the head of the Exchequer of a great nation had either the effrontery or the ineptitude, or both, to deliver a public address in which he has so far usurped the function of the central bank as to tell the country what kind of monetary policy it was going to be subjected to." When the FOMC met on January 31, McCabe told its members that he was "shocked to read the account of Snyder's speech" and that he had made no such commitment (FOMC *Minutes*, 1/31/51, p. 14). In an open challenge to the Secretary, on January 29, the FOMC lowered its support price for government bonds by 1/32.

Later, in testimony in the Patman hearings, Snyder said that McCabe had "assured the president that he need not be concerned about the 2-1/2 percent long-term rate" (U.S. Treasury 1951, p. 270). The professional conduct of Chairman McCabe throughout this period makes it inconceivable that he would have made a commitment that only the full FOMC could have made. After failing to get a clarification from Secretary Snyder on exactly what McCabe had promised, in exasperation, Sen. Douglas (U.S. Cong. 1952b, p. 37) stated:

> Talleyrand said that words were used to conceal thought. I have always thought that words should be used to express thought, and it is the lack of this quality which I find unsatisfactory in your testimony throughout.

Truman had compelling reasons to freeze interest rates.

On January 25, 1951, he froze wages and prices, apart from farm prices. Politically, raising the cost of borrowing, especially on home mortgages, while freezing wages was political poison.[3] More important, in January 1951, Truman confronted the possibility of world war. Treasury communication with the Fed referred to a possible Soviet attack on the United States "within the foreseeable future" (FOMC *Minutes*, 3/1/51, p. 119).

Truman and Snyder wanted to tie down the cost of financing the deficits that would emerge from a wider war. Truman believed it immoral to raise bond rates and lower the value of the bonds sold by the government to its citizens. He also believed that citizens had a moral imperative to support the soldiers in Korea through taxes. Furthermore, Truman and the leadership in Congress believed that deficit financing had caused the World War II inflation. Congress raised taxes sharply in September 1950 with the Revenue Act of 1950 and again in January 1951 with an excess profit tax (Goodwin and Herren 1976, p. 71). However, if the war widened to include China and possibly the Soviet Union, there would be government deficits.

By early 1951, communist forces had recaptured Pyongyang and Seoul. In a cable to Washington, Gen. MacArthur stated that the "military position is untenable, but it can hold for any length of time up to its complete destruction if overriding political considerations so dictate."[4] Secretary of State Acheson decided that the Eighth Army should withdraw from Korea if losses threatened its ability to defend Japan. A naval blockade of China that would provoke a wider war loomed as a possibility. Later, Gen. Bradley said, "[I]f we had been driven out, I think our people would have demanded something else be done against China."

On January 25, Governor Eccles, speaking for himself, openly challenged the administration in testimony before the Joint Committee on the Economic Report. He testified (U.S. Cong., 1951, p. 158):

> As long as the Federal Reserve is required to buy government securities at the will of the market for the purpose of defending a fixed pattern of interest rates established by the Treasury, it must stand ready to create new bank reserves in unlimited amount. This policy makes the entire banking system, through the action of the Federal Reserve System, an engine of inflation.

Governor Eccles and Rep. Wright Patman, a populist congressman from Texarkana, Texas, went head-to-head (U.S. Cong., 1951, pp. 172-6):

> Patman: Don't you think there is some obligation of the Federal Reserve System to protect the public against excessive interest rates?
>
> Eccles: I think there is a greater obligation to the American public to protect them against the deterioration of the dollar.
>
> Patman: Who is master, the Federal Reserve or the Treasury? You know, the Treasury came here first.
>
> Eccles: How do you reconcile the Treasury's position of saying they want the interest rate low, with the Federal Reserve standing ready to peg the market, and at the same

> time expect to stop inflation?
>
> Patman: Will the Federal Reserve System support the Secretary of the Treasury in that effort [to retain the 2-1/2 percent rate] or will it refuse? . . . You are sabotaging the Treasury. I think it ought to be stopped.
>
> Eccles: [E]ither the Federal Reserve should be recognized as having some independent status, or it should be considered as simply an agency or a bureau of the Treasury.

On January 29, the Fed raised the bond rate by 1/32. That action prompted Snyder to ask Truman to call the entire FOMC to the White House (FOMC *Minutes*, 1/31/51, pp. 20). It was the first time in history that any President had called the FOMC to meet with him.[5] The FOMC met on January 31 and McCabe informed its members that they could either resign or agree to the President's demand to peg interest rates. Sproul suggested an additional alternative, namely, to ask Congress to resolve the impasse (FOMC *Minutes*, 1/31/51, pp. 15-16, 19).

The FOMC then tried to prepare a statement for its meeting with the President. Governor Vardaman disagreed with the contents and stated that "in a period such as the present, the members of the Board ceased to be civilian officers of the government, and that he would be guided by whatever request was made by the President as Commander-in-Chief" (FOMC *Minutes*, 1/31/51, p. 21). Sproul replied that "would make the Federal Reserve System a bureau of the Treasury and, in light of the responsibilities placed in the System by the Congress, would be both impossible and improper" (FOMC *Minutes*, 1/31/51, p. 23). The FOMC abandoned the attempt to draft a statement.

The FOMC met with President Truman late in the afternoon of Wednesday, January 31 (see FOMC *Minutes*, 1/31/51, pp. 24-26). Truman began by stating that "the present emergency is the greatest this country has ever faced, including the two World Wars and all the preceding wars. . . .[W]e must combat Communist influence on many fronts. . . . [I]f the people lose confidence in government securities all we hope to gain from our military mobilization, and war if need be, might be jeopardized." Chairman McCabe, in turn, explained the responsibility of the Federal Reserve "to promote stability in the economy by regulating the volume, cost and availability of money, keeping in mind at all times the best interests of the whole economy." McCabe suggested a continuing dialogue with Secretary Snyder, and, if that dialogue failed, a meeting between him and the President.

After meeting with the President, the FOMC reconvened and asked Governor Evans to prepare a memorandum recording the events of the meeting.[6] President Sproul reviewed it. The memorandum recorded that FOMC members had made no commitment to the President. However, the next morning the White House press secretary issued a statement that "The Federal Reserve Board has pledged its support to President Truman to maintain the stability of Government securities as long as the emergency lasts." The Treasury then issued a statement saying that the White House announcement "means the market for

Government securities will be stabilized at present levels and that these levels will be maintained during the present emergency" (Eccles, 1951, pp. 491-92)

Eccles received telephone calls from Alfred Friendly of the *Washington Post* and Felix Belair, Jr., of the *New York Times*. Eccles contradicted the administration press releases by telling them that the FOMC had made no such commitment. Without attribution, the two newspapers reported Eccles' comments the next day. The following morning, Friday, members of the Executive Committee met informally at the request of Governor Vardaman.[7] Vardaman demanded to know who was the source of the *Times* story. Eccles said that he was the source and defended his release of the information.

McCabe then revealed that President Truman had sent him a "Dear Tom" letter that included the statement, "I have your assurance that the market on government securities will be stabilized and maintained at present levels." After discussion, the FOMC agreed that McCabe should meet privately with President Truman to ask him to withdraw the letter. However, McCabe went to his house in Philadelphia for the weekend without seeing Truman.

Upon seeing the stories in the *Washington Post* and *New York Times*, and without informing McCabe, Snyder had Truman release to the press his (Truman's) letter to McCabe. Later, in his memoirs, Eccles (1951, p. 494) recorded his reaction.

"[T]he letter was the final move in a Treasury attempt to impose its will on the Federal Reserve. If swift action was not taken . . . the Federal Reserve would . . . lose the independent status Congress meant it to have and . . . would be reduced to the level of a Treasury bureau."

Eccles also reports in his memoirs that he had shortly before completed a letter of resignation to the President. He then decided to postpone his resignation. Eccles had been Chairman of the FOMC from its creation in 1935 until 1948. He did not intend to leave Washington with the Federal Reserve under the control of the Treasury. According to a Truman staff member, Truman had fired Eccles in 1948 to show him "who's boss." Eccles' feeling that Truman had treated him peremptorily must have still rankled.

Belair of the *Times* telephoned Eccles (1951, p. 494) and informed him of the release of Truman's letter. Eccles then made a momentous decision. Acting on his own, he released a copy of the memorandum the FOMC had made recording its account of the meeting with President Truman. Eccles arranged for it to appear in the Sunday February 4 edition not only of the *New York Times*, but also of the *Washington Post* and the *Washington Evening Star*. The memorandum was headline news. As Eccles (1951, p. 496) put it, "[T]he fat was in the fire." Hyman (1976, p. 349) wrote, "By Monday morning the controversy had reached blast furnace heat."

Tuesday February 6, Chairman McCabe convened first a meeting of the Board and then of the FOMC to decide what to do.[8] Governor Vardaman had written a statement asserting that "McCabe had given President Truman every reason to believe that the Committee and Board would support the government financing program." Thwarted by Governor Powell in his attempt to send it out as a press release, Vardaman demanded a meeting of the Board unless he (Powell) "wished to assume responsibility for throttling another member of the Board." At the Board meeting, McCabe accused Vardaman of leaking an account of the FOMC executive session after the White House meeting to a newspaper reporter, Doris Fleeson. Vardaman denied that he was the source of the leak, and Governor Evans asked "to have the minutes show that he did not believe Mr. Vardaman's statement." Governor Szymczak said that President Truman must have signed the letter to McCabe without having seen it, and Governor Vardaman said that he "did not intend to discuss the veracity of the President."[9]

When the FOMC met, it discussed writing a letter to the President that would reestablish a working relationship with the Executive branch. However, as pointed out by Vardaman, "[T]he suggestions made by Mr. Sproul did not contemplate any change in the policy of the committee, that was the crux of the matter" (FOMC *Minutes*, 2/6/51, p. 45). Led by Sproul and Eccles, the FOMC was unwilling to make a long-term commitment to peg the price of government bonds at 2-1/2 percent.

Forced by the rate peg issue to make a stand on the role of a central bank in creating inflation, Eccles grasped the nature of a central bank in a fiat money regime. It was not private speculation or government deficits that caused inflation, it was reserve and money creation by the central bank. Eccles (FOMC *Minutes*, 2/6/51, p. 50-51) said:

> [We are making] it possible for the public to convert Government securities into money to expand the money supply. . . . We are almost solely responsible for this inflation. It is not deficit financing that is responsible because there has been surplus in the Treasury right along; the whole question of having rationing and price controls is due to the fact that we have this monetary inflation, and this committee is the only agency in existence that can curb and stop the growth of money. . . . [W]e should tell the Treasury, the President, and the Congress these facts, and do something about it. . . . We have not only the power but the responsibility. . . . If Congress does not like what we are doing, then they can change the rules.

At the next FOMC meeting, Sproul (FOMC *Minutes*, 3/1/51, p. 125-6) would state the idea that a central bank controls inflation through the monetary control made possible by allowing market determination of the interest rate:

> [T]he Committee did not in its operations drive securities to any price or yield . . . market forces had been the determining factor, and that only in resisting the creation of reserves had the committee been a party to an increase in interest rates. That . . . was the result of market forces, and not the action of the Committee.

In a letter that abandoned completely the gold standard belief that private markets determine the price level, the FOMC (FOMC *Minutes*, 2/7/51, p. 60) wrote to Truman:

> We favor the lowest rate of interest on government securities that will cause true investors to buy and hold these securities. Today's inflation. . . is due to mounting civilian expenditures largely financed directly or indirectly by sale of Government securities to the Federal Reserve. . . . The inevitable result is more and more money and cheaper and cheaper dollars.

The white-hot crucible of debate over the consequences of interest rate pegging marked an intellectual watershed. Gone was the self-image of a central bank that allows an "elastic currency" passively to "accommodate commerce." The Fed moved toward the idea of the control of money creation to stabilize the purchasing power of the dollar.

The FOMC's February 7 letter to President Truman offered to work with the Secretary of the Treasury. The FOMC also wrote a letter to the Secretary making a number of specific proposals. McCabe ended the February 7 meeting by referring to a *Wall Street Journal* article purporting falsely that the discussion in yesterday's FOMC meeting had been "acrimonious." Also, several senators had informed McCabe that a Board member was "undermining with members of Congress" the FOMC's position (FOMC *Minutes*, 2/7/51, p. 66). The purpose of the leaks of FOMC discussion was to undermine the position of the Chairman by claiming that his views did not reflect the views of the Committee. McCabe threatened dismissal for any FOMC member leaking confidential discussion to the press or Congress.

McCabe and Sproul then met Secretary Snyder. It was their first meeting since the blowup. McCabe (FOMC *Minutes*, 2/8/51, pp. 67-8) recounted it that afternoon for the FOMC. Snyder "had very strong feelings about the situation that had been created." He claimed that McCabe had not followed through on his [Snyder's] "understandings" of the January 17 meeting with the President. When McCabe read the letter the FOMC had written to the President, Snyder called it "preachy."

McCabe continued:

> I also said that if the Secretary had in mind making a public announcement like the one he made on January 18, I felt strongly that he should have let me know, especially where he used my name and the President's name. . . . I said to the Secretary, "The President told me afterward that he did not know you were going to make a speech in New York." That disturbed Secretary Snyder very greatly. He said the President knew exactly what he was going to say. . . . I said this had cut me very deeply.

During its afternoon meeting, the FOMC learned that the President at a news conference had said that "it was his understanding that a majority of the Reserve Board members sided with him on the interest rate question between the Board and the Treasury" (FOMC *Minutes*, 2/8/51, p. 70).

The Executive Committee met on Saturday February 14. McCabe then told the Committee how political pressure had converged on the Fed from both the Executive and congressional branches of government. On Saturday February 10, Snyder had announced that he was going into the hospital on Sunday. (His doctor had advised him to have a cataract operation.) McCabe called Snyder, who urged him to do nothing for the two weeks he expected to be in the hospital. Snyder then called Senator

Maybank.

Senators Maybank (D. South Carolina), Robertson (D. Virginia), and O'Mahoney (D. Wyoming) called McCabe. All three were members of the Committee on Banking and Currency and O'Mahoney was chairman of the Joint Committee on the Economic Report. They urged McCabe to heed Snyder's appeal. O'Mahoney told McCabe that Rep. Patman and Senator Capehart (R. Indiana) wanted to hold hearings that would be critical of the Fed. All three senators supported Snyder's advice to withdraw the FOMC's letter to the President. McCabe told the FOMC, "It was evident from my conversations with the Senators that they were fearful of publicity of our letter to the President and of public hearings" (FOMC *Minutes*, 2/14/51, pp. 80-1). The senators urged the Fed to do nothing while Snyder was in the hospital (Sproul 1952, p. 522).

To emphasize his point that the Fed should not openly confront the Executive Branch, Senator O'Mahoney (FOMC *Minutes*, 2/14/51, p. 83) sent McCabe a letter stating:

> The Soviet dictators are convinced that the capitalistic world will wreck itself by economic collapse arising from the inability or unwillingness of different segments of the population to unite upon economic policy. Inflation in the United States is the result of no single cause and therefore cannot be remedied by a single cure. . . . It is imperative in this crisis that there should be no conflict between the Federal Reserve Board and the Treasury.

The banking community added to the isolation of the Fed by refusing to support its position. On February 2, the Board had met with the Financial Advisory Committee, which represents the views of large banks. Eccles accused bankers of a lack of "courage and realistic leadership" (Board *Minutes*, 2/20/51, p. 389).

The Executive Committee refused to withdraw the letter to the President. Furthermore, it wrote a defiant letter to Senator O'Mahoney. The letter began with the famous quote from John Maynard Keynes "that the best way to destroy the Capitalist System was to debauch the currency." The letter expressed hope for an agreement with the Treasury, but ended by saying that if such agreement were not possible "[W]e will have no defensible alternative say but to do what, in our considered judgment, is for the best interests of the country, in accordance with our statutory responsibilities" (FOMC *Minutes*, 2/14/51, p. 89).

On the morning of February 26, McCabe and Sproul attended a meeting in the White House with the President and other government policymakers. Truman read a memorandum stating that "Changing the interest rate is only one of several methods to be considered for curbing credit expansion." He then asked the Fed chairman and other policymakers "to study ways and means to provide the necessary restraint on private credit expansion and at the same time to make it possible to maintain stability in the market for government securities" (FOMC *Minutes*, 2/26/51, p. 102). That is, the White House wanted the Fed to use only selective credit controls to control credit extension. When Chairman McCabe "commented on the situation created by the continued purchase by the system of . . . bonds," [Treasury Under Secretary] Foley countered "that the proposed action by the Federal Open Market Committee might cause a crisis which should be avoided." During the meeting, the White House released the contents of the President's memorandum to the press.

The Fed not only remained adamant, but forced resolution of the dispute. The Fed informed the Treasury that as of February 19, it "was no longer willing to maintain the existing situation in the Government security market" (U.S. Treasury 1951, p. 266). Sproul (1952, p. 522) recounted that the Fed informed the Treasury that "unless there was someone at the Treasury who could work out a prompt and definitive agreement with us . . . we would have to take unilateral action." At the time, the Treasury faced a sizable need to refund existing debt. For the first time, it also faced the prospect of issuing new debt. To quiet uncertainty in the markets, the Treasury believed it had no choice but to end the public dispute.

The Treasury maintained its view that direct controls were preferable to increases in interest rates (FOMC *Minutes*, 3/1/51 p. 117). However, the Treasury also believed that an end to the dispute with the Fed would restore market confidence and allow it to continue to sell bonds at 2-1/2 percent (FOMC *Minutes*, 3/3/51, p. 153). Moreover, as became apparent later, the Treasury still had another weapon to use.

When Snyder went into the hospital, he left negotiations with the Fed in the hands of the Assistant Secretary of the Treasury, William McChesney Martin. Martin had exceptional qualifications. In 1938 at age 31, he became chairman of the New York Stock Exchange. Newspapers called him the "boy wonder of Wall Street." After the Army drafted him in World War II, he helped run the Russian lend-lease program. In 1946, he became head of the Export-Import Bank. In December 1948, Treasury Secretary Snyder, a fellow Missourian, convinced Martin to join the Treasury. Finally, Martin's father had been governor of the Federal Reserve Bank of St. Louis.

Martin notified the Fed that he wanted to negotiate based on the February 7 letter. He reestablished the staff contact between the Treasury and the Fed that Snyder had forbidden some years earlier. Martin and Fed staff members, Rouse, Thomas, and especially Riefler, negotiated an agreement between the Treasury and the Fed.

As presented to the FOMC on March 1, the compromise reflected Riefler's original ideas. The Fed would keep the discount rate at 1-3/4 percent through the end of 1951. The Treasury would remove marketable bonds from the market by exchanging them for a nonmarketable bond yielding 2-3/4 percent.[10] To make those bonds liquid and thus more attractive to the market, they would be exchangeable for a 1-1/2 percent marketable five-year note. During the exchange, the Fed would support the price of the five-year notes. That support was central because the value of the nonmarketable bonds depended upon the price of the five-year note. However, the Fed made no commitment to support their price beyond purchases of $200 million.

On March 1, Martin presented the compromise to the FOMC. He displayed the charm for which he is legendary. He began by saying, "I want to say for the Treasury people we could not have had pleasanter or more frank or more open discussions" (FOMC *Minutes*, 3/1/51, p. 118). The sticking point with the FOMC was whether the Treasury had accepted, during the bond exchange, a limitation both on the duration and dollar amount of its intervention in support of the five-year note. Also, the FOMC wanted to make sure that its commitment to maintain "orderly markets" did not imply a rate peg.

The FOMC met again on March 3, 1951. Chairman McCabe said that Mr. Murphy, Special Counsel to the President, had inquired on behalf of President Truman whether long-term bonds would drop below par. McCabe had replied to Murphy that he could not say. During the meeting, Riefler received a telephone call from Martin informing him that Secretary

Snyder, who was still in the hospital, had accepted the limitations on Fed support during the exchange. However, Martin requested that there be no written record of that point.

The FOMC then voted to ratify the Accord and issue the following statement the next day, Sunday March 4: "The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt."

The White House moved next. Immediately after the announcement of the Accord, at Snyder's urging, Truman asked McCabe to resign (see Donovan 1982, p. 331). McCabe sent in a bitter letter of resignation, but resubmitted a bland version when asked to do so by the White House. McCabe, however, conditioned his resignation on the requirement that his successor be acceptable to the Fed. On March 15, the President appointed William McChesney Martin to replace McCabe. The Senate confirmed Martin on March 21. McCabe left office March 31, and Martin took office April 2.

The initial reaction both among Board staff and on Wall Street to Martin's appointment was that the Fed had won the battle but lost the war. That is, the Fed had broken free from the Treasury, but then the Treasury had recaptured it by installing its own man. However, as FOMC chairman, Martin supported Fed independence. Some years later, Martin happened by chance to encounter Harry Truman on a street in New York City. Truman stared at him, said one word, "traitor," and then continued.[11] Leon Keyserling (1971), chairman of the Council of Economic Advisers from 1950 through 1952, said later: "[Truman] was as strong as any President had ever been in recognizing the evils of tight money. . . . He sent Martin over to the Treasury to replace McCabe. Martin promptly double-crossed him."

In his speech accepting appointment to the Board of Governors, Martin (1951) said:

> Unless inflation is controlled, it could prove to be an even more serious threat to the vitality of our country than the more spectacular aggressions of enemies outside our borders. I pledge myself to support all reasonable measures to preserve the purchasing power of the dollar.

As FOMC chairman, Martin adopted the Fed position.

The Treasury's offering of the new 2-3/4 percent nonmarketable bonds in exchange for the 2-1/2 percent marketable issues took place from March 26 through April 6. During this period, as provided for in the Accord, the Fed purchased the five-year bonds to support their price. However, the Fed spent the entire amount agreed to in the first three days. "[D]ismayed Treasury officials asked for continued support. The request was refused, and there was nothing more the Treasury could do about the matter" (Hyman

1976, p. 351). The Fed just said "No." Thereafter, the Fed bought only small amounts of the bonds to prevent "disorderly conditions in the market." Their price went from around 100-3/4 before the Accord to around 97 in the last half of the year "when the bond market was on its own" (Board *1951 Annual Report*, p. 5).

Under its new leadership, the FOMC had issued its ultimate challenge to the White House. Why did Truman finally walk away from the conflict? For Truman to triumph over the Fed, he would have had to prevail in Congress. However, his precarious political position in early April made that impossible. In part, Truman's political popularity had plummeted because of scandal. In early 1951, Sen. Fulbright (D. Arkansas) released a report accusing two directors of the Reconstruction Finance Corporation, one a politically well connected Democrat, of favoritism. Truman called Fulbright, a former Rhodes Scholar, an "overeducated s.o.b." (Donovan 1982, p. 333).

More important, the day after the announcement of the Accord a much more serious, long simmering crisis boiled over. Gen. Douglas MacArthur had opposed Truman's policy of limited war, saying that it amounted to "surrender." Truman had made the decision to seek peace in Korea through its partition at the 38th parallel rather than to engage China in a wider war. Truman feared that such a war would involve the Soviet Union and atomic weapons. On February 13, MacArthur called that policy "unrealistic and illusory."[12]

On March 24, MacArthur claimed that he could defeat China if only Washington would stop restricting him militarily. He even offered "to confer in the field with the commander-in-chief of the enemy forces." His statements sabotaged secret negotiations to settle the war. Joe Martin (R. Mass.) advocated the use of Chiang Kai-shek's forces in Formosa to open a second front against China. MacArthur supported Martin in a letter, which included the phrase "There is no substitute for victory." On April 5, Martin read MacArthur's letter in the House of Representatives.

On April 10, four days after the end of the bond exchange, Truman fired MacArthur. Truman biographer Robert Donovan (1982, p. 358) wrote that Truman "knew well enough that he would awake in a political climate raised to a pitch of hatred and recrimination so severe that it could not fail to stain the remainder of his term in office. Of all the storms he lived through as President, the one about to break was the worst." To worsen Truman's problems, MacArthur learned of his firing over the radio. The *Chicago Tribune* wrote in a front page editorial: "Truman must be impeached and convicted. . . .[H]e is unfit, morally and mentally, for his high office" (Donovan 1982, p. 359).

Subsequent events gave the Fed time to incubate its fragile independence. Inflation abated sharply. CPI inflation averaged just over 3 percent from 1951Q2 through 1951Q4 and just less than 1.5 percent in 1952. Also, Dwight D. Eisenhower, president from 1953 to 1960, and his Treasury secretaries shared the Fed's goal of price stability.

V. Creating the modern Fed

Over time, Chairman Martin gave the Accord content and, in the process, created the modern Federal Reserve System. Under his leadership, the Fed worked hard to develop an independent government securities market. During the summer of 1951, Fed staff including myself [Leach] held a series of meetings at the Federal Reserve Board with each of the government securities dealers. All twelve regional Fed Bank presidents plus members of the Board of Governors were invited to these sessions. Their main purpose was to ascertain the ability of these dealers to support a free market in government securities. With some of the larger firms, we also explored the possibility of organizing the dealers into a self-governing association that would set minimum capital standards and assure low trading spreads.

During this period, Leach made a number of visits to the New York trading desk and listened to dealers' questions and traders' replies. In discussions with the traders I tried to explain that continued market intervention by the Fed prevented the development of a strong market. I felt that each intervention by the Fed simply caused buyers and sellers to pull away from the market and wait for the Fed's next move.

As long as the New York trading Desk was pegging the price of government securities, there was no need for the market to develop the capacity to smooth price fluctuations. Dealers did not take speculative positions. People extrapolated from that situation and concluded that, without regular Fed intervention, the government securities market would exhibit destabilizing price swings. The Board staff believed that left to itself the market would work.

Leach had graduated with an A.B. degree from the University of Chicago in 1938. At that time, Chicago had two of the great economists of the twentieth century, Frank Knight and Jacob Viner. Even at the height of the recession, they and other Chicago economists had retained a belief in free markets. Leach had absorbed that belief and made use of it while at the Board to convince the governors and others that a free market in government securities would work.[13]

On a trip to the New York Desk, Leach was vigorously pushing my free market ideas with two of the traders. Suddenly, they broke into broad smiles while looking over my head. Leach turned around and found that Allan Sproul had joined us. Leach was happily surprised when he invited me to lunch. By this time Leach felt that he and Sproul were quite good friends and hoped that he, one of the most admired financial leaders in the world, felt the same.

He opened the luncheon conversation by reminding Leach that since its founding the Federal Reserve System always had its focal point in New York, the financial capital of the United States and now of the world. He went on to predict that Leach would be leaving my present job soon and would end up with a major bank dealer in New York. "When that happens," he asked, "would you still want New York to occupy that position?" He indicated that the next phase of our discussions at FOMC meetings might change that status.

As evidenced by Sproul's comments, fundamental economic and institutional issues lay behind the debate over how best to encourage a competitive market for government securities. The economic issue was whether the implementation of monetary policy required continuous monitoring of the money market and oversight over the entire term structure of interest rates. If so, then the institutional issue should be decided in the favor of the New York Fed. New York should retain its historic role as the center of gravity of the Federal Reserve System. If not, then that center of gravity could reside in Washington with the full FOMC.

In contrast to Sproul, Martin believed that the Fed should exert its influence only over the short-term end of the government securities market. The full FOMC could then exercise oversight over such limited intervention from

Washington. Furthermore, the Manager of the New York trading Desk could report directly to the FOMC rather than to the President and Directors of the New York Fed. As my conversation with Allan Sproul made clear, resolution of an operational issue would decide the broad issues of the character of the Federal Reserve System.

The operational issue came to a head over the seemingly technical instructions the FOMC issued to the New York trading Desk in the Directive. After the Accord, those instructions had included a reference to "maintaining orderly conditions in the Government securities market." The FOMC had regularly authorized a very high level of funds for possible Desk intervention. One of the first post-Accord moves by the FOMC was to cut down the level of funds authorized for use by the trading desk. The result was to limit Desk interventions. However, the Desk retained more latitude for market tinkering than the free market group at the Board felt desirable. New York argued that even a tiny price drop could quickly develop into a disorderly market and continued to intervene on that theory. After ten years of quick intervention, the trading desk could not discard the habit.

The Board staff argued for a market in government securities characterized by "depth, breadth and resilience." I asked Win Riefler how he came up with those names. He told me that he had trouble remembering names, so he used the initials of his son, Donald B. Riefler. Buttressed by the staff, the FOMC made a truly basic change. In the March 4-5, 1953 Directive, the FOMC dropped the phrase "maintaining orderly conditions" and substituted "correcting a disorderly situation." Furthermore, the FOMC instructed the Desk to confine its operations "to the short end of the market" and stated, "It is not now the policy of the Committee to support any pattern of prices and yields in the government securities market." This step, the Board staff thought, should finally settle the debate.

Bills Only

Just before the June 11, 1953, FOMC meeting, President Sproul caucused with the regional bank presidents at the Federal Reserve Bank of Richmond. With their support, Sproul succeeded in rescinding the actions of the March 4-5 FOMC meeting. His position was that if necessary the Desk should transact in "the long-term market" so as to put reserves "in where the pressures were greatest" (1953 *Annual Report*, p. 96). However, at the September 24, 1953, FOMC meeting, the Committee returned to the restriction that the Desk confine its operations to Treasury bills.

Sproul was a redoubtable opponent. He decried the attempt to write a "constitution" that would not leave the FOMC "free to use its judgment" (1953 *Annual Report*, p. 100). According to Sproul, the exercise of monetary policy required that the Fed influence the psychology of the financial markets. The policymaker should exercise that judgment in an ongoing way in response to changing developments. Sproul's (Ritter 1980, p. 10) view that an understanding of monetary policy derives from an understanding of the psychology of financial markets appears in a letter that Sproul wrote to Robert Roosa:[14]

> [H]e [Bryan] has a strong tendency toward cosmic thinking and metaphysical roundabouts. Beneath all of the wordy embroidery he is really distrustful of the money market and people who operate it. . . .This is a legacy, perhaps, of a fundamentalist religious slant as bent and twisted by the University of Chicago, but it is also a consequence of his having had no experience in a money market.

Confining Desk operations to short-term government securities put the free market forces at a semantic disadvantage. While no public announcement was made of the new limitation until the release of the Directive the following year in the Board's *Annual Report*, knowledge of it gradually leaked into market discussions. The market adopted the phrase "bills only" to describe the policy. Possibly with a little help from the New York trading Desk, the market seized on the opportunity afforded by a then current advertisement for a deodorant. The letters "B.O." became a by-word of market commentators. Nevertheless the restriction remained.

On June 22, 1955, the FOMC abolished the Executive Committee. Henceforth, the FOMC met every three weeks and assumed full responsibility for monetary policy and its implementation by the Desk. Before 1955, the Manager of the Desk reported to the President of the New York Fed and its Board of Directors. Upon the urging of FOMC chairman William McChesney Martin, at its March 2, 1955 meeting, the FOMC initiated a study that ultimately led to making the manager responsible to the full FOMC. It is instructive to review the language Martin (*Minutes*, 3/2/55, p. 131) used:

> I have consistently endeavored to emphasize the word "System" in our activities. To me, that is the heart and core of what we are trying to build. If we do not work as a System, then we defeat the main purpose of our structure, which is really unique in terms of political science.

VI. The world's most liquid market

Sproul lost all the major battles of System governance to Martin, and he resigned in 1956. Sproul retired and moved to California but came to New York regularly and always included a lunch with old friends at Morgan. In 1953, Leach joined Guaranty Trust Company in New York, which merged with J. P. Morgan in 1959. At a luncheon in early 1961, Allan Sproul took Leach aside and said, "I just want you to know "B.O." is dead. I'll tell you about it after lunch."

End of bills only

1961

After lunch Sproul came back to my office and explained the death of bills only. The new president, John F. Kennedy, had never met Bill Martin so he invited him for lunch with the top Treasury appointees, Secretary Douglas Dillon and Under Secretary Robert Roosa. Roosa had formerly been senior vice president of the New York Fed and was very close to Sproul.

During the lunch, Roosa urged the abandonment of bills only.

Roosa wanted to replace it with a policy called later "operation twist." In 1961, the country had two conflicting economic objectives. One objective was to recover from recession. It required lower interest rates to stimulate economic activity. The other objective was to stem gold outflows that were occurring under the Bretton Woods system of pegged exchange rates.[15] It required higher interest rates to attract inflows of foreign capital.

Roosa wanted to raise short-term interest rates and lower long-term interest rates by increasing short-term debt and reducing long-term debt in the hands of the public. The Fed would have to abandon bills only and purchase government bonds for its portfolio. Roosa believed that the result would be higher short-term interest rates, which would attract foreign funds, and lower long-term interest rates, which would stimulate domestic investment and economic activity.

Martin agreed to drop the restriction that the Fed buy only short-term government securities. However, he added that there would be no change in the Fed's basic policy. The New York Desk would limit its intervention to correcting a disorderly market and would refrain from guiding it in any way. He explained that the Fed depends on a free market as an indicator of the combined judgments of investors worldwide. As it worked out, Martin retained the essential ingredient of

Fed independence. Operation Twist gave the Fed latitude to raise short-term interest rates as necessary.

The effort by the Fed to promote a competitive market in government securities was remarkably successful. In the fifties, the dealers in government securities followed the course of action the Board staff had hoped for in its 1951 discussions. They made a market with guaranteed, minimal spreads between bids and offers. Once assured of no interference by the Fed, the market strengthened quickly. Within a very short time, the Treasury invited the dealer community to advise on its financing.

For forty-odd years, the market for U.S. Treasuries has been the strongest financial market in world history. For anyone who doubts the competitive strength of the market, Leach offered the following anecdote. In 1961, the Treasury offered a $1 billion issue of long-term bonds on a competitive basis. Two syndicates formed, with Morgan Guaranty Trust heading one of them. Ordinarily, the second number after the decimal point determined the winning bid. Leach's recollection is that Morgan's competitor won the bid based on the fifth digit. A difference of $100 decided a $1 billion offering!

Chairman Martin and the Federal Reserve established the dollar as the preeminent measure of value in world markets. In the postwar period, the dollar replaced gold and the pound sterling as the standard measures of value worldwide. At its March 4-5, 1953, meeting, the FOMC had stated its desire to create a market that would "reflect natural forces of supply and demand and thus furnish a signal of the effectiveness of credit policy." Over time, by measuring inflationary expectations, the behavior of the government bond market would become an essential ingredient in the monetary policy process.

VII. Concluding comment

So in 2001, raise your glass and drink a toast to the 50th anniversary of one of the most important days in Fed history. Remember the intellect of Allan Sproul, the courage of Marriner Eccles, and the integrity of Thomas McCabe. Your second toast would, of course, be to Bill Martin who more than anyone else created the modern Federal Reserve System.

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[1] At that time, the 2-1/2 percent government bonds were selling above par, that is, at an interest rate less than 2-1/2 percent. The Fed wanted to replace them with nonmarketable bonds to prevent possible future sale to the Fed with the attendant monetization.

[2] The Treasury's version of the dispute appears in the reply to the Patman questionnaire by Treasury Secretary Snyder in U.S. Congress (1952a). The reply is also reprinted in U.S. Treasury (1951). The Fed's version is contained in Allan Sproul's (1952, p. 521) testimony in the Patman Hearings in U.S. Congress (1952b). Walker (1955) contains a readable summary.

[3] See, for example, the exchange between Governor Eccles and Senator Joseph C. O'Mahoney in U.S. Cong., 1951, p. 181.

[4] The material in this paragraph is from Donovan (1982, p. 346-8).

[5] Allan Sproul (1980) and Marriner Eccles (1951) have provided eyewitness accounts. (Stein [1990] and Walker [1955] provide an historical overview.)

[6] The above quotes are from this memorandum.

[7] This account is from Eccles 1951, pp. 491-7 and Hyman 1976, pp. 349-51.

[8] This paragraph is from Board *Minutes* (1951, pp. 254-9).

[9] Vardaman resigned in 1958 under a cloud because of leaks concerning Board discussions of discount rate decisions.

[10] About $40 billion in 2-1/2 percent bonds were outstanding (U.S. Treasury, 1950 *Annual Report*, Table 17.

[11] Telephone interview, Robert Mayo, April 10, 1998.

[12] This paragraph and the next are from Donovan 1982, pages 349-51.

[13] The same issue arose later in the debate over whether to abandon the Bretton Woods system of pegged exchange rates for a system of floating rates. Policymakers and traders believed that without central bank intervention the market would be unstable. Milton Friedman (1953) argued for floating exchange rates. That was a position associated with the University of Chicago economists like Lloyd Mints. They argued that stabilizing speculation would make a free market in foreign exchange self-equilibrating.

[14] The letter comments on the views of Malcolm Bryan, president of the Atlanta Fed, who argued that the FOMC should control bank reserves rather than money market conditions. Bryan corresponded with Milton Friedman at the University of Chicago. See Hafer 1999.

[15] At the end of World War II, the United States held a large fraction of the world's gold reserves. It willingly allowed gold to flow out. However, in 1958 the outflows had reduced gold stocks to the point where the U.S became concerned that its stocks could become depleted.