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The nature and significance of the federal reserve-treasury controversy with respect to monetary policy 1945-1950

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THE NATURE AND SIGNIFICANCE OF THE FEDERAL
RESERVE-TREASURY CONTROVERSY WITH
RESPECT TO MONETARY POLICY
1945-1950

A THESIS
SUBMITTED TO THE FACULTY OF ATLANTA UNIVERSITY IN
PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE
DEGREE OF MASTER OF BUSINESS ADMINISTRATION

BY
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SCHOOL OF BUSINESS ADMINISTRATION

ATLANTA, GEORGIA
JUNE 1957
The object of this study was to contribute to an understanding of the nature and significance of the issues between the Federal Reserve and Treasury in their efforts to maintain financial stability throughout the economy.

Although a good deal of materials have been devoted to the general area of maintenance of financial stability following World War II, this study is the first of its kind which strives to coordinate the various issues which developed between the two agencies. The investigation begins in mid-1945. The problem of reconversion from war to a peacetime economy presented serious monetary problems.


The writer is deeply indebted to Doctor Samuel Z. Westerfield, Jr. whose unfailing patience, penetrating suggestions, and helpful criticisms during the preparation of this thesis have proved invaluable; to Mr. John G. Gloster for his painstaking review; and to Mrs. Evelyn C. Campbell for checking the text for correctness in grammar, punctuation, and form.
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CHAPTER I

INTRODUCTION

The dynamic events which occurred immediately following World War II and continuing through March 4, 1951 seemed to warrant investigation and fresh interpretations. During the first three postwar years, effective demand so greatly exceeded the available supply of goods that a sharp rise of prices took place in all countries. In all of this, monetary and banking changes played a leading role.

Monetary policy was considered an effective weapon designed to promote general economic stability. Principally, its effectiveness was attributed to the fact that it was highly flexible. It was the nucleus around which revolved the points of agreement and disagreement between the Federal Reserve and the Treasury.

The fundamental problem which confronted both of these agencies developed out of the various issues created by the existence of a huge public debt in a period of growing private demands for goods and services. The differences were primarily on matters of emphasis, selection of instruments and methods to be employed, and timing. These were considered matters of judgment. Judgments, of course, will differ. On the whole, the degree of cooperation between the two agencies was very high. Most of the differences were worked out in a genuine spirit of give-and-take; and they worked closely with each other to find programs acceptable to both.

The Treasury was cautious throughout the postwar period. In the early part of the period, the situation was one which required extreme caution since at any time the dislocations accompanying the decline in military output might have proved serious.

It was not only in the early postwar period, however, that caution was required. There were many occasions when the country felt uncertain about the economic future. There were recurring waves of pessimism throughout the entire postwar period -- particularly among businessmen. This pessimism occurred in 1946, 1947, 1948, and again -- most seriously -- in 1949.1 Year after year, there were forecasts that the postwar prosperity was at an end and that recession was about to set in. Every year as segments of the economy completed reconversion, there were some economists who felt that the high level of employment and production must surely fall back. This was not surprising, for a severe postwar depression had occurred after every major war in the history of our country. Table 3 shows a drastic reduction in durable goods and a reduction of one point in nondurables for 1946. There was a similar reduction in 1949.

The question was: Did we, as a nation, have the wisdom to prevent a depression from developing? It was in these circumstances that the Federal Reserve and Treasury tried to work out programs which could achieve our over-all objective of maintaining a high level of production, employment, and income with as great price stability as possible under the varying conditions which existed in the economy.

1Ibid.
Statement of the Problem. - It was the purpose of this study to describe fully the nature of the issues in the Federal Reserve-Treasury controversy, and to determine their influence upon economic activity of the period.

Scope. - This study was concerned primarily with points of differences which arose between the Federal Reserve authorities and the Treasury from 1945 to the "accord" announced by these agencies on March 4, 1951. It also considered areas on which the two agencies agreed in the solution of their problems.

Source of Data. - Data for this study were gathered from the following sources: (1) reports of the Subcommittee on General Credit Control and Debt Management; (2) reports of the Subcommittee on Monetary, Credit, and Fiscal Policies; (3) articles in periodicals, general reference works, and books.

Definition of Terms. - In this study, "stable market" was used to mean a market in which prices and yields fluctuate within a moderate range over a considerable period of time, but without exhibiting any pronounced upward or downward trend.

"Monetary policy" referred to the course followed in dealing with banking and credit -- the availability of loans to firms and households, and interest rates --, the public debt and its management, and the monetary standard.


2 Ibid.
"Open-market operations" referred to the purchase and sale, in the open market, of various securities, chiefly obligations of the United States, and of bills of exchange and bankers' acceptances of the kinds and maturities eligible for discount by the Federal Reserve Banks. ¹

¹Ibid., p. 527.
CHAPTER II

THE AMERICAN ECONOMY, 1945-1946

The repercussions of the Second World War were felt throughout the economy. At the end of the war, a substantial part of the nation’s total product was going for war purposes. This, of course, meant that a sizable part of the productive facilities of the nation had to be shifted from a war to peacetime production. Here, conflicting opinions developed between the Federal Reserve Board and the Secretary of the Treasury on how this reconversion process should be carried out and still maintain a high level of employment and production. The demobilization of men in the armed forces at the end of the war, and an approximately equivalent number of workers with war production jobs also had to be absorbed into the peacetime economy.

Deflationary and Inflationary Pressures

In 1946, it became apparent that there were great inflationary pressures on the economy. A large volume of money and liquid assets, and an accumulated world-wide demand for goods presented a good background for inflation. An offsetting factor was the large volume of government balances which were being utilized in the reduction of the public debt. This operation in itself was essentially bookkeeping in nature, in so far as it canceled an equal amount of bank assets and government deposits, but, nevertheless, it had a restraining influence in two ways. First, from the negative point of view, it used up the
government deposits before they were incorporated into the economy; and secondly, since some of the retired debt had been held by the Federal Reserve and was not replaced, this part of the liquidation diminished the 1 volume of member-bank reserves. This action also reduced somewhat the banks' ratio of liquid to total assets; a decline which usually tended to make them more cautious.

The Federal Reserve policy was essentially static with little done to counteract inflationary forces and little occasion to support the government security market, except for Treasury bills. A business recession was generally expected, 2 but it did not materialize.

Shortages of particular types of goods were prevalent throughout the country at a time when consumers and businessmen had a large volume of easily available purchasing power in the form of accumulated currency, demand and time deposits, government securities, and others. For individuals -- and this included unincorporated businesses and trust funds -- the total liquid asset holdings was $130 billion at the end of 1945; for corporations, it was $45 billions. 3 This was an inflationary potential that had to be taken into account.

The prices of stock and real estate advanced so rapidly that the chances of a reaction was considerable. Yet, such a reaction, it was believed, would prove only that the boom had proceeded too fast, not that the United States was headed for the kind of depression that

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2As an accompaniment to the drastic drop in government war spending, and anticipated delays and difficulties in converting to a peacetime output.

3Wright Patman, *op. cit.*, p. 52.
afflicted it in the 1930's. These forces resulted from a vast increase in spendable income on the one hand, and a vast decrease in the stock of both consumer and capital goods on the other. The reconversion of the United States industry from war to peace proceeded rapidly. Yet, demand for clothing, household goods, and even food outstripped supply, while the economy did not even begin to satisfy the need for consumer durables, notably automobiles. Despite the huge increase in machine-tool capacity induced by the war, it was still difficult to get particular tools needed for peace. Steel buyers discovered that the specific kinds of steel they needed were simply not available. Steel was still tightly rationed, with the automobile industry, for one, definitely worried about getting enough. Beyond the demands of Detroit, there were those of the railroads, which had gone five years without adequate replacements and repairs.

Thus, it appeared that if the immediate dangers of inflation could have been overcome, the prospects favored a prolonged and brilliant period of recovery. The "if," however, was very large indeed, especially in view of the contradictory policies of the administration. The direct price controls left over from the war were the first line of defense against inflation. They were essentially a stopgap, representing the direct antithesis of the kind of market economy that the United States hoped to restore.²

United States Debt: 1946.— By the time the United States debt reached the impressive magnitude of $279 billion (in February, 1946),

¹Henry L. Luce, "The Promise of the American Recovery," Fortune, XXXII (February, 1946), 89.

²Ibid.
it had affected the life of a whole generation of Americans in innumerable ways.\(^1\) It had financed the greatest depression and greatest war in history. It had also modified the real value of the dollar and altered the structure of the national economy. The debt still remained, as it had been for years, a major theme of argument and editorial debate.

In the 1930's, while the New Deal\(^2\) deficits averaging \$3\ billion per year were gradually raising the debt from less than \$20\ billion to more than \$45\ billion, anxieties focused on the question how much bigger would the federal debt grow? Then came World War II, and in less than seven years piled an additional \$230\ billion on top of the \$45\ billion federal debt that seemed so huge in 1933.\(^3\) The big question of debt management policy in 1946 was how to prevent the debt from feeding further inflation. The debt was intimately related to the money supply. The money supply, while not the sole or primary cause, was one of the basic factors in inflation.

Postwar Transition in Banking.— Deposits of business and individuals continued to grow, but at a somewhat slower rate than during the war years. This was partly attributed to bank loan expansion, but largely to transfers of Treasury deposits to private hands through debt retirement and meeting a budget deficit. The Treasury's debt retirement

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\(^2\) A general term applying to various measures, initiated during the administration of President Franklin D. Roosevelt, to promote national economic recovery and social security in the United States, following the advent of the economic depression of the 1930’s. These measures involved industrial recovery, farm relief, direct unemployment relief, control of public-utility holding companies, old-age pensions, and unemployment insurance.

\(^3\) Henry R. Luce, op. cit., p. 97.
program, by drawing funds from commercial banks to redeem government securities held by Federal Reserve Banks, exerted a drain on bank reserves. In addition, expansion of deposits of businesses and individuals raised the level of required reserves. Commercial banks sold securities from their portfolios, and a sufficient amount of these were purchased by Reserve banks to maintain the reserve position of banks. These developments removed some of the ease that prevailed in the money market during war years and early in 1946.¹

Rates on short-term government securities were maintained by Federal Reserve Bank purchases, but there were some slight adjustments in other open-market rates. In addition, yields on Treasury and other bonds were raised somewhat from the extremely low levels reached early in the spring of 1945 when they were still being driven down by bank purchases financed from the sale of short-term government securities to the Federal Reserve Banks.

The Treasury's preoccupation with the maintenance of low interest rates on its debt severely limited the scope of the Reserve System's anti-inflationary activities. In point of fact, the Reserve authorities favored low interest rates too. In 1945, the Board stated that it "does not favor a higher level of interest rates than the government is now paying."² Yields on long-term issues declined throughout 1945 and the early part of 1946, because of heavy sales of short-term issues and large-scale purchases of the longer issues. Despite


the express desire to maintain interest rates on both short- and long-term government debt at the unprecedentedly low wartime levels, the authorities were not entirely successful.\(^1\)

**Treasury Debt Retirement.**— The financing of the war expanded the public debt from less than $50 billion in 1941 to a total of nearly $280 billion. This high point was reached in February, 1946.\(^2\) By then, the rapid decline in military expenditures and the continuation of high tax receipts had sharply reduced the Treasury’s current deficit. Beginning in March, therefore, it became possible not only to meet the greatly reduced deficit without further borrowing, but to enter upon a program of debt retirement by drawing upon accumulated balances.

The debt retirement program strongly influenced the course of banking developments. In the first place, it brought about a large decrease in bank holdings of government securities. In the second place, by imposing a drain upon bank reserves, it exerted some brake on further expansion of bank credit. And in the third place, by reducing the amount of short-term governments held by banks, the program discouraged shifting by banks from short- to medium-term issues which was a major source of credit expansion in the previous period.\(^3\)

While these factors were sufficient to slacken the growth of deposits held by businesses and individuals, private deposit holdings continued to increase somewhat. This further expansion resulted largely from a shift of deposits from government to private accounts, incident

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\(^1\)Ibid.

\(^2\)Elliott Thurston, *op. cit.*, p. 1098.

\(^3\)Ibid.
to the cash retirement of debt held by nonbank investors. Another factor was a net expansion of bank loans, reflecting increased lending to business and consumers. Because of the expansion in deposits of individuals and businesses, the decline in total deposits dropped considerably less than the reduction in the Treasury deposits. The net effect of the retirement program during September 1946 was some tightening of the reserve position and, therefore, of the loan and investment position of banks.

Maintenance of Financial Stability

Differences between the Federal Reserve and the Treasury developed in the area involving financial stability in the transition period. The Federal Reserve was mainly concerned about the inflationary aspects of the reconversion period. In particular, the Federal Reserve was concerned about the possibilities of credit expansion and monetization of the debt, and in this connection proposed that the preferential discount rate be eliminated and that the fixed three-eights per cent Treasury bill rate be abolished.

Credit Expansion and Monetization of Debt.-- Government security

1Ibid.

2The preferential discount rate was the preferred rate at which commercial banks might borrow at the Federal Reserve Banks on government securities due or callable within 1 year; it was one-half of 1 per cent compared with 1 per cent on other government securities. The three-eights per cent fixed rate on Treasury bills was the result of a decision made early in the war finance period by which it was agreed that the Federal Reserve Banks would buy all Treasury bills offered to them at a three-eights per cent rate.

3Wright Patman, op. cit., p. 53.
holdings of Federal Reserve Banks reached a peak of $243 billion at the end of 1945. ¹ During the period between December 31, 1945 and April 24, 1946 when the Federal Reserve and the Treasury were most actively discussing the elimination of the preferential discount rate, Federal Reserve holdings of government securities were being sharply reduced by nearly $2 billion. ² The Treasury also felt that the business outlook for the reconversion period was not clear and recognized the inflationary aspects of the situation. At the same time, it recognized that there were deflationary possibilities in the change-over from war to peace. The Treasury cautiously approached the problem of too much money in the economy in relation to too few goods, and shaped its policies to encourage increasing production so that the volume of goods available for purchase would more nearly match the funds available to purchase those goods. ³ It felt that the reconversion process could be expedited by expanding production with a period of a stable money market. The Secretary of the Treasury, John W. Snyder, emphasized in a press statement of April 24, 1946 (after the Board of Governors of the Federal Reserve System had approved the elimination of the preferential discount rate) that "...the Treasury has been and is concerned to see that the reconversion of industry, which had progressed so rapidly, should not be disturbed by uncertainty in the money markets." ⁴ Primarily, the measure of the degree of monetization of the debt was the extent to which net purchases

¹Ibid.

²Ibid.

³Ibid., p. 55.

⁴Ibid.
of government securities by the System were increasing the volume of Federal Reserve credit outstanding. The Federal Reserve, too, recognized the need for increased production. However, the Federal Reserve, especially in its discussion with the Treasury, was concerned primarily with ways to dampen the inflationary potential through monetary actions; the Treasury felt that the proposed actions held considerable risk in the early postwar environment.¹

Changes in Treasury Finance.— As the Treasury's financial position and needs changed in the first quarter of 1946, banking and monetary developments began to assume a new pattern. At the end of 1945 following the Victory Loan in which $21 billion of newly issued government securities were bought by the public, the Treasury's general fund balance amounted to an unusually large sum of $26 billion.² During January and February, Treasury revenues, together with deferred payments for subscriptions during the loan drive and receipts from continuous sales of government securities, were about equal to Treasury expenditures.

In March, income tax receipts were large and Treasury revenues exceeded budget expenditures by a substantial amount — net receipts for the first quarter was $13.2 billion; expenditures, $12.8 billion. The Treasury drew on its cash balance to retire a substantial amount of maturing securities, and it called securities on March 1 and March 15.³ The Treasury continued its debt reduction program; cash balances were

¹Ibid.


³Ibid.
used to retire additional amounts of debt on April 1 and on May 1, and bonds were called for redemption on June 15.¹

Stabilization of Yields on Government Securities.— The Federal Reserve and Treasury officials offered many reasons for continuing to stabilize the yields on government securities at low levels despite the developing pressures of inflation. Some of the many reasons advanced by these agencies were as follows:

(1) Increased rates on the federal debt would add to the already large interest burden. It was pointed out that with interest charges already amounting to about $5 billion a year and averaging 2 per cent of the outstanding debt, every increase of one-half of a percentage point in the average rate would add about $1.25 billion to federal costs.

(2) Fluctuating prices and yields on governments would greatly complicate the Treasury's refunding operations. This was a serious matter with an enormous debt falling due within a year ($49 billion).

(3) An increase of the yield on governments, which without an increase on coupon rates would mean a decline of their prices, would impose capital losses on financial institutions and other holders and might lead to panicky selling and loss of confidence in financial institutions.

(4) A decline in the prices of marketable government securities might lead to wholesale redemptions of the non-marketable savings bonds, which are in effect demand obligations.

(5) A moderate rise on the yields of government securities would not be effective as an anti-inflation measure.

(6) Low interest rates and generally easy credit eased the process of reconversion and will help to maintain high levels of employment and production.²

¹Ibid.

Preferential Discount Rate and Treasury Bills

In December, 1945 and again early 1946, the preferential discount rate and the three-eighths per cent Treasury bill were measures which warranted consideration. The question concerning the removal of the three-eighths per cent bill rate arose during this period, but the Federal Reserve concentrated its discussions on the elimination of the preferential discount rate.¹

Treasury's Reaction.— The Treasury felt that the elimination of the rate would be interpreted as presaging higher rates to come; that it would not do much good as an anti-inflationary measure; and that certain risks were inherent in the action. It further contended that the stakes — i.e., the danger of upsetting the reconversion effort — were too high to take actions when the outcome was so uncertain and risky.² The Treasury's opposition to the elimination of the preferential discount rate, at this time, was based on the following position.

The elimination rate at that time would have been interpreted by the market as — and, in fact, was — a first move in the direction of higher short-term interest rates. Higher short-term rates would have raised the cost of carrying the public debt and thus, benefited commercial banks, most of which were already enjoying very high earnings.³

¹Wright Patman, op. cit., p. 55.
²Ibid.
³Ibid.
The significance of the preferential discount rate during this period was almost entirely psychological in nature. The total borrowings under it were not high in relation to total Federal Reserve credit, member bank reserves, or any other relevant measure. The principal significance of the rate was that it signaled the market concerning the continuance of the official policy of low interest rates.¹ Mr. Snyder was concerned about inflation and he was personally responsible for the government's anti-inflationary program during his tenure as Director of War Mobilization and Reconversion. He stated rather lucidly, therefore, that he saw no way in which increasing short-term interest rates would help in combating inflation.²

Federal Reserve's Reaction.— The Federal Reserve did not advocate a higher level of interest rates than the government was already paying, because higher rates suggested increased costs of servicing the public debt and increased earnings of commercial banks growing out of their holdings of government securities. It emphatically stated that its proposal to eliminate the preferential discount rate was not really part of a program to increase short-term interest rates. At that time, the Federal Reserve did not agree with the Treasury on the statement which said, in effect, that the significance of the preferential rate was almost entirely psychological.

The Federal Reserve contended that the amount of borrowing under the preferential rate could easily be misleading because bank reserves thus created provided the basis for an expansion in credit of

¹Ibid., p. 56.
²Ibid.
approximately six times the amounts borrowed.\(^1\) Thus, borrowings of $300 to $700 million in recent weeks provided support for about six times as much additional bank credit, which was by no means insignificant. It based the case for eliminating the preferential discount rate on the fact that it would tend to restrict monetization of the debt. The Federal Reserve Board said, for example that:

The figures on the amount of borrowing under the preferential rate can easily be misleading because bank reserves thus created provide the basis for an expansion in credit of approximately six times the amounts borrowed. Thus, borrowings of 300 to 700 million dollars in recent weeks have provided support for about six times as much additional bank credit, which is by no means insignificant. Moreover, banks are thus encouraged to lend to their customers at excessively low rates which, in turn, makes for speculation in and holding of Government securities on bank credit. For example, current figures for reporting member banks show loans of $1.6 million dollars to dealers and loans of $1.9 billions to others for the purpose of purchasing or carrying Government securities, or a total of some 3.5 billion dollars. Such bank loans represent exactly as monetization of the public debt as if the banks themselves purchased the Government securities directly.\(^2\)

The Treasury recognized monetization of the debt as a potential problem, but felt that the figures did not indicate any real tendency in that direction during this period.\(^3\) In the first place, there was a temporary bulge in member bank borrowings from the Federal Reserve banks. In the second place, there was no evidence that member bank borrowing was actually being used as a basis for additional credit of approximately six times the amount borrowed.\(^4\) According to the Federal Reserve Bulletin for May 1946, the bulge was accounted for by

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\(^1\)Ibid., p. 58.

\(^2\)Ibid., pp. 59-60.

\(^3\)Ibid.

\(^4\)Ibid.
drains on member bank reserves resulting from the retirement of
government securities held by Federal Reserve Banks, and from large
income tax receipts by the Treasury which temporarily added to
Treasury balances at the Reserve Banks. The commercial banks were
borrowing temporarily to meet this drain, rather than meeting it by sales
of government securities.

Elimination of Preferential Discount Rate Approved.— In order to
discourage the undue use of Reserve Bank credit by banks, the Federal
Reserve Banks, with the approval of the Board of Governors, eliminated
the wartime preferential discount rate of \( \frac{3}{4} \) of one per cent on advances
to member banks secured by government obligations due or callable in
not more than one year.\(^1\) The regular discount rate on advances secured
by government obligations remained at 1 per cent. In announcing its
approval of the change at three Reserve Banks on April 24, 1946, the Board
issued the following statement:

The Board has approved discontinuance of the preferential
rate because it has secured the purpose of facilitating the war-
financing program for which it was adopted in 1942. The Board
does not favor a higher level of interest rates than it is now
paying. Discontinuance of the special rate will not involve any
increase in the cost to the Government of carrying the public debt.

The preferential rate encourages member banks to purchase
additional Government securities, or to lend to others at low
rates for the purpose of holding or purchasing Government
securities.

Discontinuance of the preferential rate, therefore, signifies
an appropriate adjustment from wartime to postwar conditions in
accordance with the Government's program of economic stabilization.\(^2\)

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\(^1\)Elliott Thurston, *op. cit.*, p. 463.

\(^2\)Ibid.
Since bank indebtedness was small, the elimination of the preferential rate had only symbolic significance which was an indication of a return of more normal condition. 1

**Expansion of Short-Term Bank Loans.**—Beginning in the second quarter of 1946, bank lending activity was highlighted by the sharp rise in commercial and industrial loans, reflecting mainly current needs for short term funds on the part of small business firms. Inventory accumulation, the carrying of increased customer receivables, and an enlarged volume of notes payable to trade made for drains on working capital of many business establishments. In part, this was a seasonal occurrence.

Commercial and industrial loans at the end of September 19, 1946, it was estimated, amounted to roughly $5 billion more than at the beginning of the year. 2 The overall volume of agricultural loans showed little change. It appeared that much of the expansion of bank loans to business immediately following V-J Day reflected the making of longer-term loans. The recent sharp rise seemed not to be attributable to an increasing volume of term loans. 3 Loans of over twelve months' duration made during the first three quarters of 1946 amounted to slightly less in volume than for the comparable period of 1945. Loans to consumers by commercial banks kept pace with the general advance in consumer credit. During the first half of 1946, total consumer

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1E. A. Goldenweiser, *op. cit.*, p. 199.
2Elliott Thurston, *op. cit.*, p. 1102.
3Ibid.
credit outstanding at all commercial banks rose approximately $750 million.\(^1\) This corresponded closely with the percentage increase in total consumer credit.

The relative importance of commercial banks in the installment credit field increased more rapidly than was indicated by the expansion in all consumer loans. Bank holdings of consumer installment loans increased over 50 per cent from the beginning of the year.\(^2\) This percentage gain in volume was double the rate of increase shown by all other agencies extending consumer installment credit. This was attributable to the growth of installment credit in the form of personal cash loans. The gains registered by banks represented, in part, a shifting from single payment lending to installment lending as banks extended their promotional efforts and more banks established consumer credit departments.

A further striking change in the loan portfolio of commercial banks was the increasing volume of real estate loans. During the first half of 1946, insured bank holdings of real estate loans, largely representing residential properties, rose almost $1 billion. The rise in real estate loans, which began about mid-1945, was accelerated in the spring of 1946.\(^3\) Despite the sharp increases in commercial loans, the total volume of loans outstanding at commercial banks at the end of

\(^1\)Ibid., pp. 1102-1103.

\(^2\)Ibid.

\(^3\)Ibid.
September was only moderately larger than at the beginning of the year. The conversion of bank lending activities from a predominantly war financing to a civilian financing basis, without significant expansionary effects on total bank loans, resulted in a $3 billion decline in loans to brokers and dealers and to others for purchasing or carrying securities -- mostly United States Government securities. By April 1946, total bank loans had declined substantially from the peak reached in December 1945 and they continued to decline throughout 1946. The Board of Governors noted this in its Annual Report for this year, in which it said: "Such loans, after reaching a peak at the end of 1945 during the Victory Loan Drive declined rapidly and almost without interruption."¹

¹Wright Patman, op. cit., p. 60.
As the year of 1947 approached an end, it was becoming clear that the country had done a remarkably good job of reconversion and the widespread fear of transitional unemployment was being reduced. The inflationary problem stood out in clearer perspective. In these conditions, the Treasury felt that the risk attached to market unsettlement was not so grave and that it was possible to move toward more flexibility in short-term rates. In this instance, it was construed to mean a move in the direction of higher short-term interest rates.

Shifting Problem and Long-Term Bond Market

Shifts from Short- to Long-Term Debt. -- As the end of the first phase of the debt pay-off program approached, the Federal Reserve was again concerned about the possibility of shifts by security holders, chiefly commercial banks, from short-term debt to long-term debt. In this connection, the Federal Reserve and the Treasury began a discussion. They looked forward to some change.

In early 1947, the Federal Reserve was worried that there might be a resumption of the tendency for banks to sell short-term securities to the System in order to buy longer-term securities with the resulting monetization of the debt. Again the Treasury did not feel that the


2 Ibid.
The shifting problem was as serious a prospect as the Federal Reserve thought it to be.

There was some increase at this time in bank holdings in the one- to five-year maturity range, but this was more than offset by a decline in holdings with more than five years to maturity. Holdings of securities having one year or less to maturity had, of course, been reduced substantially as a result of the debt payoff program in which a substantial proportion of maturing certificates and other issues had been retired.

After the economy had passed through the critical transition stage, the Treasury felt it could prudently consider taking steps toward higher short-term rates. No one knew how useful this would have been as a counter-inflationary step, but in any event, it seemed appropriate to free Americans from the rigidity of wartime rates. The Treasury never believed that any interest rate pattern was good for all time; obviously, peacetime fluctuations in the level of business activity called for changing general credit control actions and for some accompanying changes in interest rates.

There was some difference of opinion between the Federal Reserve and the Treasury as to the timing of the interest rate actions and the rapidity with which they should be put into effect. Despite these differences in emphasis, the Treasury and the Federal Reserve did move together in the direction of higher rates during this period. The bill rate was allowed to move up. The change began in July, 1947. The one-

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1 Ibid.
2 Ibid., p. 62.
3 Ibid.
year certificate rate was raised from the 7/8 per cent wartime rate which still existed in 1947 to 1 1/4 per cent by the fall of 1948, by means of a series of certificate and short-term note issues which accomplished the change in a gradual way.

**Long-Term Bond Market.** -- In the same period, also, the Treasury and the Federal Reserve took important steps in the long-term bond market; and in the latter part of 1946 and early in 1947, upward pressure developed on the prices of government bonds. ¹

Long-term bonds were sold at substantial premiums -- the Victory Loan 2 1/2's were high enough in price to approach a 2 1/2-per cent yield; and at one point in the spring of 1946, they had stood at 2 1/8 per cent. ² The Federal Reserve and Treasury felt that there was a real danger that the prices of the longest-term restricted bonds would go high enough to force yields down near the 2-per cent level. This would have meant prices around 108.

The two agencies were agreed that the supply of long-term government securities should be increased in order to dampen the market. ³ Under these circumstances -- and in the absence of any substantial holdings of government bonds by the Federal Reserve Open Market Account -- the Treasury sold long-term taxable government securities from government accounts where the proceeds could be appropriately shifted to special

¹Ibid.
²Ibid.
³Ibid.
securities\(^1\) issued to these accounts. Then in 1947, they sold $1.5 billion of such bonds from April into October.

In September and October, 1947, further upward adjustments in rates on short-term government securities and continued large offerings of new long-term securities were reflected in a rapid rise in yields on medium- and short-term securities -- government as well as corporate.\(^2\) Subsequently, the sale of governments was accelerated and the Federal Reserve Banks began buying bonds in substantial amounts in order to cushion the price decline and maintain orderliness in the market. On December 24 of this year, prices of government bonds were permitted to decline to a pattern in line with a 2\(\frac{2}{3}\) per cent yield on the longest-term issues and a rate of one-year certificates or 1 1/8 per cent in order that Federal Reserve credit might not be obtained through the sale of securities at premium prices previously prevailing.\(^3\) The System purchased bonds aggressively at this level in order to assure confidence in the stability of bond prices.

In the first half of 1948, yields on long-term government bonds remained at the 2\(\frac{1}{2}\) per cent support rate, while yields on medium-term issues declined somewhat. The volume of Federal Reserve purchases of bonds slackened considerably after February. The spread between yields

\(^1\) Securities from which income is subject to both the normal rates and the surtax rates of the Federal income tax -- Federal Old-Age and Survivors Insurance Trust Fund (notes), Federal Home Loan Bank (notes), Civil Service Retirement Fund (notes), etc.


\(^3\) Ibid.
on long-term government bonds and on high-grade corporate bonds, which
during the war period, had been relatively narrow but had gradually
widened after the war to about 0.30 of a percentage point in the first
half of 1947. It widened further in the last half of 1947 to 0.50.  
During 1947, this spread had fluctuated between 0.30 and 0.45. For slightly
lower-grade corporate securities, rated by Moody's as Aa and A, the yield
margin over government bonds amounted to about \( \frac{1}{2} \) and \( \frac{2}{3} \) of a percentage
point respectively.  
Margin similar to these constituted an inducement
to insurance companies and other investors to sell long-term government
bonds in order to buy corporate bonds.

Late in September, 1947, as a part of the policy of increasing the
supply of long-term bonds in the market, the Treasury offered a new long-
term nonmarketable bond to institutional investors -- the investment
Series A issue. This was adapted from Series G savings bonds. It paid
2\( \frac{1}{2} \) per cent interest per annum if the bonds were held to maturity (18
years), but yielded a smaller return if redeemed earlier. The Federal
Reserve recommended that this issue should be placed "on top," rather
than limiting the amount which could be purchased by each investor.

The Treasury felt, however, that caution should be taken not to
oversupply the market. This might have resulted in switches out of
existing holdings and too much downward pressure on the market.

\[1\text{Ibid.} \]
\[2\text{Elliott Thurston, op. cit., p. 1460.} \]
\[3\text{Wright Patman, op. cit., p. 62.} \]
Accordingly, applications for the Investment Series were limited by a purchase formula; and about $1 billion of the bonds was sold. In all, the Treasury thus provided the market with over $2\frac{1}{2}$ billion of long-term bonds to meet the buying pressure which had developed.\footnote{Ibid., p. 63.}

The above actions accomplished the purpose of taking the upward pressure off the prices of long-term government securities. In fact, it appeared that the program had probably been prosecuted too vigorously, in view of the surrounding circumstances.

While the program was being carried on, opportunities for investment in mortgages and corporate securities increased sharply, with a consequent decline in the demand for government bonds, especially on the part of institutional investors. The result was a marked weakness in the government bond market. The selling program was abandoned; and the Treasury and the Federal Reserve bought government securities to keep the market stable.\footnote{Ibid.}

The period between the end of World War II and the commencing of the Korean conflict illustrated fairly well the Treasury's idea of a stable long-term market. However, there was a moderate range of fluctuation in long-term 2\frac{1}{2} per cent marketable Treasury bonds during this period.\footnote{Ibid., p. 99.} Prices of the Victory Loan 2\frac{1}{2}s of December 1967-72 fluctuated within a 6-point range (a range of approximately three-eights per cent

\footnote{Ibid., p. 63.}
in interest yield). The Federal Reserve and the Treasury worked toward a stable long-term market by increasing the supply of bonds when there was a tendency for prices to rise too sharply, and by taking bonds off the market when the situation was in reverse.  

Purchasing and Open-Market Operations

During the last half of 1946 and most of 1947, there was insistent buying pressure in the market, and the Treasury supplied over $2.5 billion of additional bonds to the market to prevent long-term interest rates from being driven lower. Then the situation turned around for about 12 months. Beginning with November, 1947, the Federal Reserve bought about $10 billion of bonds as certain investor groups were heavy sellers, partly because they feared losses from a declining market and partly because they needed funds to make loans for capital spending.  

Purchase of Government Securities.-- The buying program was commenced in November, 1947. The Federal Reserve bought largely short- and medium term bonds. It was a hesitant buyer at this stage, for it failed to take all of the securities offered. The general technique was for the Federal Reserve to purchase only a portion of the securities offered by any seller at any one time. Accordingly, an increasingly large amount of securities came to be held by investors who wanted to sell. There was continued downward pressure on prices. The Treasury pursued an aggressive

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1Ibid., pp. 99-100.

2Ibid.

3Wright Patman, loc. cit., p. 63.
policy in the purchase of longer-term, higher-yield bonds -- principally bank-restricted issues -- which it bought for its investment accounts.1

During the period of the buying program, the Federal Reserve acquired, on net balance, approximately $10 billion of bonds in the market.2 Simultaneously, however, the System reduced its portfolio of short-term securities drastically. A large Federal budget surplus, coupled with a substantial increase in the nonmarketable government security holdings of nonbank investors, made it possible for the Treasury to take important steps to reduce the amount of government securities held by the commercial banking system.

While the buying program was in progress, the Treasury paid off approximately $9 billion of maturing marketable issues of government securities.3 These payoffs were a major factor in enabling the Federal Reserve to limit the increase in its total portfolio of government securities to a little less than $1 billion, even though it was buying $10 billion of bonds.4 These reserve requirement increases and the reinstitution of consumer credit controls, after Congress provided the authority, became part of the Reserve System's anti-inflationary program in 1948.

On July 2, 1947, the Federal Open Market Committee of the Federal

1Ibid.
2Ibid.
3Ibid., p. 64.
4Ibid.
Reserve System directed the Federal Reserve Banks to terminate the policy of buying all Treasury bills offered to them at a fixed rate of 3/8 per cent per annum and to terminate the repurchase option privilege on Treasury bills. The above action was taken by the Committee after consultation with the Secretary of the Treasury.

The so-called posted rate on Treasury bills was a wartime measure adopted in 1942 to facilitate war financing and to stabilize the market for government securities. It was designed primarily to encourage banks to make fuller use of their excess reserves and thus bring about a wider distribution of Treasury bills. Under the peacetime conditions at this time, these arrangements no longer served their original purpose and tended to distort conditions in the money market and the securities market. Certificates of indebtedness which bore a higher rate than Treasury bills largely replaced bills in the market, not only as a medium for the investment of short-term funds but also as a means by which banks adjusted their reserve positions.

Increased amounts of Treasury bills were sold to the Federal Reserve Banks by the market, and bills ceased to be a market instrument. During this period, there was about $1.5 billion of the nearly $16 billion total of Treasury bills outstanding held outside the Federal Reserve Banks. Thus, the Treasury bill rate was eliminated as a factor.

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2Ibid.
in the money market. The need for large-scale borrowing of new money by the Treasury ceased with the completion of the Victory Loan Drive, and since that time the public debt had been reduced substantially; consequently, there was no reason for continuing this wartime mechanism. On the contrary, its elimination served a useful purpose in restoring the bill as a market instrument and gave added flexibility to the Treasury's debt management program.

The buying program terminated in the latter part of 1948. It was a tremendous operation and the repercussions on the economy might have been serious if the Federal Reserve had not carried out the program vigorously.

Price Reduction and Open-Market Operations.— During December, 1947, the Federal Open Market Committee dropped sharply the prices at which it stood ready to purchase government securities, and began to purchase freely all government securities offered. No issue was allowed to fall below par, but the price-drops in some cases amounted to more than two points. For example, the bank eligible 2s of September 15, 1967-72 had sold at 103 7/32 (bid) at the close of business on December 23. The new purchase price established by the Federal Reserve on December 24 was 101. The new purchase price on the longest-term bank-restricted issue—the Victory Loan 2s—was 100 8/32 (bid).

With the Treasury balance at or close to a working minimum, it was

\[1\] Ibid.

\[2\] Wright Patman, op. cit., p. 63.
estimated that debt reduction in the future, would have to be financed out of Treasury surplus.\footnote{1}{Elliott Thurston, op. cit. (July, 1947), pp. 784-735.} While the budget outlook remained uncertain, it was evident that future debt retirement would be at a much slower rate than during the past year and that available funds would have been small relative to the large volume of debt that would mature.

Nearly two-thirds of the maturing issues, other than Treasury bills were held by commercial banks and Federal Reserve Banks combined. Commercial banks held about 70 per cent of the maturing bonds.\footnote{2}{Ibid.}

The competition of the public debt and its distribution by types of holders was an important conditioning factor in the refunding program. The largest part of the wartime increase in the outstanding public debt was in longer-term securities --- i.e., in Treasury bonds --- and the next largest was in one-year certificates.\footnote{3}{The substitution of a new issue of bonds for an older issue or part of an older issue. Usually, the purpose of the operation was to reduce the interest rate and often to prolong an existing debt.} Commercial banks absorbed about one-third of the total increase in Treasury bonds outstanding, with practically the entire amount in issues bought in the early years of the war, as well as substantial amounts of outstanding issues bought in the market.

About half of the wartime increase in certificates was absorbed by commercial banks and the remainder was divided between Federal Reserve Banks and nonbank investors.\footnote{4}{Elliott Thurston, loc. cit.} Treasury notes, similarly, were

\footnote{5}{Ibid., pp. 786-787.}
absorbed largely by commercial banks. Treasury bills, which had served as an effective short-term market instrument, drifted almost entirely into the Federal Reserve Banks and ceased to be traded actively in the market. The recent action to discontinue the posted buying rate and repurchase option was designed to reinstate the bill as a market instrument.

The manner in which the maturing issues were refunded had an important bearing upon the cost of the public debt, outlets for various investor groups, and the pattern of rates and yields. The refunding program facilitated the adoption of credit policies designed to restrict excessive bank credit expansion and, at the same time, maintain an orderly market for government securities.

The Open Market Committee decided to drop prices on government securities after the Treasury's refunding operation was completed. The Treasury had some misgivings about this step, but the Open Market Committee decided to take it, and a date of action was agreed upon. Although the Federal Reserve had hoped that the action would reduce selling of bonds, such selling continued. Part of the selling reflected portfolio switching by investors to protect themselves against further price declines.¹

The action came as a complete surprise to the market. Some life insurance companies, for example, traded holdings of 20-year, 2\(\frac{3}{4}\)-per cent bonds for 3-month 1 per cent Treasury bills. Many investors sold the same government securities they bought a few months before. The result was further disruption of the market. For some time, the market

¹Wright Patman, op. cit., p. 63.
continued to reflect uncertainties on the part of portfolio managers and institutional investors.\(^1\)

Beginning late in 1947, a great pressure developed for liquidation of long-term Treasury bonds by institutional investors to obtain funds for other uses, and from December, 1947 to October, 1948 the Federal Reserve made large scale purchases of bonds to support the 2\(\frac{1}{2}\) per cent yield on the longest-term restricted bonds outstanding. In this manner investors were supplied directly with investment funds and commercial banks were supplied with reserves. At first, such purchases were more than offset by Federal Reserve sales and cash redemptions of short-term securities. The gold inflow and a reduction of currency in circulation, however, enabled member banks to maintain their reserves and they continued to reduce their holdings of government securities in order to expand private credit. After May, 1948, the Federal Reserve security portfolio increased and bank reserves expanded.\(^2\) In order to absorb a portion of bank reserves and thus restrict the availability of credit, the Board of Governors of the Federal Reserve System raised the reserve requirements of central reserve city banks early in 1948 and, under authorization of special legislation permitting a temporary increase above the maximum prescribed in the Banking Act of 1935, increased reserve requirements of all classes of member banks in September, 1948.\(^3\) Also, the discount rates of Reserve Banks were increased.

\(^1\)Ibid.


\(^3\)Ibid.
during this period. Some purchases of bank-held securities were made to facilitate the adjustment to increased reserve requirements.

By the end of 1948, the demand for funds had become less urgent and the pressure for liquidation of government securities had subsided.\(^1\) The Federal Reserve began to sell bonds in order to meet a strong market demand and keep yields generally stable. Early in 1949, it became clear that inflationary forces in the economy had decreased and that a less restrictive credit and monetary policy could be adopted.\(^2\)

\(^1\)Ibid.

\(^2\)Ibid.
CHAPTER IV

MONETARY AND DEBT MANAGEMENT POLICY

JANUARY, 1949 - JUNE, 1950

The Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury believed that an appropriate, flexible, and vigorous monetary policy, employed in coordination with fiscal and other policies, should be one of our principal instruments for achieving and maintaining economic stability.¹ For several reasons, which follow, they rejected the idea, held by a few economists and others, that for stabilization purposes little or no reliance should be placed on monetary policy and that they should rely exclusively on other measures such as fiscal policies.

(1) It is highly doubtful that fiscal policy would be powerful enough to maintain stability in the face of strong destabilizing forces even if monetary policy were neutral, and a conflicting monetary policy could lessen still further the effectiveness of fiscal policy. (2) Monetary policy is strong precisely where fiscal policy is weakest; it is capable of being highly flexible. It can be altered with changes in economic conditions on a monthly, daily, or even hourly basis. (3) It is a familiar instrument of control and thoroughly consistent with the maintenance of our democratic government and our competitive free-enterprise system. It is certainly much to be preferred over a harness of direct controls. (4) Our monetary history gives little indication as to how effectively we can expect appropriate and vigorous monetary policies to promote stability, for we have never really tried them.²

Maintenance of Financial Stability

The Federal Reserve had three principal weapons which it could use to control the over-all supply and cost of money and credit. (1) Altering


²Ibid.
the discount rate at which it will lend to member banks, (2) open-market operations in government securities, and (3) altering the reserve ratios which the member banks must keep against their deposits.¹

The Functions of the Discount Rate. Alteration of the discount rate was the method chiefly relied upon during the early period of the Federal Reserve. It was said that by raising the discount rate in periods of developing inflationary pressures, the member banks would not present so much paper to the Federal Reserve for rediscount and consequently would not build up their reserves and lending power as much as they would otherwise. Moreover, the rise in the discount rate would lead the member banks to increase the interest rates which they in turn charged private borrowers, and this higher rate would curtail the amount of credit taken and would curb inflation. Conversely, in a period of recession, it was said that the Federal Reserve by lowering its discount rate would stimulate banks to present paper to build up their reserves. This would have given them abundant supplies of potential credit which they would make available to business at relatively low rates. This, it was said, would induce business firms to borrow and would stimulate trade and investment and, consequently, production and employment.

The Importance of the Discount Rate. During the post World War II period, the importance of the discount rate was far less than originally intended.² In the first place commercial paper had become much

¹Ibid., p. 19.

²Ibid.
less important. These loans from banks were originally designed to help manufacturers finance the costs of purchasing and fabricating raw materials prior to their final sale. They were designed to finance the successive steps of consumers' goods as they moved through the hands of wholesalers and retailers on their way to final purchase and consumption. As business units grew larger, they tended to finance themselves, to a much greater extent, out of earnings or from the sale of longer-term securities and issued much less commercial paper. In the second place, the vast increase in the public debt, the readiness of the Open Market Committee of the Federal Reserve System to purchase these securities in virtually unlimited quantities, and the giving of banks additional reserves in return meant that the banks depended almost exclusively on sales of government securities rather than on borrowings from the Federal Reserve as a means of replenishing their reserve accounts. This seemed to have been more important in explaining the decline in the significance of the discount rate. The discount rate of the System was not, therefore, a very effective instrument with which to stabilize the economy.

Open-Market Operations.— This method of controlling the over-all supply and cost of money and credit was discussed in the preceding chapter, but the occurrence of dynamic events during this period appeared to require further discussion. As a weapon of stabilization, the open-market operations seemed to have been more effective than the

1Ibid.

2Ibid., pp. 19-20
alteration of the discount rate. Under the open-market operations, the Federal Reserve would sell government securities, which it held in abundant quantities, when it wished to check inflationary movements. When the banks bought these securities, they paid for them by giving their checks to the Federal Reserve which then decreased the reserve accounts of the member banks. This reduced the lending capacity of the banking system by about six times the amount of shrinkage in the reserve.¹

Conversely, Federal Reserve purchases of government securities increased the volume of bank reserves, increased the total lending power of the banking system, and tended to make credit both cheaper and more available.

A sale of securities by Federal Reserve Banks or by the Treasury resulted in a flow of checks from buyers to the Federal Reserve Banks. These were subtracted from the reserve accounts of commercial banks, i. e., their deposits with the Reserve banks, with the result that their reserves were lowered by the amount paid for the securities.

In the other direction, a purchase of securities by a Federal Reserve Bank led to the issue of a check which, when collected by a bank from the Reserve Bank, added directly to the reserves of that bank. The Federal Reserve bought and sold large amounts of securities every week on its own account and as fiscal agent of the Treasury. If the net effect of these operations was an excess of sales over purchases, bank reserves were reduced. If the net effect was an excess of purchases over sales, bank reserves were expanded."²

¹Ibid., p. 20.
Maintenance of Orderly Market for Government Securities.— Throughout this period, the Federal Reserve made it clear that it was continuing its policy of maintaining an orderly market for government securities. Even the rise of short-term rates was never allowed to proceed very far and in no case was the price of a government security allowed to decline below par.¹ The following press release by the Federal Reserve on June 28, 1949 indicated, according to Chairman McCabe, that policy in the future would be flexible.

The Federal Open Market Committee, after consultation with the Treasury, announced today that with a view to increasing the supply of funds available in the market to meet the needs of commerce, business, and agriculture, it will be the policy of the Committee to direct purchases, sales, and exchanges of Government securities by the Federal Reserve banks with primary regard to the general business and credit situation. The policy of maintaining orderly conditions in the Government security market, and the confidence of investors in Government bonds will be continued. Under present conditions the maintenance of a relatively fixed pattern of rates has the desirable effect of absorbing reserves from the market at a time when the availability of credit should be increased.²

But in the interpretation of this statement, two facts seemed important: (1) the June 1949 decision had the effect of lowering interest rates, thereby facilitating Treasury finance. The Treasury might not have assented so readily had the policy been toward higher interest rates. And (2) the statement did not, and, of course, could not indicate the extent of flexibility that would be employed in the future.

Federal Reserve and Treasury officials advanced a number of reasons for the policy of holding down the yields and supporting the prices of

²Ibid.
governments in the face of inflation. (1) Service charges on Federal debt were held at a minimum by such a policy. (2) The maintenance of relatively stable prices on governments helped to maintain confidence in the public credit and facilitated Treasury sales of securities for both new financing and refunding purposes. (3) The maintenance of stable security prices protected investors against capital depreciation and prevented any loss of public confidence in financial institutions, including banks, that might have resulted from a serious decline of these prices. (4) Any marked decline in the prices of governments was communicated to other parts of the credit market and might have brought about unemployment and deflation by interfering with the flotation of new private securities. And (5), any feasible rise in the yields on governments was so ineffective as an anti-inflationary measure that it was not worth its costs.¹ The two agencies were highly influenced by the objectives of holding down the service charges on the Federal debt and of facilitating Treasury security flotations. It should be born in mind, however, that there were other considerations behind the postwar policy. These considerations related to the protection of individual and institutional investors against capital depreciation, the prevention of a financial panic, and the avoidance of restrictive policies that would be so vigorous as to reduce employment and production.

prevent, the use of restrictive monetary policy as an instrument for combating inflation.¹ The low-interest, easy-money policy that was conducive to business recovery also held down service changes on the Federal debt and facilitated security sales by the Treasury. During periods of inflation, however, the objective of preventing or narrowly limiting increases of yields on government securities might have conflicted directly with that of combating inflation. The former objective required a policy of continued easy credit and low interest rates while the latter required a lessened availability of credit accompanied by higher interest rates.

Relationship Between Monetary and Debt Management. -- It seemed rather difficult for the Joint Committee on Economic Report to prescribe by legislation specific rules to guide the determination of monetary and debt management policies, for it was impossible to foresee all situations that could arise in the future. The committee believed that specific policies should conform to the following broad principles:

(1) They should prevent "disorderly" movements in the prices and yields of government securities while avoiding the maintenance of such inflexibly low yields as to reduce seriously the effectiveness of monetary policy for anti-inflationary purposes....
(2) The advantages of avoiding inflation are so great that they should be pursued even if the cost is a significant increase in the service charges on the federal debt and a greater inconvenience to the Treasury in its sale of securities for new financing and refunding purposes.... There is good reason to believe that secularly low interest rates will be in the national interest, for they will stimulate private capital construction. We favor interest rates low as they can be without inducing inflationary pressures. But flexibility of interest rates, without which a monetary policy is impossible, should be restored.²

¹Ibid.
²Ibid., p. 28.
Also involved in this broad problem of the relationship between monetary and debt management were questions relating to the division of authority. The traditional position in this country has been that power and responsibility for monetary policy should be lodged in the "independent" Federal Reserve System which is accountable to Congress but should not be responsible to the executive branch.\(^1\) To assure the maintenance of this independence the members of the Board of Governors have been given 14-year terms, the Secretary of the Treasury and the Comptroller of the currency were removed from the Board, and a certain amount of decentralization of authority within the Federal Reserve System was continued. On the other hand, power and responsibility for debt management within very broad limitations laid down by Congress had been delegated to the Treasury Department.\(^2\) In theory, therefore, the Federal Reserve exercised the power of monetary management while the Treasury exercised the power of debt management. This seemed hardly a realistic description of the actual location of these powers. The Federal Reserve exercised an influence on debt management policies through its general monetary policies. Moreover, the Treasury exercised its greatest influence on monetary policy through its debt management policies and especially through its power to fix the various terms, including interest rates, on its new issues.\(^3\)

At this point it was deemed by the subcommittee that the following questions deserved some discussion: Who determined the levels at which

\(^1\)Ibid.

\(^2\)Ibid., pp. 28-29.

\(^3\)Ibid., p. 29.
the yields on the outstanding and new issues would be equalized -- the Federal Reserve or the Treasury? Did the Federal Reserve officials determine the general level of interest rates, including yields on government securities, that they would establish so that the Treasury in fixing rates on new issues must conform to the decisions of the Federal Reserve? Or did the Federal Reserve officials conform their general credit policies, including their support levels for government securities, to the pattern desired by the Treasury. The evidence presented showed that there was no simple answer to these questions. Federal Reserve and Treasury officials and staff members were in frequent consultation, and many decisions were agreed upon by the two agencies without marked differences of opinion. The evidence indicated that in a majority of the cases where the judgments of the two agencies differed it was the judgment of the Treasury that prevailed. On some occasions, however, when there were originally differences of opinion the Treasury "went along" with the Federal Reserve requests for higher interest rates. It appeared that in the absence of strong Treasury influence the Federal Reserve would have initiated a tighter monetary policy.

Allen Spraul, then president of the Federal Reserve Bank of New York and vice chairman of the Federal Open Market Committee, participated in negotiations with the Treasury and offered the following testimony at their hearings:

1Ibid.

2Ibid.
It is important that better means be found, if possible, for reconciling potential differences between the Treasury and the Federal Reserve System, so that action in the credit sphere may be taken promptly, as needed, in reasonable harmony with the action being taken by the Treasury in the sphere of debt management.

The record of cooperation in the postwar years has been better than might have been expected, and so has the record of our economy, whatever connection there may be between the two. But agreed action, in my opinion, has most often been too little and too late, so far as the aims of an effective monetary program were concerned.

For example, the System wanted to discontinue its preferential discount rate on Government securities maturing within one year, before the end of 1945; Treasury acquiescence, and the action, did not come until April 1946.

From the closing months of 1945 through all of 1946, the System was pressing for discontinuance of its artificially low buying rate -- three-eights of 1 per cent -- on Treasury bills; the action finally came, with Treasury agreement, in July 1947.

... The Treasury did a large part of the job, of course, by devoting its substantial cash surpluses to the retirement of debt in such a manner as greatly to aid in achieving the common objective; but the Treasury was generally several months behind in accepting the implications of a tightening policy for the interest rates on its short-term securities.¹

There were many proposals for altering the division of authority and responsibility for monetary and debt management powers in the interest of securing more appropriate policies. These ranged all the way from proposals that all monetary and debt management powers be lodged in the Treasury or in a newly created department of money and finance directly responsible to the government, to proposals that all these powers should be lodged in the Federal Reserve.² The Subcommittee on monetary, credit, and fiscal policies opposed both of these extreme proposals.

¹Ibid., pp. 29-30.
²Ibid., p. 30.
The Subcommittee recommended that three general methods be employed to secure more appropriate monetary and debt management policies. They were as follows: (1) That every effort should be made to build up the quality and prestige of the Federal Reserve officials; (2) that Congress by joint resolution issue general instructions to the Federal Reserve and the Treasury regarding the objectives of monetary and debt management policies and the division of authority over these policies; and (3) that the Secretary of the Treasury and the Chairman of the Board of the Governors of the Federal Reserve System be made members of the National Monetary and Credit Council.¹

The "independence" of the Federal Reserve did, of course, create the possibility that it might follow policies which were directly at variance with important policies of the executive department and which might tend to defeat an over-all economic program that met the approval of a majority of the American people. In practice, however, this was not a real danger. Serious adverse effects could be guarded against without making the Federal Reserve directly responsible to the executive department. Federal Reserve officials were kept fully informed as to the government's policies; the executive department was free to make its views and wishes known to the Federal Reserve; and Congress could always use its investigatory and legislative powers to bring about a change in Federal Reserve policies if these should at any time prove to be seriously at variance with important national policies.²

¹Ibid., pp. 30-31.
²Ibid., p. 32.
Open-Market Policy.-- Late in 1948, open-market policy was reversed as bond prices rose in the market and yields declined. With the active demand for bonds in the market, buying support was no longer required.

The Federal Reserve sold over $3 billion of bonds and also further reduced its Treasury bill holdings so that its total holdings of government securities declined from $23 billion in December, 1948, to $19 billion at the end of June, 1949. Total Federal Reserve credit outstanding declined correspondingly. This reversal of open-market policy was in line with the principle of maintaining stability in the bond market. Events demonstrated that this worked no better in a recession than in a boom. It brought out its perverse proclivities. Sales of securities by the Federal Reserve diminished member-bank reserves at a time when bank credit was contracting in a recession. However, Federal Reserve authorities were not so rigid in their attitude toward a rise in bond prices and a decline in yields as they had been when the movement was in the opposite direction.

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1E. A. Goldenweiser, op. cit., p. 209.

2Ibid., p. 211.

3Ibid.
CHAPTER V

CHANGES IN MONETARY POLICIES

JULY, 1950-MARCH 4, 1951

In early June, 1950, there were striking evidences of recovery from the inventory adjustment in 1949.\(^1\) Industrial production and employment increased, commodity prices moved up, and total spending was at a record high. Economic conditions showed definite reversal of the 1949 trend. This revival of economic activity continued through the first half of the year and inflationary pressures were again approaching.

After the Korean conflict began in June, a wave of precautionary buying was promptly reflected in acceleration in the rise of prices, in advances in the rate of economic activity, and in a more rapid growth of bank credit. The Korean outbreak greatly accentuated the inflationary forces in the economy. Business scrambled for materials to build up inventories and to expand plant and equipment. The pace of government stock piling was accelerated. Labor obtained a substantial increase in wages. From June, 1950 to March, 1951, prices rose some 16 per cent.\(^2\)

During this period, the government accumulated a cash surplus of over $7 billion. Therefore, the inflation was not attributed to government deficit financing. The forces making for rapid price rises were reflected in a rapid expansion of private credit. Total bank loans increased over $10 billion -- one of the largest increases that ever occurred in a period

\(^1\)W. H. Steiner, op. cit., p. 715.

\(^2\)Ibid.
of comparable length. The immediate reaction of the Congress was to pass the Defense Production Act of 1950 which became effective in September. A comprehensive freeze of prices and wages was not undertaken until January, 1951. Two revenue acts were passed in 1950; these acts substantially increased the tax collections of the Treasury.

Monetary Issues Which Grew Out of the Korean Conflict

The outbreak of the Korean conflict in June, 1950 made it necessary for the Federal Reserve and Treasury to take a new look at monetary problems and policies. In these discussions, divergent views between the two agencies developed. Up to the Korean conflict, their disagreements had generally been relatively minor. They felt that they had time to work things out and that mistakes or concessions in policy on the part of one agency or the other could be ironed out in the course of time. It was suggested that differences of opinion between the two agencies be resolved by discussion, mutual understanding, and when necessary, by compromise.

Federal Reserve's Approach to Monetary Issues.— Officials of the Federal Reserve System were in favor of increasing taxes. They encouraged the savings bond program and administered the President's program of selective credit restraints which were among those measures asked for by the Congress in the Defense Production Act of 1950. The Federal Reserve also felt that great reliance should be placed on traditional measures of general credit restraint which involved a declining securities market.

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1Ibid., p. 716.
2Ibid., p. 717.
3Wright Patman, op. cit., p. 66.
4Ibid., p. 69.
and increases in interest rates. It was in this specific area that disagreements between the Federal Reserve and Treasury developed.

On August 18, 1950, the Board and the Federal Open Market Committee issued the following statement:

The Board of Governors of the Federal Reserve System today approve an increase in the discount rate of the Federal Reserve Bank of New York from 1 1/2 per cent of 1 3/4 cent.... Effective restraint of inflation must depend ultimately on the willingness of the American people to tax themselves adequately to meet the Government's needs on a pay-as-you-go basis. Taxation alone, however, will not do the job. Parallel and prompt restraint in the area of monetary and credit policy is essential.¹

The increase in discount rates was largely symbolic for bank indebtedness was at a low level. This action was followed by changes in open-market technique by which sales of short-term securities to the Federal Reserve were somewhat discouraged. The Board also joined with other Federal and State supervisory agencies, including the Home Loan Bank Board, in a statement requesting voluntary cooperation of banks and other lenders in restricting their lending and investment activities.² During September, the Board placed consumer installment credit under regulation in accordance with authority contained in the Defense Production Act of 1950. Its regulation were stiffened in October.³

On October 12, credit extended by private interests for constructing, purchasing, and financing new houses was placed under rather strict regulation by the Board with the concurrence of the Housing and Home Finance Administrator. At the same time Federal agencies in this field tightened construction credit under their jurisdiction. A moderate increase in tax

¹E. A. Goldenweiser, op. cit., p. 213.
²Ibid.
³Ibid.
rates was adopted by Congress. It was noted, however, that short-term interest rates moved up and short-term government securities with coupon rates below the market were selling at a discount. The Federal Reserve did not have the cooperation of the Treasury on the action to restrain over-all credit expansion.

The result of the actions of the Federal Reserve System was a significant financing failure for the Federal Government. Some $13.5 billion of government securities was involved. Less than 6 per cent of this amount was exchanged for the new issues by private holders.

Between the time of the announcement and the dates (September-October, 1950) of the refunding operations, private investors sold over $8 billion of their holdings to the Federal Reserve. Sales of other government securities from the System's portfolio offset to a considerable extent those purchases of the maturing issues. The sales did not, however, completely offset the buying operation; and as a result of the Federal Reserve actions, there was a net increase in the System's government security holdings.

In addition to the securities sold to the Open-Market Account, private investors turned in over $2.5 billion to the Treasury for cash redemption. This cash turn-in constituted an important drain on the government's cash balance. In the weeks that followed, the Federal Reserve open-market operation had the effect of further depressing prices on outstanding government securities.

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1Ibid.
2Wright Patman, op. cit., p. 70.
3Ibid.
4Ibid., pp. 71-72
Because of the decreases in security prices in the intervening period, a higher interest rate was offered than in August in order to price the new issue in line with the market. Holders of the December and January maturing securities were offered 5-year Treasury notes drawing interest at the rate of 1 3/4 per cent per year. The new issue was in accord with the Federal Reserve recommendation to the Treasury at this time. The holders of these new issues were largely banks, corporations, and other short-term investors. The Federal Reserve, however, thought it was advisable to extend the maturity. The terms of the issue were approved by the President; and the Chairman of the Board of Governors and the Federal Reserve authorities assured the Treasury of full cooperation of the System in the refunding operation.

About 51 per cent of the maturing issues were turned in to the Treasury by private holders for the new issues. The Federal Reserve bought over $2.5 billion of the maturing securities during the refunding period. Moreover, the cash redemption experience was only slightly better than in September through October. Cash redemption amounted to 14.5 per cent of the total of the maturing issues; in the previous operation, they had amounted to approximately 17.5 per cent.

The net result of the Federal Reserve open-market operations from August 21, 1950 through the end of the year was an increase in the System's Open Market Account of over $2.5 billion. This was debt monetization.

1Ibid., p. 72.
2Ibid.
3Ibid.
Treasury's Approach to Monetary Issues.— The Treasury believed that an effective approach to the inflationary problem required a broad program operating on many fronts. It required increased tax revenues. It required that the government cut its expenditures in the nondefense area wherever practical; and especially that the government, as well as the public, exercise great restraint in the use of those goods and services which could be needed for our increased military requirements.¹

The Treasury also required a strong program to promote greater savings in all forms. This, indeed, was the keynote of the Treasury's savings bond promotional efforts throughout the war. It had not been concerned with selling savings bonds alone, for efforts were directed toward promoting thrift in all forms.

As the necessity for a greatly increased defense program became clear following the invasion of Korea, the importance of savings programs of all kinds also became greatly enhanced. Here, the Treasury visualized the possibility of a third World War. The two agencies reviewed what a war would mean with respect to the finances of the government of the United States. It seemed clear, moreover, that even if a third World War did not materialize, it would hardly be possible to avoid, in the period ahead, a tremendous expansion in the country's military programs. This required that the financial affairs of the nation be maintained at a desirable level.

The Treasury felt that preparation should be made for all eventualities. This was made clear to the Federal Reserve immediately. The

¹Ibid., p. 68.
²Ibid., pp. 66-67.
Treasury's position was expressed again in a letter which was sent to Thomas B. McCabe, then Chairman of the Board of Governors of the Federal Reserve System, on July 17, 1960, in which it was restated that stability in the government bond market was of paramount importance. The letter also stated that it was imperative that every financing operation of the government be carried through to a successful conclusion.¹

Moreover, the Treasury felt that there were significant reasons why important reliance on traditional measures of general credit restraint was not appropriate under the circumstances existing after the outbreak of hostilities in Korea. In the first place, some credit expansion in certain areas of the economy was necessary to facilitate the country's primary objective. It was believed that in order to be effective in the areas of special inflationary pressures which needed to be restrained during the defense period, measures of general credit restraint might have had a stringently repressive effect upon every area of the economy. In the second place, the country, as a whole, had such a large volume of liquid assets that it was insulated to a considerable extent from the effects of general credit restraint actions. It was obvious that credit expansion and unnecessary loans should have been curtailed. However, credit expansion was one of the many factors contributing to the rise in the general price level.

As previously mentioned, the primary cause of the inflationary situation, throughout the entire postwar period, was an unprecedented demand for goods and services by business and consumers generally. Before Korea, individuals bought goods to fulfill the stored-up demands which had

¹Ibid., p. 67.
resulted from World War II. Industry replaced and expanded plant and equipment in order to meet civilian peacetime needs.

Some of these purchases were financed by expansion of bank credit but not all of them by any means. ¹ Bank credit, for example, accounted for only about one-tenth of the 1950 financial needs of business corporations.² Accordingly, the Treasury felt that major reliance in controlling inflationary pressures should not be placed on traditional methods of general credit control.

The Treasury felt, further, that stability in the market for government securities was essential and that the pursuit of policies which would unsettle the market would be unwise.

Stability of Government Securities and Refunding Operations

The issues between the Federal Reserve and the Treasury on the necessity for stability in the government security market in connection with the Treasury's September-October refunding operation became serious. The decision to maintain the 11\(^{1}/_{4}\) per cent rate on the two issues of 13-month Treasury notes, offered in exchange for the September-October maturities, was in accord with the Treasury's policy of maintaining stability in the government security market.³ The Federal Reserve was advised of the intended action of the Treasury which had the approval of the President as required by law.

The terms of the new issues announced on August 18 were identical with the terms offered in connection with the issues which had matured on June 1 and July 1. Furthermore, the terms of the new issue were in

¹Ibid., p. 69.
²Ibid.
³Ibid., p. 70.
accord with the market on the day of the refunding announcement. They also met the needs of the market which required a short-term security at that time. Apparently, this was frequently overlooked in the public discussions which followed in subsequent weeks.

The Federal Reserve, however, took action to increase the rediscount rate. Immediately after the opening of trade on August 21, short-term rates on outstanding issues of government securities were allowed to reach levels inconsistent with the rate on the refunding offering of the Treasury. Subsequently, the Open Market Committee through its open market operations, permitted short-term rates to run up further. The Open Market Account offered government securities at prices which gave purchasers a higher rate of return than they would have received on the new issues offered by the government. The result was to make the new Treasury issues unattractive to the market. Most of the holders of the maturing issues did not wait to exchange them for the new refunding issues, inasmuch as they could buy higher-yielding securities of the same type from the Federal Reserve. An increase in the Federal Reserve's Open Market Account affected primarily the short- and medium-term issues of government securities. Early in January, 1951, however, officials of the Federal Reserve System outlined for the Treasury a program which would have involved a reorientation of the debt management policy. The program included proposals for further increases in interest rates, including increases in the long term area.

1Ibid.

2Ibid.

3Ibid.

4Ibid., p. 72.
In view of the importance of these matters to the whole defense financing program and the rumors and confusions in the market, the Chairman of the Board of Governors and the Treasury felt that the matter should be discussed with the President. At this meeting, the three of them -- President Harry S. Truman, Thomas B. McCabe, and John W. Snyder -- agreed that market stability was desirable.

It was against this background that Mr. McCabe made a speech on January 18, 1951, before the New York Board of Trade, announcing this policy. Following his speech, the market was strengthened. Some officials of the Federal Reserve differed publicly with the policy. This created further uncertainties in the government security market. The Open Market Committee further reduced its buying price for Victory Loan 2\(\frac{1}{2}\)s. Market-wise, this was the most significant of the long-term Treasury issues. In view of the previous conferences and the market situation on January 31, President Truman conferred with the entire Open Market Committee to clarify the situation. As a result of this conference, strength was created in the government market for a few days. Again, confusion was injected into the market by statements made by a Federal Reserve official on February 3. 

It was generally agreed between the parties involved -- Chairman of the Board of Governors, Treasury, Chairman of the Banking Committees in Congress, and Chairman of the Joint Committee on Economic Report -- that there should be no change in the existing situation of the government security market.

\[\text{Ibid., p. 73.}\]
\[\text{Ibid.}\]
\[\text{Ibid.}\]
Shortly after these meetings, however, a change in the attitude of the Federal Reserve was apparent; and Mr. McCabe informed the Treasury that as of February 19, 1951, the Federal Reserve was no longer willing to maintain the existing situation in the government security market. It became evident that some agreement had to be reached since the proposed action of the Federal Reserve would have intensified the confusion and uncertainty in the market. The government was approaching a quarterly period when expenditures would exceed receipts. The President's budget message projected nearly doubled national security requirements for the coming year with a sizable deficit in the government's financial accounts unless new taxes were enacted. It appeared that the Treasury would need to borrow new money in the not too distant future. This would have been in addition to the refunding operations which would have been approximately $50 billion during the calendar year 1951.

Therefore, representatives of the Federal Reserve and the Treasury were named to work out a way in which differences could be compromised. The result was the accord announced jointly by the two agencies in a statement released for publication on March 4, 1951. The announcement was as follows:

The Treasury and 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 their successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt.  

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1Ibid.  
2Ibid.  
3Ibid.  
4Ibid., pp. 73-74.
The above statement reflected agreements that had been reached, following extended discussion between representatives of the two agencies, regarding their mutual and related problems. It was agreed that there were both immediate and long-run factors which had to be taken into account in arriving at an accord. It was also agreed that the purpose of the negotiation was to reach agreement upon policies that would reduce, to a minimum, the monetization of the public debt without creating an adverse market psychology with reference to government securities.

First, consideration was given to the matter of long-term bonds overhanging the market, and at the time, being offered for daily sale in large amounts. It was agreed that a substantial portion of these bonds could be taken off the market by a Treasury offer to exchange for them a nonmarketable 2 3/4 per cent, 29-year bond, redeemable at the holder's option before maturity only by conversion into a 5-year marketable Treasury note. The purpose of offering this new security, as announced by the Treasury, was to encourage long-term investors to retain their holdings of government securities, in order to minimize monetization of the public debt through liquidation of outstanding holdings of the Treasury bonds of 1967-72.

Second, there was the problem of the long-term government securities which private holders might try to sell on the market after the terms of the exchange offering became public. It was agreed that a limited volume of open market purchases would be made after the exchange offering was announced. It was also agreed that if sales on the market were excessive, the situation would be assessed daily, the market would be kept orderly, and open market policies, if any, would be made on a scale-down of prices.

Third, the pending task of refunding the large volume of short-term
securities maturing or callable in the near future presented difficult problems for both agencies. It was agreed that the Federal Reserve, in order to minimize monetization of the debt, would immediately reduce or discontinue purchases of short-term securities and permit the short-term market to adjust to a position at which banks would depend upon borrowing at the Federal Reserve to make needed adjustments in their reserves.

Fourth, the raising of new funds by the Treasury to finance the defense mobilization program presented other problems. It was recognized that there were no substantial amounts of nonbank funds seeking investment, and it would be some time before such funds would accumulate. It was agreed that more frequent conferences between the Federal Reserve and Treasury officials and staff should be held so that the Federal Reserve might collaborate more closely with the Treasury in working out a joint program of government financing as well as in maintaining orderly markets for government securities.
CHAPTER VI

SUMMARY AND CONCLUSION

In this study, we were primarily concerned with issues between the Federal Reserve and Treasury and how they were resolved. Yet, we did not want the reader to gain the impression that the two agencies were not sympathetic to each other's problems. The record was considered in the light of the difficult problems which had to be dealt with during the period of this study.

On many occasions the two agencies disagreed on how their objectives could be achieved. The differences were primarily on matters of emphasis, in selection of instruments and methods to be employed, and in timing. The first major issue in the postwar period was in the general area involving the maintenance of financial stability. Some difference of opinion arose with respect to the timing of the interest rate actions and the rapidity with which they were to be effectuated. After the outbreak of hostilities in Korea the Federal Reserve felt that great reliance should be placed on traditional measures of general credit restraint which involved a declining securities market and increase in interest rates. The Treasury felt differently, for in the first place, some credit expansion in certain areas of the economy was necessary to facilitate the country's primary objective -- the production of essential defense and military goods. In the second place, the country, as a whole had such a large volume of liquid assets that it was insulated to a considerable extent from the effects of the type of general credit restraint action proposed by the Federal Reserve. Differences between the two
agencies became serious in connection with the Treasury's September-October refunding operations as an instrument for the maintenance of stability in the government securities market.

The record was also considered in the light of the degree of agreement which existed between the Federal Reserve and the Treasury. Particularly, during the immediate postwar period, the two agencies were agreed upon the over-all objective of maintaining a high level of production, employment, and income with as much price stability as possible under the varying conditions which existed in the economy. This was, of course, also the over-all objective of the country generally.

The Federal Reserve and the Treasury were also agreed on the related objectives which were involved. They agreed that the reconversion of the nation's economy from war to peace should be expedited. They agreed that it was desirable to maintain confidence in the credit of the government. They agreed that it was necessary to maintain a sound market for the securities of the government. They agreed that it was desirable, during much of the period, to restrain over-all credit expansion. They agreed that it was desirable to increase the ownership of government securities by nonbank investors and to reduce the holdings of the banking system. They agreed that rigidly fixed interest rates were undesirable and that adjustments should be made in the wartime pattern of rates from time to time as this became appropriate.

The two agencies agreed on the desirability of a number of specific programs to achieve our objective. They were, for example, agreed upon the usefulness of a debt reduction program concentrated on the holdings of the commercial banking system. Both were in favor of encouraging
savings throughout the economy.

The primary cause of the inflationary situation, throughout the postwar period, was an unprecedented demand for goods by business and consumers generally. Before the Korean conflict, individuals bought goods to fulfill the stored-up demands which resulted from the shortages of World War II. Industry replaced and expanded plant and equipment to meet these demands. After the Korean conflict began, individuals and businesses — remembering the shortages of World War II — bought goods in anticipation of shortages during the defense period. Here, turbulence was created in the government securities market because of the unwillingness of the Federal Reserve and Treasury to agree on appropriate measures necessary to prevent inflation. Confidence was necessary in the market.

The presumed area of differences had become greatly magnified in the newspapers and other public discussion and there was urgent need to reassure the public that the two agencies were in agreement as to the proper monetary policies in the existing situation. The Federal Reserve and Treasury felt that everything possible should be done to terminate the unwholesome situation that had developed and to coordinate responsibilities — debt management by the Treasury and restraint of credit expansion by the Federal Reserve. Therefore, representatives of the two agencies were designated to work out a way in which differences could be compromised. The result was the accord announced jointly by the Federal Reserve and the Treasury in a statement released for publication on March 4, 1951.

The rate of interest acts as a uniform deterrent to the current use of resources. A change in the interest rate can discourage some current investment and some current consumption. The rate of interest can make it
more costly or difficult to get control over capital.

A low interest rate will tend to increase attempted "investment," i.e., it will increase the quantity of goods that individuals or firms seek to buy to increase their stock of capital goods or to replace items used up or sold. Here, investment includes not only expenditures on plant and equipment, but also business expenditures on inventories and goods in process, and consumer expenditures on goods and houses. The amount by which investment will be increased depends on the interest elasticity of the demand for investment. Also, a low interest rate will tend to increase the proportion of income devoted to consumption (the propensity to consume) in two ways. First, it will make "savings" less attractive. Second, a low rate of interest tends to increase the capital value of existing flows of income. Therefore, it is conceivable that a low interest rate may be a contributory factor to inflation.

The impossibility of restraining credit expansion while carrying out a policy of supporting bonds at par was clearly demonstrated during this period. Under the policy of bond support, the sale of government bonds to the Federal Reserve System by nonbank holders, particularly insurance companies, resulted in the creation of additional bank reserves. However, the anti-inflationary effects on bank reserves by the Treasury operations were more than offset by Federal Reserve purchases of government securities in carrying out its market support policy.

The Federal Reserve Board was unable to discharge its responsibility for national monetary policy so long as it was committed to the policy of supporting bonds at par. The obligation of this agency to support the market for government securities limited its powers to exert effective
restraint on credit expansion. Consequently, if credit expansion is to be restrained by Federal Reserve action, the bond support policy must be subordinated to monetary policy.

Table 1 shows the annual public debt by security classes which are grouped into two main headings — marketable and nonmarketable issues. If a marketable security suited the need of a particular investor class and at the same time satisfied the needs of both the government and the economy as a whole, in all probability, the Treasury and Federal Reserve would issue it. If, on the other hand, a nonmarketable instrument would do a better job, the two agencies would issue it. On some occasions, they issued both types of securities simultaneously to satisfy the various needs of a particular investor class. Table 2 shows the annual guaranteed matured and unmatured obligations not held by the Treasury.

With a built-up backlog of urgent demands for all types of civilian goods -- especially for durables -- during the first years of this period, much of the pressure exerted by intensive consumer, business, and foreign buying was reflected in price movements. After the termination of the wartime controls in the latter half of 1946, prices rose sharply, as indicated in Table 3. Serious inflationary tendencies accompanied the postwar boom until 1948. The year of 1949 showed a drastic reduction in prices. The average price index of all commodities during the period of this study was 174.4 and it was 209.2 in the following 5-year period. The average annual interest rate, charged customers by commercial banks in 19 principal cities, was 2.4 per cent during this period and 3.6 per cent in the succeeding 5-year period. Table 4 shows the average yields of government securities from 1945-1950. The average annual yields were lowest
for the 3-month bills, higher for the 9 to 12-month certificate of indebtedness, and highest for the 3 to 5-year taxable issues.

Because of the huge wartime growth in the public debt and the wide distribution of marketable government securities, large-scale Federal Reserve operations were essential for the maintenance of orderliness and stability in the market. The operations of the Federal Reserve largely determined the general level of prices and interest yields on government securities, although wide variations in prices among individual issues were determined by market preference.

The effectiveness of monetary policy as an instrument for the maintenance of financial stability was argued pro and con by several leading economists. Lester V. Chandler and Milton Friedman, professors of economics, Princeton University and the University of Chicago respectively argued the pro point of view. The anti-monetary policy was argued by Seymour E. Harris, Alvin H. Hansen, professors of economics and political economy respectively, Harvard University; Abba P. Lerner, professor of economics, Roosevelt College of Chicago; and James Tobin, associate professor of economics, Yale University. From this discussion, it seems clear that monetary policies are potent weapons in combating inflation and preventing deflation in our economy.  

John Kenneth Galbraith, professor of economics, Harvard University, takes essentially the same view as those opposing monetary policy above. In the first place, according to Professor Galbraith, monetary policy attacks inflation by attacking the volume of investment. When it is

effective, it reduces the rate of economic growth. Thus, one who advocates a tight money policy is, in effect, calling for a slower rate of investment and of economic expansion than it the curbs were placed on consumption.

In the second place, monetary policy creates the lack of competitive balance between large and small businesses. For instance, when banks must limit credit, they are impelled to protect their oldest, strongest, and most reliable customers. These in general, will be the larger firms. As a result, the burden of the cut falls on newer, weaker, less reliable -- and smaller -- borrowers. Moreover, the resources of the larger and stronger firm may make it more or less independent of loans and its market power may allow it to pass higher interest costs along to customers in the form of higher prices. This is hardly possible for the farmer and the small businessman.

A final difficulty with our monetary policy is that it probably does not end inflation. The evidence of the day can hardly be ignored. A policy of tight money has been employed with increasing severity for many months and inflation has not been curtailed. Prices are still rising; the pace, at the time of this writing, is accelerating. The usual test of a policy, it is believed, is whether it works.
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## TABLE 1

PUBLIC DEBT BY SECURITY CLASSES FOR YEARS ENDING JUNE 30, 1946-51

<table>
<thead>
<tr>
<th>Classes</th>
<th>1946</th>
<th>1947</th>
<th>1948</th>
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<th>1950</th>
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<td>Treasury bills</td>
<td>17,039</td>
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<td>11,536</td>
<td>13,533</td>
<td>13,614</td>
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<td>Certificates of indebtedness</td>
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<td>29,427</td>
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<td>Treasury bonds:</td>
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<tr>
<td>Bank eligible</td>
<td>65,864</td>
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<td>Bank restricted</td>
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<td>49,638</td>
<td>49,638</td>
<td>49,638</td>
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<td>Panama canal loan bonds</td>
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<td>Conversion bonds of 1946-47</td>
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<td>--</td>
<td>--</td>
<td>--</td>
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<td>--</td>
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<td>Postal saving bonds</td>
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<td>114</td>
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<td>Total marketable securities</td>
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<td>160,346</td>
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<tr>
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<td>U.S. Savings bonds</td>
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</tr>
<tr>
<td>Armed forces leave bonds</td>
<td>--</td>
<td>1,793</td>
<td>563</td>
<td>393</td>
<td>237</td>
<td>47</td>
</tr>
<tr>
<td>Treasury bonds -- investment series</td>
<td>--</td>
<td>--</td>
<td>954</td>
<td>954</td>
<td>954</td>
<td>14,526</td>
</tr>
<tr>
<td>Total nonmarketable issues</td>
<td>56,173</td>
<td>59,045</td>
<td>59,506</td>
<td>62,839</td>
<td>67,544</td>
<td>80,281</td>
</tr>
<tr>
<td><strong>Total Public Issues</strong></td>
<td>245,779</td>
<td>227,747</td>
<td>219,852</td>
<td>217,986</td>
<td>222,853</td>
<td>218,198</td>
</tr>
</tbody>
</table>


*In Millions of Dollars.*
### TABLE 2

GUARANTEED OBLIGATIONS HELD OUTSIDE THE TREASURY, CLASSIFIED BY GOVERNMENT CORPORATIONS AND OTHER BUSINESS-TYPE ACTIVITIES
FOR YEARS ENDING JUNE 30, 1946-51*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unmatured obligations</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodity, credit corporations (notes, etc.)</td>
<td>424,147</td>
<td>45,002</td>
<td>41,703</td>
<td>10,909</td>
<td>1,432</td>
<td>14</td>
</tr>
<tr>
<td>Federal Housing Administration:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mutual mortgage insurance fund (debentures)</td>
<td>8,370</td>
<td>7,497</td>
<td>7,445</td>
<td>4,480</td>
<td>7,673</td>
<td>8,433</td>
</tr>
<tr>
<td>Housing insurance fund (debentures)</td>
<td>7,038</td>
<td>5,938</td>
<td>5,938</td>
<td>3,938</td>
<td>3,440</td>
<td>1,290</td>
</tr>
<tr>
<td>War housing insurance fund (debentures)</td>
<td>27,117</td>
<td>24,775</td>
<td>15,682</td>
<td>1,536</td>
<td>4,532</td>
<td>17,528</td>
</tr>
<tr>
<td>Total unmatured obligations</td>
<td>455,672</td>
<td>85,212</td>
<td>65,785</td>
<td>28,952</td>
<td>17,077</td>
<td>27,564</td>
</tr>
<tr>
<td><strong>Matured obligations</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal Farm Mortgage Corporation</td>
<td>3,714</td>
<td>2,425</td>
<td>1,738</td>
<td>1,886</td>
<td>841</td>
<td>636</td>
</tr>
<tr>
<td>Federal Housing Administrationa</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Home Owners Loan Corporation</td>
<td>5,988</td>
<td>3,873</td>
<td>2,953</td>
<td>2,224</td>
<td>1,584</td>
<td>1,227</td>
</tr>
<tr>
<td>Reconstruction Finance Corporation</td>
<td>8</td>
<td>3</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Total matured obligations</td>
<td>9,713</td>
<td>6,308</td>
<td>4,693</td>
<td>3,413</td>
<td>2,425</td>
<td>1,863</td>
</tr>
<tr>
<td>Total based on guarantees</td>
<td>476,385</td>
<td>89,520</td>
<td>73,461</td>
<td>27,275</td>
<td>19,503</td>
<td>29,227</td>
</tr>
</tbody>
</table>

*aPursuant to Reconstruction Plan No. 3 of 1947, which became law on July 27, 1947, name changed from Federal Public Housing Authority to Public Housing Administration.

*bIn Thousands of Dollars.

### TABLE 3

**INDUSTRIAL PRODUCTION**  
*(PHYSICAL VOLUME)*  
1935-39 = 100

<table>
<thead>
<tr>
<th>Year</th>
<th>Durable</th>
<th>Nondurable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1945</td>
<td>274</td>
<td>166</td>
</tr>
<tr>
<td>1946</td>
<td>192</td>
<td>165</td>
</tr>
<tr>
<td>1947</td>
<td>220</td>
<td>172</td>
</tr>
<tr>
<td>1948</td>
<td>225</td>
<td>177</td>
</tr>
<tr>
<td>1949</td>
<td>202</td>
<td>168</td>
</tr>
<tr>
<td>1950</td>
<td>237</td>
<td>187</td>
</tr>
</tbody>
</table>


### TABLE 4

**UNITED STATES GOVERNMENT SECURITY YIELDS**  
*(Average)*

<table>
<thead>
<tr>
<th>Year</th>
<th>3-month bills</th>
<th>9 - 12-month Certificate of indebtedness</th>
<th>3 - 5-year Taxable issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>1945</td>
<td>.375</td>
<td>.81</td>
<td>1.18</td>
</tr>
<tr>
<td>1946</td>
<td>.375</td>
<td>.82</td>
<td>1.16</td>
</tr>
<tr>
<td>1947</td>
<td>.604</td>
<td>.88</td>
<td>1.32</td>
</tr>
<tr>
<td>1948</td>
<td>1.040</td>
<td>1.14</td>
<td>1.62</td>
</tr>
<tr>
<td>1949</td>
<td>1.102</td>
<td>1.14</td>
<td>1.43</td>
</tr>
<tr>
<td>1950</td>
<td>1.218</td>
<td>1.26</td>
<td>1.50</td>
</tr>
</tbody>
</table>