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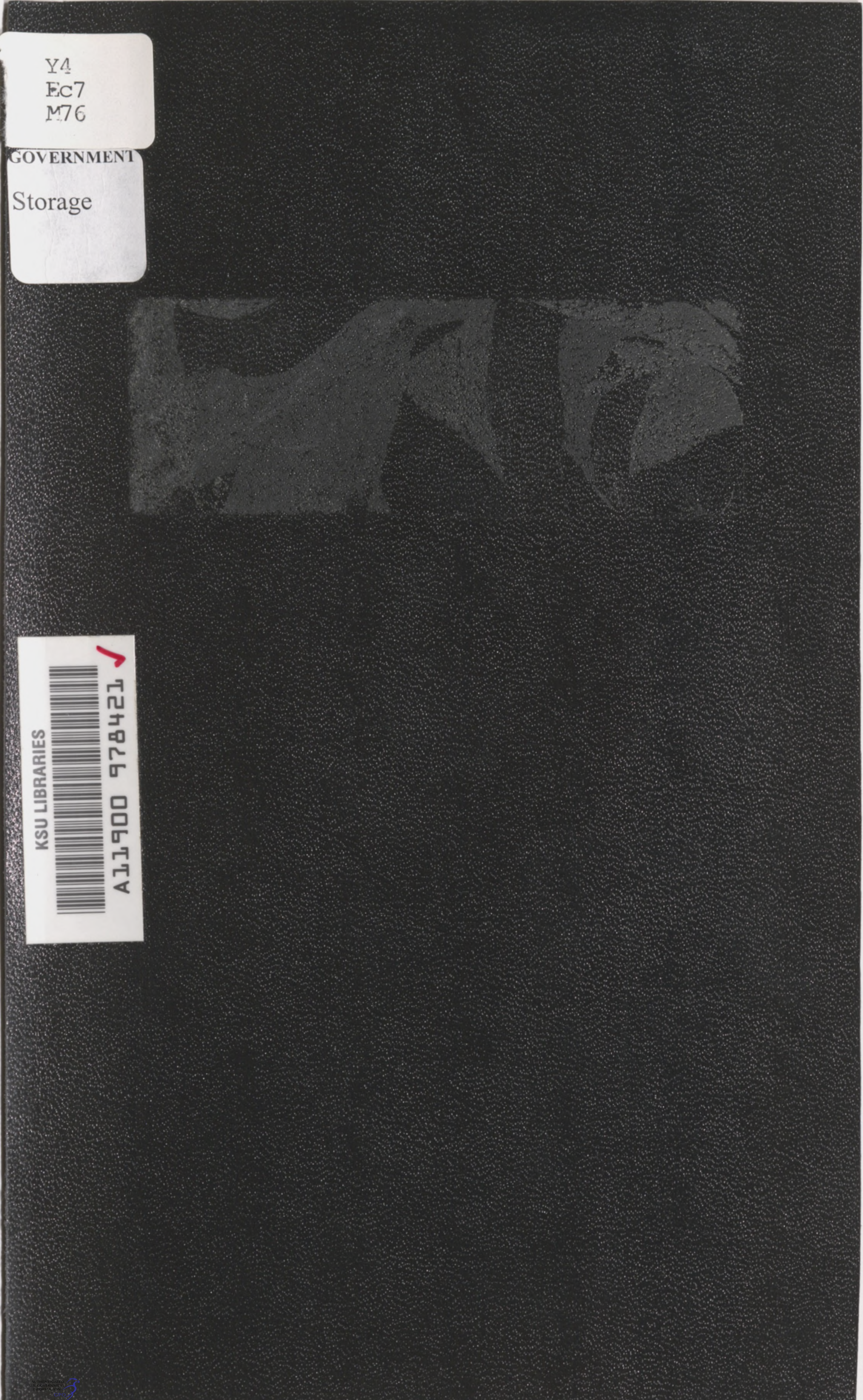

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MONETARY POLICY AND THE MANAGEMENT OF THE PUBLIC DEBT

REPORT

OF THE

SUBCOMMITTEE ON GENERAL CREDIT CONTROL AND DEBT MANAGEMENT

OF THE

JOINT COMMITTEE ON THE ECONOMIC REPORT

CONGRESS OF THE UNITED STATES

Printed for the use of the Joint Committee on the Economic Report

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(Created pursuant to sec. 5 (a) of Public Law 304, 79th Cong.)

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LETTER OF TRANSMITTAL

DEAR SENATOR O'MAHONEY: There is transmitted herewith the Report of the Subcommittee on General Credit Control and Debt Management.

This Subcommittee, which was appointed by you in the spring of 1951, has made an intensive study of the general field assigned to it. In the fall of 1951, after a long period of preparation, it addressed a series of questions to the principal officers of the Federal Government concerned with monetary policy and debt management, and to numerous persons in the private economy. An excellent response was had from those addressed, both inside and outside the Government, and the results, published by the Subcommittee in February 1952 in a two-volume document entitled *Monetary Policy and the Management of the Public Debt; Their Role in Achieving Price Stability and High-Level Employment*, served as the basis for the subsequent hearings of the Subcommittee, which extended from March 10 through March 31, 1952.

The procedure of the Subcommittee is described at length in the Foreword to the document just referred to and in my opening statement at the hearings. It is also described briefly in the Introduction to the appended Report. Throughout the entire inquiry the Subcommittee has worked together in a spirit of cooperative endeavor and every member has made a substantial contribution to our joint product. I wish to take this occasion, on behalf of the whole Subcommittee, to thank again those who answered our questionnaire, the witnesses at our hearings, and all others who have contributed so effectively to the successful completion of our work.

The report covers a wide variety of subject matter, and, dealing as it does with material which has so often been treated more in the heat of the emotions than in the light of the intellect, shows a surprisingly large area of agreement. We believe that this widening of the area of agreement on matters on monetary policy and debt management, both among the members of the Subcommittee and among students of the subject generally, represents the principal accomplishment of our inquiry. The extension of areas of agreement by patient discussion represents the democratic process at its best; the persistence of residual areas of disagreement shows that the process is the democratic process indeed, for complete agreement can seldom be attained this side of either Utopia or Tyranny.

We express our special appreciation to Dr. Henry C. Murphy for his services as Economist to the Subcommittee. His technical competence and resourcefulness were of invaluable assistance to the Sub-

committee. We are grateful to the International Monetary Fund for the loan of his services to the Joint Committee on the Economic Report for this assignment.

Finally, I want to express my personal thanks to all members of the Subcommittee for their cooperation in conducting this study of general credit control and debt management.

Respectfully submitted.

WRIGHT PATMAN,
Chairman, Subcommittee on General Credit Control and Debt Management.

JUNE 26, 1952.

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MONETARY POLICY AND THE MANAGEMENT OF THE PUBLIC DEBT

SUMMARY OF FINDINGS AND RECOMMENDATIONS

I. Fiscal and Monetary Policy Since the Outbreak in Korea

1. Wholesale prices in the United States rose about 16 percent between June 1950 and March 1951. This rise might have been moderated somewhat by the earlier adoption of a more restrictive monetary policy. But the use of monetary measures sufficiently powerful to have averted most or all of the rise probably would have had consequences even more undesirable than the rise itself. Reviewing the circumstances of the period, it is an open question whether the somewhat more restrictive monetary policy which followed the Treasury-Federal Reserve "accord" of March 4, 1951, should have been applied earlier.

[With respect to the timing, Senator Flanders notes that the predecessor subcommittee recommended in January 1950 that the freedom of the Federal Reserve to restrict credit and raise interest rates for general stabilization purposes should be restored even if this involved higher debt service charges and greater inconvenience to the Treasury in debt management. In his estimation, an "accord" established at that time would not have been too early.]

2. Wholesale prices reached a peak in March 1951 and declined about 4 percent during the following year. Some of the credit for this turn in the price situation is doubtless due to the more restrictive monetary policy following the accord and some is doubtless due to the imposition of price and wage controls in January 1951. For the most part, however, it appears to have been a natural reaction from the wave of "scare buying" set off by the Korean outbreak and would have occurred in any event.

3. An examination of the relevant data shows remarkably little correlation between price changes since the outbreak in Korea and changes in either the money supply or in the budgetary position of the Federal Government. During the period of rapid price rise the budget was strongly over-balanced and the money supply was increasing very slowly; during the subsequent period of price stability and decline the budget showed a deficit and the money supply was rising much more rapidly. These factors doubtless had an influence on prices; but, in the short run, this influence was outweighed by that of other factors. In the long run, however—when other factors tend to average out—changes in the money supply and in the budgetary position of the Federal Government are likely to have a decisive influence. They are important at all times because they are subject to the conscious control of the Government, whereas the factors originating in

the "outside economy" are not. It is only by persisting in appropriate fiscal and monetary policies that the Government can make its full contribution to price stability and high-level employment over the longer period.

4. The differences between the Treasury and the Federal Reserve during the period between the outbreak in Korea and the accord were rather small when viewed in perspective. Prior to the turn of the year 1950–51, they were concerned principally with short-term interest rates. It was not until early 1951 that the Federal Reserve evidenced a desire to increase the long-term interest rate above 2½ percent. An examination of the confidential correspondence between the Treasury and the Federal Reserve, and of the Federal Reserve with the President, shows, for the most part, that each agency was striving to serve the public interest as it saw it. The officials of the Federal Reserve System, the Secretary of the Treasury, and the President, however, appear at times to have interpreted agreements differently and not to have been aware of each other's interpretations. This might have been avoided by better staff work and by staff attendance at top-level conferences.

5. We believe that general monetary, credit, and fiscal policies should be the Government's primary and principal means of promoting the ends of price stability and high-level employment and that whenever possible reliance should be placed on these means in preference to devices such as price, wage, and allocation controls and, to a lesser extent, selective credit controls—all of which involve intervention in particular markets. Nevertheless, under present circumstances—in which we do not yet know the full impact on the economy of the defense expenditure program—we believe that it would be improvident to repeal the legislative authority for either price, wage, and allocation controls or for selective credit controls.

[Mr. Patman believes that the disadvantages of selective controls over consumer and housing credit are so great that the authority for the imposition of these controls should be repealed immediately.]

II. Fiscal and Monetary Policy for the Future

6. We reaffirm the recommendation of our predecessor subcommittee that a flexible fiscal policy producing a surplus of revenues over expenditures in periods of high prosperity and a surplus of expenditures over revenues in periods of depression should be a principal reliance of the Federal Government in promoting price stability and high-level employment.

7. We believe that monetary policy (variations in the ease or tightness of credit) should also be used as a principal means of seeking price stability and high-level employment. It must be used with caution, however, in order to insure that measures taken to halt an inflation do not aggravate a subsequent period of depression, or *vice versa*.

[Senator Flanders feels that resoluteness in the use of monetary policy should be emphasized as well as caution; effective efforts to check inflation should not be unduly inhibited by alarms about possible subsequent depressions, or *vice versa*.

There is much to be said for more frequent small changes in credit policy. This would help get the country out of "crisis

psychology" in these matters. Furthermore, skillful steering, whether of an automobile or of the national economy, is brought about by small, frequent adjustments.]

8. Selective credit controls interfere with the allocation of resources which would occur under the unfettered operation of the price system. In the absence of affirmative evidence to the contrary, the allocation of resources which would result from the free operation of the price system must be considered that most likely to maximize social welfare. Selective credit controls should be used with especial caution, therefore, and only when thoroughly justified by special circumstances.

9. The voluntary credit restraint program, initiated in March 1951 and terminated in May 1952, was probably helpful in restraining inflationary pressures during the period in which it was in effect. Programs of this character are easily subject to abuse, however, and are unlikely to be uniform in their distribution of burden. They also tend to become less effective with the passage of time. We believe that such programs should be resorted to only under extraordinary conditions.

10. Neither the problems of monetary policy nor those of debt management can be solved in isolation from the other. We recommend that the Treasury and the Federal Reserve should continue to endeavor to find by mutual discussion the solutions most in the public interest for their common problems, with final appeal to Congress.

11. We recommend against the issuance of securities the terms of repayment of which are determined wholly or partly by changes in the purchasing power of the dollar.

12. The principal mandate concerning economic policy at present given by Congress to both the Treasury and the Federal Reserve System is that contained in the Declaration of Policy in the Employment Act of 1946. Neither agency has any clear directive other than this to seek the ends of price stability and high-level employment. The declaration of policy does not directly mention price stability, but this can be inferred and the Treasury and the Federal Reserve each state that they have taken it into account in their own interpretations. We agree with these interpretations, but suggest that further studies be made of the wording of the declaration in order to secure a more balanced emphasis. We do not believe that this is a matter of great urgency, however, as each agency is in fact interpreting the present declaration in the same manner as it would if the aim of price stability were more explicitly spelled out.

III. Bank Reserve Requirements

13. We believe that nonmember banks should be required to maintain the same reserves as member banks and should be given equal access to loans at the Federal Reserve banks. This change is desirable both in order to increase the effectiveness of credit control and to spread its cost more uniformly over all banks. We see in it no threat to the dual banking system.

14. While we see no immediate need for the imposition of higher reserve requirements or for reserve requirements of new forms (e. g., requirements which might be met in whole or in part by United States securities or requirements expressed as percentages of assets rather

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than of liabilities), we believe that further consideration should be given to the adoption of legislation providing the Board of Governors with additional powers over bank reserve requirements for use at its discretion. The time to provide such powers is during a period of quiescence in inflationary pressures and not when the discussion of them would dramatize and so intensify existing pressures.

IV. The Machinery for the Determination of Monetary Policy

15. The independence of the Federal Reserve System is based, not on legal right, but on expediency. Congress, desiring that the claims of restrictive monetary policy should be strongly stated on appropriate occasions, has chosen to endow the System with a considerable degree of independence, both from itself and from the Chief Executive. This independence is in no way related to the unsettled question of whether the Board of Governors is or is not a part of the Executive Branch of the Government. It is naturally limited by the overriding requirement that all of the economic policies of the Government—monetary policy and fiscal policy among them—be coordinated with each other in such a way as to make a meaningful whole. The independence of the Federal Reserve System is desirable, not as an end in itself, but as a means of contributing to the formulation of the best over-all economic policy. In our judgment, the present degree of independence of the System is about that best suited for this purpose under present conditions.

16. The independence of the Federal Reserve System must be an independence *within* and not *from* the Government. The determination of monetary policy is an important public function and cannot be finally delegated to private parties.

17. The three principal instruments of Federal Reserve policy are the determination of rediscount rates, the variation of reserve requirements, and open-market operations. These three instruments must be used in conjunction to serve a common end, and there is no rational basis for the assignment of the most important of them, open-market operations, to a body (the Federal Open Market Committee) different from that controlling the other two (the Board of Governors). Nevertheless, we recommend the continuation of the Federal Open Market Committee as a useful link between the directors and managements of the individual Reserve banks, on the one hand, and the Board of Governors, on the other. Such a continuation presents some danger that the Open Market Committee (not all of the members of which are responsible either directly or indirectly to the electorate) might at some future date adopt an open-market policy not compatible with the over-all economic policy of the Government as approved by Congress. In such an event this recommendation would have to be reconsidered.

18. We note with concern the complete absence of any representation of labor on the directorates of the Federal Reserve banks, despite the fact that labor is so vitally affected by monetary policy. We recommend that the Board of Governors give consideration to including representatives of labor among those whom it considers eligible for appointment as class C directors.

[Senator Flanders believes that class C directors should represent the broad public interest and to this end well-qualified representatives of labor should be eligible. However, he is opposed to any requirements which would tend to make these directorships partisan by parceling them out to members of special-interest groups, whether business, agriculture, or labor.]

19. We recommend that the term of office of members of the Board of Governors be reduced from 14 to 6 years and that members of the Board be made eligible for reappointment.

[Senator Flanders favors a reduction in the term of office of members of the Board of Governors from 14 to 10 years, a reduction in the number of members of the Board from 7 to 5, and the removal of the limitation on eligibility for reappointment. His proposal would permit two appointments to the Board in each Presidential term but would not permit a President to appoint a majority of the Board in a single term (except through appointments due to death and resignations). He believes that such an arrangement would achieve the best balance between the objectives described in the text of the Report.]

20. In order to insure the selection of persons of the highest caliber as members of the Board of Governors, we recommend that the number of members of the Board be reduced from 7 to not more than 5, and that the salary of the Chairman be raised to the same level as that of Cabinet members—namely, $22,500—and the salaries of other Board members be raised to $20,000 a year. We also recommend that the number of Federal Reserve bank presidents on the Federal Open Market Committee be reduced so as to maintain, as far as possible, the present proportion between members of the Board of Governors and Federal Reserve bank presidents in the composition of the Committee.

21. We recommend that the law be amended so that the designation of the Chairman of the Board of Governors by the President shall run for a term beginning shortly after the commencement of each presidential term.

22. We recommend that the present geographical and other qualifications for appointment to membership on the Board of Governors be eliminated and the appointments be left to the full discretion of the President and the Senate.

23. We believe that it is not merely the right but the duty of the President to seek to coordinate the economic policies of the Govern ment by discussion with all agencies participating in their formulation, including the Federal Reserve System.

24. We recommend that a consultative and advisory council of the type recommended by Secretary Snyder be established on an experimental basis by executive order. Such a council would have no directive powers over its members. If the council works well in practical operation, Congress might give consideration at a later date to establishing it by legislation and providing it with a small staff of its own, as suggested by Mr. Ruml.

25. We recommend that the Joint Committee on the Economic Report, either through frequent meetings of the full Committee or through the appointment of a standing subcommittee, as the Chairman may see fit, should maintain more active liaison at the top level

with the Federal Reserve and the executive agencies, including the proposed consultative council. Good liaison is now maintained at the staff level.

26. In order to insure, as far as possible, that balanced consideration is given at the top-policy level to the implications, advantages, and disadvantages of proposed fiscal, monetary, and other economic policies, we recommend that adequate funds be provided for the economic staffs of the Treasury Department, the Council of Economic Advisers, and the Department of Commerce. (The special financial structure of the Federal Reserve System insures that the advantages of monetary policy, especially restrictive monetary policy, will be adequately presented.)

27. The private ownership of the stock of the Federal Reserve banks serves partly as a symbol of the will of Congress that, subject to its final authority, it has chosen to leave to the System a great deal of autonomy in its day-by-day and year-by-year operations, and partly as a convenient link between the Federal Reserve banks and the business and financial communities. As long as this ownership continues to serve a useful purpose, we see no reason why it should be disturbed.

28. The gross earnings of the Federal Reserve banks are derived from the exercise, under exclusive privilege granted by Congress, of public functions (including the issuance of money) of an intrinsically lucrative character. After the payment of necessary expenses and of dividends on private capital, they are the property of the Federal Government, subject to the disposition of Congress. No stockholder of the Federal Reserve banks or any other person has any legal or moral interest in these earnings beyond his right to receive dividends in the amount determined by statute. At the present time the Federal Reserve banks pay 90 percent of their net earnings after dividends to the Treasury in accordance with an order of the Board of Governors issued pursuant to an obscure and long-dormant provision of the Federal Reserve Act. While we approve of the action of the Board of Governors in this respect, we recommend that legislation be enacted providing that 90 percent of the earnings of the Federal Reserve banks, after expenses and statutory dividends, be paid to the Treasury as a franchise tax.

29. We recommend that legislation be enacted providing that the dividends on all stock of the Federal Reserve banks (not merely those on stock issued after March 28, 1942) should be subject to Federal income taxation in the same manner as other income.

30. We recommend that the Board of Governors should be required to submit annually its budget and the budgets of each of the 12 Federal Reserve banks, together with a statement of performance on the budgets of the previous year, to the Banking and Currency Committees of each House for such consideration and action as these Committees consider suitable. (The effect of the procedure here recommended would be confined to improving the information of the legislative committees. In the absence of further legislation—which is not here recommended—the Board of Governors and the Federal Reserve banks would continue to conduct their finances without Congressional approval.)

[Senator Flanders dissents from this recommendation. While the recommendation, if adopted, would, in itself, make no change in the present independence of the Federal Reserve System in the

management of its finances, he believes that the necessity for this closer surveillance has not been demonstrated and that it might prove an entering wedge for a subsequent impairment of the System's independence.]

31. We recommend that the accounts of the Board of Governors should be audited annually by the General Accounting Office. This should be a post-audit only and the authority of the Comptroller General should be limited to reporting to Congress any expenditures or other actions of the Board which he considers to be improper and to making such suggestions as he considers appropriate. A full copy of each such audit should be filed with the Committees on Banking and Currency of each House for such consideration and action as they consider appropriate.

[Senator Flanders dissents from this recommendation as stated. He would, however, be willing to see the Board of Governors included in the following recommendation (32).]

32. We recommend that each of the 12 Federal Reserve banks should be audited at least annually by an outside auditor appointed by its Board of Directors and approved by the Board of Governors. We recommend further that the General Accounting Office be authorized to perform such audits if requested by a Federal Reserve bank. The full reports resulting from such audits, by whomever performed, should be filed with the Banking and Currency Committees of each House in the same manner as previously suggested for the budgets of the Board and of the banks, and for the audits of the Board.

[Senator Flanders would include the Board of Governors as well as the Federal Reserve banks in the scope of this recommendation (except, of course, that in the case of the Board of Governors the appointment of auditors would require no approval).]

V. The Gold Standard

33. The United States dollar is now on an international gold standard and the price of gold is fixed at $35 a fine ounce. Except for a small margin between the authorized buying and selling rates, the price of gold cannot be changed except by act of Congress. This price is implemented by the willingness of the United States Treasury to sell gold to, and buy gold from, foreign governments and central banks in such amounts as may be necessary to maintain the international value of the dollar. We believe that this form of the gold standard has proved its worth in maintaining the stability of the United States dollar in world markets, and we recommend that it be continued.

34. We believe that to restore the free domestic convertibility of money into gold coin or gold bullion would militate against rather than promote the purposes of the Employment Act, and we recommend against such restoration.

INTRODUCTION

The Subcommittee on General Credit Control and Debt Management was appointed by Senator Joseph C. O'Mahoney, Chairman of the Joint Committee on the Economic Report, early in April 1951. Somewhat more than a year before (in January 1950) a previous subcommittee—the Subcommittee on Monetary, Credit, and Fiscal Policies, under the chairmanship of Senator Douglas—had submitted a report dealing with fiscal and monetary policy. Since that time the invasion of South Korea by Communist forces, beginning in late June 1950, had caused a marked increase in international tension and the launching of a greatly enhanced program of defense expenditure by the United States and, to a lesser extent, by the other countries of the free world. Accompanying this increase in tension and increased planning for defense expenditure was a world-wide increase in prices, coming in two waves—one immediately following the outbreak in Korea and the other following the Chinese intervention in November. Wholesale prices in the United States rose altogether about 16 percent between June 1950 and March 1951.

During the period of this rapid rise in wholesale prices, the budget of the United States Government was not merely balanced but showed a substantial surplus. This coincidence of a rapidly rising price level and an over-balanced budget naturally caused many people to question whether the price rise could not, and should not, have been averted by the more vigorous use of monetary policy. This question was given especial point by the large price rise which had already occurred since the end of the war; by the report of the previous subcommittee, which had recommended a more vigorous use of monetary policy; by a return to a more vigorous use of monetary policy in certain European countries, notably Belgium and Italy; by a revival among many academic economists in the United States of confidence in the efficacy of monetary policy as a means of combating inflation; and, most important of all, by a prolonged struggle between the Treasury and the Federal Reserve System over the extent, if any, to which general credit policy should be used as a means of combating the post-Korean inflation in the United States. This struggle had just terminated in a so-called "accord" between the two agencies, announced on March 4, 1951. The extent of the disagreement between the two agencies during the struggle and the points upon which they were now in agreement were equally unknown. The announcement of the accord simply said:

> The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt.

It was against this background that the present Subcommittee commenced its work. The two tasks before it were, broadly, to study and make recommendations concerning (1) the appropriate policies, and particularly the appropriate monetary policies which

should be used in promoting economic stability, and (2) the appropriate governmental machinery for implementing these policies.

As the first step in its inquiry, the Subcommittee sent questionnaires to the heads of the principal Government agencies concerned and to many persons in the private economy. The questions were different for each class of respondent, depending on the interests and special sources of information of each, and, in the case of those addressed to Government agencies, involved the preparation of a considerable volume of background material. The questions, which were developed in discussions with the respondents and others extending over a period of several months, were published by the Subcommittee in October 1951 in a pamphlet entitled *Questions on General Credit Control and Debt Management.* The answers to these questions, containing much valuable material on the issues before the Subcommittee, were published in February 1952 in a two-volume document entitled *Monetary Policy and the Management of the Public Debt; Their Role in Achieving Price Stability and High-Level Employment.* [1] This document, which is hereafter cited as the *Compendium*, served as the basis for the subsequent hearings of the Subcommittee, which extended from March 10 through March 31, 1952. Many of the witnesses at the hearings had been contributors to the *Compendium* and all of them were furnished copies to study as an aid in preparing their testimony. General reference is made to both the *Compendium* and the *Hearings* for support of the subsequent discussion and conclusions in this report (and in many cases for argument supporting other conclusions, as most of the matters dealt with are highly controversial). In the interest of brevity, particular reference is made only in cases where it appears especially helpful to the discussion.

[1] Senate Document No. 123, 82d Cong., 2d Sess.

I. FISCAL AND MONETARY POLICY SINCE THE OUTBREAK IN KOREA

A. Price Movements Following the Outbreak in Korea

1. *The Period of Price Rise, June 1950–March 1951.* Wholesale prices in the United States rose about 16 percent between June 1950 and March 1951. The increase in prices which followed the outbreak of hostilities in Korea was world-wide in scope and was greatest in internationally-traded raw materials. The increases during this period in the prices of each of 14 leading commodities imported into the United States are shown in Table 1. The average price of all commodities imported into the United States increased during this period by 57.1 percent, as shown in Chart 1, taken from the testimony of Roy Reierson, Vice President of the Bankers Trust Company of New York. The increase in the average of all wholesale prices in the United States during this period was somewhat less than that in most of the other principal trading countries of Western Europe and the British Commonwealth, as shown in Table 2. This comparison is not in any way intended to acquit the responsible policy-making authorities of the United States, including Congress, the Treasury Department and the Federal Reserve System, for any failure on their part to adopt appropriate policies during this period, but merely to indicate the scope of the problem with which they were confronted.

Table 1.—*Increases in the prices of leading import commodities in the United States, June 1950–March 1951*

Commodity and unit	June 1950 price	Peak price			March 1951 price	
		Month	Price	Index June 1950=100	Price	Index June 1950=100
Newsprint (per short ton)	$101.00	November 1950	$106.80	106	$106.80	106
Sugar (refined per 100 pounds)	7.60	September 1950	8.10	107	8.10	107
Copper (per 100 pounds)	22.30	October 1950	24.50	110	24.50	110
Coffee (per 100 pounds)	47.80	September 1950	56.10	117	54.80	115
Woodpulp (per short ton)	118.00	January 1951	140.00	119	140.00	119
Flaxseed (per bushel)	4.00	March 1951	4.90	122	4.90	122
Cocoa (per 100 pounds)	30.80	September 1950	42.00	136	38.40	125
Hides (per 100 pounds)	23.20	December 1950	37.70	162	35.70	154
Copra (per 100 pounds)	8.60	February 1951	13.80	160	13.80	160
Coconut oil (per 100 pounds)	14.00	February 1951	24.30	174	24.00	171
Tin (per 100 pounds)	77.80	February 1951	182.70	235	147.40	189
Wool tops (per 100 pounds)	178.00	March 1951	360.00	203	360.00	203
Burlap (per 100 pounds)	16.40	February 1951	34.00	207	34.00	207
Rubber (per 100 pounds)	30.90	January 1951	73.50	238	72.20	234

Source: *International Financial Statistics*, monthly bulletin of the International Monetary Fund.

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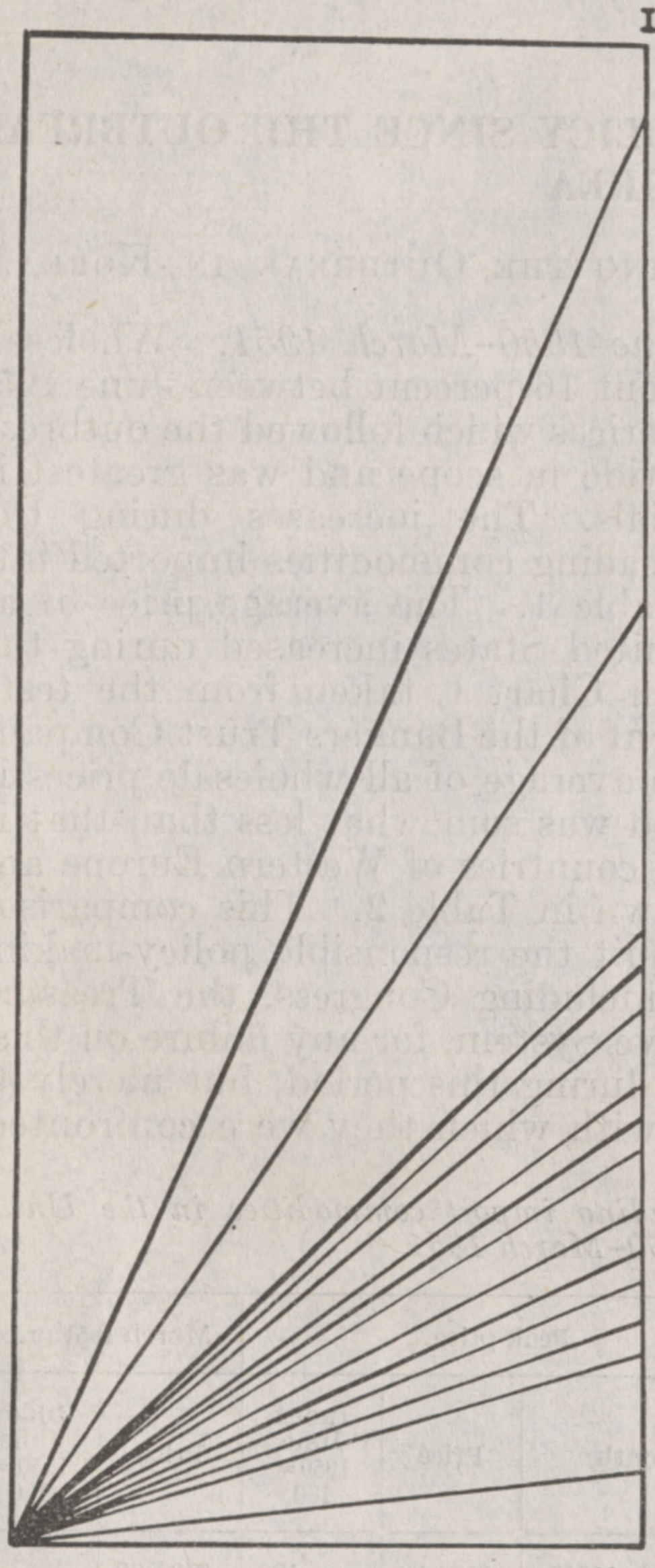
CHART 1.—SELECTED ECONOMIC FACTORS IN THE POST-KOREAN BOOM



Per cent Increase	Item
57.1	Prices of Import Commodities
37.6	Manufacturers' New Orders
23.5	Business Inventories
22.8	Prices of Farm Products
21.5	Bank Loans
17.0	Wholesale Prices
16.3	Plant and Equipment Outlays
15.7	Wage and Salary Incomes
11.6	Industrial Production
10.7	Consumer Spending
10.6	Turnover of Money Supply
9.9	Federal Spending
8.4	Consumers' Price Index
2.9	Money Supply

June 1950 — March 1951

NOTE.—The beginning and ending dates and the definition of money supply used in preparing this chart (taken from the testimony of Mr. Roy Reierson at p. 647 of the *Hearings*) are somewhat different than those used elsewhere in this report. These differences are of no importance as far as the argument of the report is concerned.

TABLE 2.—*Comparison of change in wholesale price index in the United States with that in principal countries of Europe and the British Commonwealth, June 1950–March 1951*

Country	*Price index March 1951 (June 1950=100)*
New Zealand	108
Union of South Africa	108
Portugal	109
India	111
Canada	115
Ireland	115
UNITED STATES	116
Switzerland	118
Norway	120
Western Germany	122
Italy	122
United Kingdom	122
Australia	123
Netherlands	126
Denmark	127
Sweden	128
Austria	129
Greece	129
France	130
Belgium	131
Finland	136
Spain	136

Source: *International Financial Statistics*, monthly bulletin of the International Monetary Fund.

One explanation which has commonly been given for price increases on other occasions was notably absent during the period under discussion. During the nine months from July 1950 through March 1951 the Federal Government operated at a cash surplus in an aggregate amount of $7.7 billion—or at a surplus of $5.1 billion on a conventional accounting basis. This surplus was in part the result of some reduction in non-defense expenditures. To a greater extent it reflected the effect of the rapid increase in prices, production, and business activity following the outbreak in Korea upon revenues due under existing law. But it was also due in part to the prompt action of Congress in raising taxes to meet the prospective rise in defense expenditures. The effect of these tax increases was much more important, however, in the following period (discussed subsequently) in preventing the fiscal situation from worsening more than it did. They were a necessary and important step in any adequate long-run program to safeguard the purchasing power of the dollar. But, their results in the period under discussion were a disappointment to those who believed it possible to place almost exclusive reliance on fiscal policy in maintaining price stability.

The Defense Production Act of 1950, authorizing the direct control of prices and wages, became effective on September 8, 1950. A comprehensive freeze of prices and wages was not undertaken, however, until January 1951—and was then based on wages prevailing on January 25, 1951, and on the highest prices at which goods had been sold during the period between December 19, 1950, and January 25, 1951. Prior to this comprehensive freeze, only two selective control orders had been issued, one applying to the price of automobiles and the other to the price of hides. Aside from these two orders, exclusive reliance was placed upon appeals for voluntary

cooperation.[1] It is probable that during the period under review the *anticipation* of the imposition of mandatory controls raised prices at least as much as they were held down by the use of hortatory techniques and by the two controls actually imposed.

The Defense Production Act also authorized the control of consumer and housing credit, and in September the Board of Governors issued Regulation W, imposing selective controls on instalment credit. In October, it tightened the terms on instalment credit set by Regulation W and issued Regulation X, imposing selective controls on credit for the purchase of new housing. In January and February 1951, Regulation X was broadened to include certain commercial construction. The rise in instalment credit, which had been very rapid in the months immediately following the Korean outbreak, soon leveled off and the outstanding amount did not increase appreciably during the year 1951. The regulation of new real estate credit was less prompt in taking hold due to the large number of loans for which commitments had been made at the time it went into effect—which commitments were exempted from the terms of the Regulation. Naturally many commitments were hastened in anticipation of the imposition of the Regulation. It seems, on the whole, that the selective regulation of real-estate credit had no net restraining effect on inflationary pressures during the period up to March 1951.

During this period, while prices were rising rapidly, some modest steps were taken toward the institution of a stronger monetary policy. These steps were confined principally to increases in short-term interest rates. (It is recognized that the cutting edge of monetary policy, at least during the early stages of its application, consists largely in a reduction of the availability of credit rather than in an increase in its cost. Nevertheless, making due allowance for this qualification, changes in interest rates are the most convenient quantitative measure of changes in the intensity of a general credit restriction.) The average yield on three-month Treasury bills advanced from 1.17 percent in June 1950 to 1.39 percent in February 1951, while that on Treasury bonds with more than fifteen years to maturity or earliest call date advanced from 2.33 percent to 2.40 percent. These increases occurred before the "accord" between the Treasury and the Federal Reserve System, which was reached on March 4, 1951. As shown by the record, they were, for the most part, opposed by the Treasury.

Despite the degree of reduction in the availability of credit reflected in the increases in interest rates just mentioned, total bank loans increased by $10.5 billion—one of the largest increases which has ever occurred in a period of equal length. In evaluating this increase, it should be remembered that Congress had decided that the defense build-up should proceed, as far as possible, by the expansion of privately owned plant capacity rather than principally by the con-

[1] The Defense Production Act states in part:

"SEC. 402. (a) In order to carry out the objectives of this title, the President may encourage and promote voluntary action by business, agriculture, labor and consumers. * * *

"(b) (1) To the extent that the objectives of this title cannot be attained by action under subsection (a), the President may issue regulations and orders establishing a ceiling or ceilings * * *"

Some advisers of the Economic Stabilization Agency believed that these provisions constituted a mandate from Congress to give the voluntary method "a fair trial" before using compulsory methods, while other advisers disputed this contention. The relevant Committee reports provide little support for it. It should be remembered in this connection that the price-fixing power was conferred upon the President by Congress on its own motion rather than upon his request.

struction of Government-owned plant capacity, as had been the case during and preceding World War II. This policy tended, on the one hand, to reduce the volume of Government expenditures, and, on the other hand, to increase the strain on private financial resources and so to cause a greater demand for business loans from banks and other lenders. The proportion of bank loans used for plant expansion directly connected with the defense effort seems to have been larger, however, during the following year (when the total loan expansion was smaller) than it was during the period under discussion.

During this period of rapid expansion of bank loans, the privately held money supply (defined in accordance with the usage of *Economic Indicators* as adjusted deposits plus currency outside of banks) increased only $2.5 billion (1.5 percent) during this period. The most important of the offsetting factors which held down the increase to such small proportions were a *decline* in the Government security holdings of the banking system [2] and an outflow of gold. The factors affecting the money supply during this period are analyzed in Table 3.

TABLE 3.—*Factors affecting the money supply (consolidated accounts of the Federal Reserve banks, all commercial banks, mutual savings banks, and the Postal Savings System), June 30, 1950, to March 28, 1951*

[Billions of dollars]

Increase in loans	+10.5
Increase in investments other than Government securities	+1.3
Decrease in Government securities	−4.0
Decrease in gold stock	−2.4
Increase in net assets of banking system	+5.4
Increase in capital and miscellaneous accounts, net	−0.3
Increase in assets held *per contra* to deposits and currency	+5.1
Increase in cash and deposits held by the Treasury and deposits held by foreign banks (not part of the money supply)	−2.6
Increase in Treasury currency (not issued by the banking system)	(1)
Increase in money supply	+2.5

[1] Less than $50 million.

NOTE.—Direction of change of individual items indicated in words; "plus" and "minus" signs indicate effect on money supply. Detail may not add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System.

During the period under review the reserves available for expansion in the commercial banking system increased by a net amount of $1.1 billion. The factors which resulted on net balance in this increase, and the nature of the concept itself, are shown in Table 4. It will be noted that of the $4.3 billion increase in Reserve bank holdings of Government securities during the period, about $2.4 billion was offset by a net outflow of gold and another $2.0 billion by the increase in reserve requirements which became effective in January and February 1951. Excess reserves increased about $300 million and the remainder of the increase in available reserves was used to support the expansion of the banking system during the period.

[2] An increase in the Government security holdings of the Federal Reserve banks was more than offset by a decrease in the holdings of other banks.

TABLE 4.—*Increase in reserves available for expansion in the banking system, June 30, 1950, to March 28, 1951*

[Billions of dollars]

Increase in Government security holdings of the Federal Reserve banks	+4.3
Increase in all other Federal Reserve credit	+0.9
Decrease in monetary gold stock	−2.4
Decrease in money in circulation	+0.1
Other factors, net	+0.2
Increase in member bank reserve balances	+3.1
Less: Increase in required reserves due to increases in reserve requirements	−2.0
Increase during period in reserves available for expansion	+1.1

NOTE.—Direction of change of individual items indicated in words; "plus" and "minus" signs indicate effect on member bank reserve balances available for credit expansion. Detail may not add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System.

The substantial increase in prices between June 1950 and March 1951, occurring during a period of relatively strong fiscal policy (i. e., a relatively large budget surplus) but of relatively weak monetary policy (i. e., relatively easy money), together with the rough equality of the percentage increase in bank loans (20 percent) and in wholesale prices (16 percent) during the period, naturally raised the question in many minds of whether the price rise could not have been averted—or whether it could not then be stopped—by the adoption of a strong monetary policy. This was the situation at the time the present Subcommittee was appointed.

2. *The Period of Relative Price Stability, March 1951-March 1952.*—The average level of wholesale prices, after reaching a high in March 1951, stabilized and then turned slightly downward. The average level of all wholesale prices declined about 4 percent during the year following March 1951 and stood about 12 percent above its 1947–49 average in March 1952. Consumers' prices—which normally lag after wholesale prices and which had advanced about 8 percent during the period between June 1950 and March 1951—slowed down their rise markedly and rose only about 2 percent during the year which ended in March 1952.

A number of causes could be assigned for this abrupt change in the inflationary situation. Much attention was given in the testimony to an attempt to arrange these causes in order of significance. Those which appear most important to the Subcommittee are listed here without prejudice as to order:

(*a*) The international inflation in raw material prices had run its course. Most raw material prices had reached their high and turned down by early 1951. (From the viewpoint of the world as a whole this was, of course, an effect rather than a cause of the diminution in inflationary pressures. But, from the viewpoint of any individual country—even the United States—it was a cause and an important one of a diminution in domestic pressures.) The sharp rise in the prices of raw materials may have been partly caused by the stockpiling methods of American Government and business, and the down-turn may have been in part brought about by changes in these methods.

(*b*) The wave of "scare buying" on the part of both business and consumers had spent itself. Consumers who had rushed to buy goods

during the earlier period found that most types of goods were still available, while they themselves were short of cash or faced with greatly increased debts. A natural revulsion set in which was reflected in an increase in consumer savings from a low of 2.2 percent of disposable income in the third quarter of 1950 to a high of 9.2 percent of disposable income in the third quarter of 1951. A corresponding revulsion took place in the attitude of businessmen with respect to their inventories.

(*c*) The price and wage controls—which had been the occasion of anticipatory increases as well as of restraint in prices and wages during the earlier period—became purely restraining influences, the effectiveness of which may be variously evaluated. At the same time, the backlog of commitments made in anticipation of the selective regulation of real estate credit began to be worked off, so that this selective regulation came to have a substantial net restraining effect on new housing starts and on expenditures for construction.

(*d*) A more active monetary policy was inaugurated, commencing with the Treasury-Federal Reserve accord of March 4, 1951.[3] This more active policy was reflected (subject to the qualifications made earlier) in an increase in the yield of three-month Treasury bills from 1.39 percent in February 1951 to 1.66 percent in March 1952, and in an increase in the average yield of Treasury bonds with a maturity or earliest call date of 15 years or over, from 2.40 percent to 2.70 percent. Furthermore, in the same month as the accord—March 1951—a formal Voluntary Credit Restraint Program was launched under the auspices of the Federal Reserve System. The effectiveness of this program, which is difficult to measure, would, of course, be felt only in the totals of credit extended and not in the interest rate figures just quoted.

It is difficult to measure the effectiveness of this increase in the intensity of monetary policy (including the Voluntary Credit Restraint Program). Money supply (privately-held deposits plus currency outside of banks), which had increased only $2.5 billion during the nine-month period July 1950 through March 1951 (characterized by relatively easy money), increased $10.4 billion during the year of somewhat more stringent monetary policy which followed.[4] The factors affecting money supply during this period are analyzed in Table 5. The most important factors accounting for the striking difference between the two periods are (1) the Government security holdings of the banking system, which had fallen in the first period, rose in the second,[5] and (2) the monetary gold stock, which had fallen

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[3] The substance of the Treasury-Federal Reserve accord was an agreement that the Federal Reserve would pursue a somewhat more restrictive monetary policy than theretofore, that the Treasury, in cooperation with this policy, would offer a new 2¾ percent nonmarketable bond in exchange for certain of its outstanding marketable 2½ percent bonds, and that the Federal Reserve would cooperate in insuring the success of Treasury short-term borrowing operations during the remainder of the year at rates consistent with the Federal Reserve rediscount rate of 1¾ percent (which "in the absence of compelling circumstances not then foreseen" would continue unchanged until the close of the year). The accord, the terms of which had never previously been revealed, was described in identical language by the Secretary of the Treasury and the Chairman of the Board of Governors in answers to the Subcommittee's questionnaire (*Compendium*, pp. 74-76 and 349-351). This identical reply is reprinted in full in the Appendix to this Report.

[4] It should be noted that the first period is 9 months, the second a full year. There is also some tendency for March figures to be seasonally low. The contrast—and the variance from *a priori* expectations—is, nevertheless, remarkable.

[5] Government security holdings of the *Federal Reserve banks* rose in the first period and fell in the second, but the Government security holdings of other banks fell in the first period and rose in the second. In each case the changes in the holdings of other banks (i. e., commercial and mutual savings banks and the Postal Savings System) were larger and dominated the movement of the consolidated series. The difference between the two periods is as much a commentary on fiscal policy as on monetary policy—in the first period the total debt was falling and in the second period it was rising. In each period it all had to be held by some one.

in the first period, rose in the second. Total bank loans, which had risen by $10.5 billion in the first (nine-month) period, rose by $5.2 billion in the following year, and it appears were more largely concentrated on purposes having to do with the defense effort in the second period than in the first. The principal factors affecting member bank reserve balances during the later period are summarized in Table 6. The addition to the reserves available for commercial bank expansion, which had been $1.1 billion in the earlier nine-month period, was $1.3 billion in the later one-year period. The Government security portfolio of the Federal Reserve banks declined slightly in the later period, but gold, which had been flowing out of the country in the earlier period, was flowing in during the later. Money in circulation, which had remained unchanged during the earlier period, increased substantially during the later period.[6]

TABLE 5.—*Factors affecting the money supply (consolidated accounts of the Federal Reserve banks, all commercial banks, mutual savings banks, and the Postal Savings System), March 28, 1951, to March 26, 1952*

[Billions of dollars]

Increase in loans	+5.2
Increase in investments other than Government securities	+1.5
Increase in Government securities	+1.4
Increase in gold stock	+1.4
Increase in net assets of banking system	+9.5
Increase in capital and miscellaneous accounts, net	−1.0
Increase in assets held *per contra* to deposits and currency	+8.5
Decrease in cash and deposits held by the Treasury and deposits held by foreign banks (not part of the money supply)	+1.9
Increase in Treasury currency (not issued by the banking system)	+0.1
Increase in money supply	+10.4

NOTE.—Direction of change of individual items indicated in words; "plus" and "minus" signs indicate effect on money supply. Detail may not add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System.

TABLE 6.—*Increase in reserves available for expansion in the banking system March 28, 1951, to March 26, 1952*

[Billions of dollars]

Decrease in Government security holdings of the Federal Reserve banks	−0.1
Decrease in all other Federal Reserve credit	−0.4
Increase in monetary gold stock	+1.4
Increase in money in circulation	−1.3
Decrease in Treasury, foreign bank, and other nonmember deposits in the Federal Reserve banks	+1.5
Other factors, net	(1)
Increase in member bank reserve balances	+1.3

[1] Less than $50 million.

NOTE.—Direction of change of individual items indicated in words; "plus" and "minus" signs indicate effect on member bank reserve balances. Detail may not add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System.

[6] Treasury, foreign bank, and other nonmember deposits with the Federal Reserve banks—fluctuations in which are not of long-run significance but which occasionally dominate the situation in periods as short as a year—were extremely important in the later period, as the Treasury balance with the Federal Reserve banks declined from the unusually high level of $1.1 billion on March 28, 1951 to substantially zero on March 26, 1952. There is at least a possibility that, if this decline had not occurred, there would have been some offsetting increase in Federal Reserve credit of some type. Indeed, the portion of the decline immediately following the March 15 tax date had been arranged by the Treasury, presumably in collaboration with the Federal Reserve, in order to avoid the Federal Reserve operations which might otherwise have been necessary in order to have averted a temporary credit stringency.

The results are certainly not impressive as a demonstration of the *short period* efficacy of general monetary policy, but must be judged in the light of the available alternatives. In the absence of the stronger monetary policy represented by the "accord," the money supply might have risen more sharply and bank loans have leveled off less than they did.

A striking sidelight is the absence of *short period* correlation between changes in prices and changes in the money supply. The money supply increased very little during the period of sharply rising prices, but commenced to rise briskly after prices had leveled off. The history of changes in prices and money supply over a much longer period, as reviewed in the testimony before the Subcommittee, shows a general correspondence between changes in prices and changes in money supply (adjusted for the growth of the economy and for changes in customs with respect to the holding of cash balances) over long periods, but a notable absence of short-run correlation between such changes. This is brought out very well in Chart 2, taken from the testimony of Mr. Reierson. In the short run, changes in the velocity of circulation—over which the authorities have little control—are likely to be of greater importance. In the period between the Korean outbreak and early 1952, short-run changes in prices correlated very well with changes in velocity and not at all with changes in money supply. This is shown clearly in Chart 3, which was introduced in the hearings by Senator Flanders. On the basis of the evidence, the Subcommittee is convinced of the importance of changes in the money supply in influencing prices in the *long run*, but does not believe that short-run changes in the money supply provide a reliable basis for explaining short-run price changes.

While the factors just discussed, and doubtless others, were operating to check the inflation, the fiscal situation worsened—although, due to the extremely high taxes imposed after Korea and raised again in the fall of 1951, it continued remarkably good considering the tremendous rise in defense expenditures. As contrasted with the budgetary surplus (on a conventional accounting basis) of $5.1 billion during the nine months ending in March 1951, there was a deficit of $5.0 billion in the year ending in March 1952. On a cash basis, the surplus of $7.7 billion in the earlier period was contrasted with a deficit of $0.6 billion in the later period.[7]

The Subcommittee is inclined to assign some of the credit for the turn in the inflationary situation to each of the positive factors cited above but cannot say confidently which of them should be accorded primacy, or the order in which they should be arranged. Neither can it be sure what weight should be given to the worsening in the fiscal situation as an offset to the positive factors.

Over the period actually under review it may well be that the more superficial factors listed under (1) and (2) were of the greater importance. Over a longer period of time, however, the fiscal and monetary factors would doubtless be dominant. Even in the short run, they are of special importance because, unlike factors originating in the "outside economy," they are subject to a considerable degree

[7] Although the change in the fiscal situation doubtless worked in favor of *higher* prices for the period as a whole, the large "tax bite" in March 1951 may have contributed to the down-turn which began in that month.

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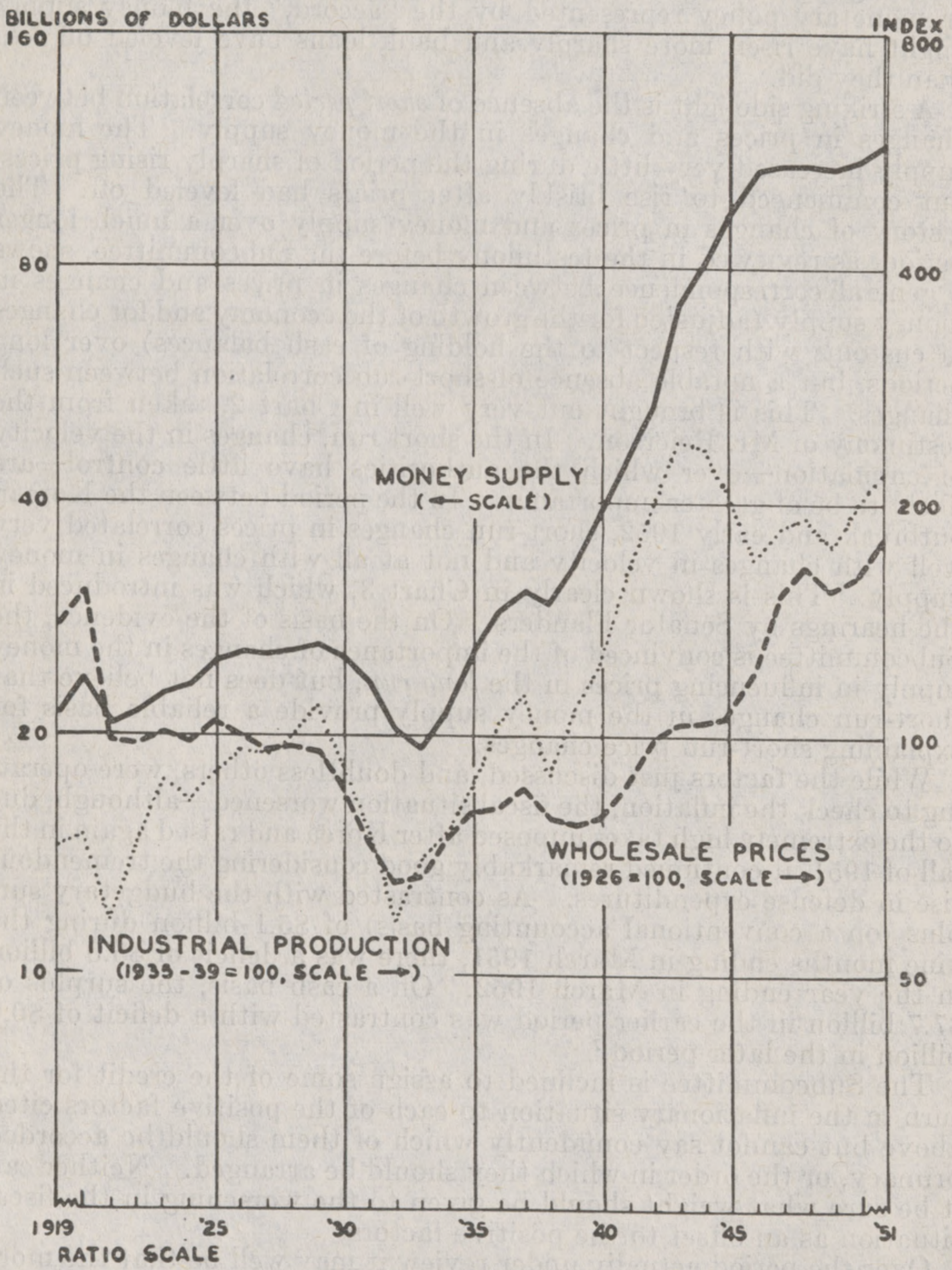
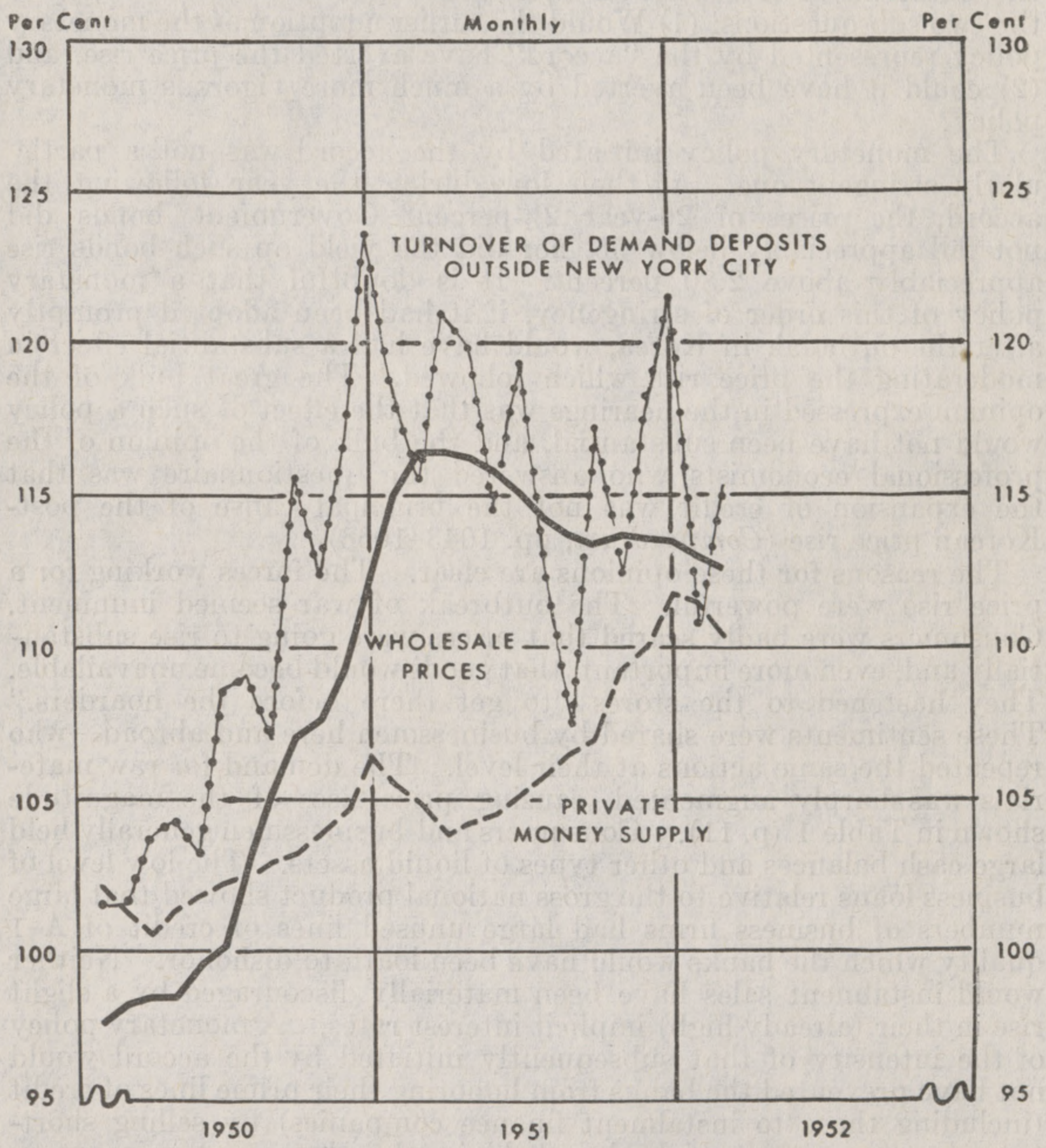
CHART 2.—PRICES, PRODUCTION, AND THE MONEY SUPPLY, 1919–51



NOTE.—The definition of money supply used in this chart (taken from the testimony of Mr. Roy Reierson at p. 638 of the *Hearings*) is somewhat different than that used throughout the remainder of the report. The essential characteristics of the chart, however, would be the same with any definition of money supply.

CHART 3.—MONEY SUPPLY, TURN-OVER OF BANK DEPOSITS, AND WHOLESALE PRICES, JANUARY 1950–FEBRUARY 1952

[1947–49=100]



Source: Introduced by Senator Flanders; appears at p. 720 of the *Hearings*.

of control by the Government. It is only by persisting in appropriate fiscal and monetary policies that the Government can make its full contribution to price stability and high-level employment over the longer period.

3. *Could a More Vigorous Monetary Policy Have Averted the Price Rise?* The preceding discussion gives rise to the question: "Could a more vigorous monetary policy have averted the price rise between the outbreak in Korea and March 1951?" This breaks down into the two sub-questions: (1) Would the earlier adoption of the monetary policy represented by the "accord" have averted the price rise, and (2) could it have been averted by a much more vigorous monetary policy?

The monetary policy initiated by the accord was not a particularly stringent one. At their low during the year following the accord, the prices of 20-year 2½-percent Government bonds did not fall appreciably below 96, nor did the yield on such bonds rise appreciably above 2.80 percent. It is doubtful that a monetary policy of this order of stringency, if it had been adopted promptly after the outbreak in Korea, would have had a substantial effect in moderating the price rise which followed. The great bulk of the opinion expressed in the hearings was that the effect of such a policy would not have been substantial, and the bulk of the opinion of the professional economists who answered the questionnaire was that the expansion of credit was not the principal cause of the post-Korean price rise (*Compendium*, pp. 1043–1066).

The reasons for these opinions are clear. The forces working for a price rise were powerful. The outbreak of war seemed imminent. Consumers were badly scared that prices were going to rise substantially and, even more important, that goods would become unavailable. They hastened to the stores "to get there before the hoarders." These sentiments were shared by businessmen here and abroad—who repeated the same actions at their level. The demand for raw materials was sharply augmented, causing price rises of the magnitude shown in Table 1 (p. 11). Consumers and businessmen generally held large cash balances and other types of liquid assets. The low level of business loans relative to the gross national product showed that large numbers of business firms had large unused lines of credit of A–1 quality which the banks would have been loath to dishonor. Neither would instalment sales have been materially discouraged by a slight rise in their (already high) implicit interest rates. A monetary policy of the intensity of that subsequently initiated by the accord would not have prevented the banks from honoring their prime lines of credit (including those to instalment finance companies) by selling short-term governments—which they held in abundance—at prices very close to cost and by selling long-term governments at yields of around 2.80 percent.

The above discussion refers principally to the so-called "mechanical" impact of an increasing intensity of monetary policy. In addition, actions of a deflationary character by the Federal Reserve System—such as increases in the rediscount rate—often have an additional psychological impact through their effects on the expectations of businessmen. In this way, actions by the Federal Reserve System often have a much greater influence on the price situation than would appear justified by their direct effects alone. The early months after

the outbreak in Korea, however, were an unpromising time for such an additional psychological impact to have much effect. There had been an "inventory adjustment" a year earlier; business had been rising since the fall of 1949 and had a substantial momentum which was accelerated into a boom by the outbreak of hostilities. Expectations were sanguine and were further heightened by talk, including statements by Government officials, of impending shortages. They were not likely to be greatly affected by, say, an additional ¼ of 1 percent rise in the rediscount rate.

Under the circumstances, it seems futile to suppose that such a small change in monetary policy could have made a substantial difference in the price rise following the outbreak in Korea. It would, of course, have made *some* difference—and there can be many shades of opinion as to how much—but the difference could scarcely have been decisive.

[COMMENT BY SENATOR FLANDERS: While not disputing the above appraisal of economic conditions, I believe that a somewhat more restrictive monetary policy such as followed the "accord" should have been adopted at least early in 1950. The predecessor subcommittee recommended in January 1950 that the freedom of the Federal Reserve to restrict credit and raise interest rates for general stabilization purposes should be restored even if this involved higher debt service charges and greater inconvenience to the Treasury in debt management. The present report now endorses this recommendation. See p. 36.

I feel that there is much to be said for more frequent small changes in credit policy. This would help get the country out of "crisis psychology" in these matters. Furthermore, skillful steering, whether of an automobile or of the national economy, is brought about by small, frequent adjustments.]

This is not to say, however, that a *sufficiently* vigorous policy could not have *completely* averted the price rise. There is no doubt that a monetary policy so vigorous as to have caused a 20- or 30-point decline in the prices of Government securities and forced banks to cancel the lines of credit of even their best customers could have averted the increase in the wholesale price index completely. But it could have done so only by an *averaging* process. Some prices—copra, tin, lead, wool, rubber, jute—were bound to rise, and the average could have been maintained only by forcing other prices down to maintain the average. This might have resulted in a serious depression, and in the actual fact such a policy had few serious advocates.

[COMMENT BY SENATOR FLANDERS: In my estimation there was little probability of a serious depression in the months following the Korean outbreak. The fear of creating a depression through more stringent monetary policy at that time seems unwarranted. Monetary policy affords a considerable degree of flexibility and I do not believe that its effective use should be unduly inhibited in times of inflation (or deflation) by the fear that it will produce a disastrous deflation (or inflation).

Nevertheless, I do not think it would have been wise or feasible to depend on monetary measures to prevent any rise in the general price level immediately following June 1950. Such a course would have made it more difficult to achieve desired increases in defense output and productive capacity.

The same arguments, of course, would apply to fiscal policy and tax increases which would have been severe enough to prevent any rise in the price level in this period.]

It does not follow at all, however, that there was no choice between such drastic action and no action at all. On the contrary, there is reason to believe that the situation was one in which the relationship between action and result would have been fairly continuous—i. e., that the size of the results obtained would have been proportioned to the vigor of the action taken. But the circumstances were such that the yield in results per unit of action taken would probably have been low—and there were other reasons, to be discussed presently, for acting with moderation. Under these conditions, the question of the intensity of the action which should have been taken was one of judgment, upon which reasonable men could and did differ.

B. The Wisdom of Monetary and Debt Management Policy Following the Outbreak in Korea

1. *Factors Which Had to be Considered in the Period, June 1950–March 1951.* Three important considerations confronted the monetary authorities following the outbreak in Korea: (1) the purchasing power of the United States dollar had to be maintained; (2) production had to be maintained *and increased* to a sufficiently high level to provide for the necessary rearmament with a minimum impairment of the civilian standard of living; (3) the financial markets and the confidence of the investing public in United States securities had to be maintained so that the Treasury could finance a total war if that became necessary. These objectives were in part conflicting and it was not possible to achieve all of them perfectly.

It has already been suggested that the purchasing power of the dollar could have been maintained completely only by *forcing down* the prices of enough commodities to average out those which were being forced up by the exigencies of the world and national situation. In an economy such as ours (and every other free-enterprise economy of which we have record), in which neither wages nor the majority of prices are easily reduced, an effort to force down prices could have resulted only in frustration and unemployment. It would have been decidedly incompatible with achieving the second objective—that of high production. On the other hand, a single-minded devotion to the objective of high production might have resulted in unrestrained inflation.

In the meantime, both the Treasury and the Federal Reserve System had to give thought to the possibility of the outbreak of war. In such an event, it would have been necessary to borrow large sums of money at rates of interest which investors would have considered fair and equitable, and which would have been as little likely as possible to cause difficulties in the subsequent postwar period (either because they were too high or too low). During the war period itself, however, it would have been necessary to rely for the control of inflation principally upon high rates of taxation and upon the direct control of prices and wages and upon the allocation and rationing of goods and materials. At the time of the outbreak in Korea the interest rate for long-term Government borrowing was 2½ percent, and had remained at that level for nearly ten years. Investor confidence in

the rate was high (see particularly Chap. XIII of the *Compendium*, Replies by Government Security Dealers) and it might have taken a long period to establish an equal degree of investor confidence in any other rate, either higher or lower. This period could have been ill afforded in the event of the immediate outbreak of war, and under the circumstances it is not surprising that the Treasury placed great emphasis on the maintenance of stability in the Government bond market. The fact that war did not break out should not make this concern seem puerile in retrospect. Fiscal preparedness, like military preparedness, serves the national interest best when it does not need to be called into action.

The fiscal and monetary authorities had to, and did, give considerable weight to each of these objectives. That the Federal Reserve placed great emphasis on the objective of price stability, the Council of Economic Advisers on the objective of high production, and the Treasury on the objective of fiscal preparedness, is not surprising in view of the major preoccupation of each agency. It is possible that each of these agencies may have somewhat overweighted that aspect of most direct concern to it relatively to the other two, but each seems to have made a genuine effort to view the situation as a whole. In retrospect, it seems that it might have been desirable to have instituted a somewhat stronger monetary policy (like that of the accord) somewhat sooner, but it is difficult to be too positive when we go back and recreate the atmosphere and expectations of the period. Perhaps the situation was best summed up by Mr. W. L. Hemingway, representing the American Bankers Association, who, in answer to a question, said (*Hearings*, pp. 342–343):

> * * * I have this feeling, that after the outbreak of the Korean war that nothing would have stopped a certain amount of buying. The money was in the hands of the people, and they were afraid that there would be a shortage of goods, so they went in and bought, and there was no way to stop that.
>
> Now, it is possible that a tighter money market might have prevented some manufacturers and merchants from increasing the inventories as much as they did; that is a matter that no one can tell. It is purely a matter of surmise; but I am certain that there would have been a tremendous amount of buying because the people had the money; it was in the banks, in their safe-deposit boxes, and in their pockets.
>
> Now, the first question, as to when it would have been advisable to tighten up the money after Korea, is pretty hard to say, there was one condition there that the Secretary of the Treasury and the members of the Federal Reserve Board, the Open Market Committee, had to consider, and that was the danger of a foreign war.
>
> You remember how all this talk existed about Russia, how we might get into that difficulty, and they wanted to be very careful that they did not do anything that would shake the credit in the Government's security markets, because they might be called on to finance a tremendous war, and it was not an easy question to decide. Whether it was decided right or wrong, why, that is just a matter of opinion.
>
> I think, perhaps, after the feeling had grown that the danger of imminent war was over that they might have acted a little sooner and, perhaps, have stopped some of the inflation.

2. *The Actions of the Monetary and Debt Management Authorities, June 1950 to March 1951.* The Subcommittee approaches the subject of the personal relationships involved in the formulation of monetary policy and the management of the public debt with reluctance. The Joint Committee on the Economic Report was conceived as a forum in which ideas rather than personalities would contend for supremacy, and the Subcommittee would have avoided any inquiry into the

personal aspects of the subject had it not feared that, in the existing situation, this would have involved more loss than gain in the clarity of the issues. The Subcommittee's interest lies in the future and not in the past and its comments on this subject, as on all others, are presented for their value in preventing the repetition of past errors and in securing a more effective formulation and administration of monetary and debt management policies in the future.

The Secretary of the Treasury, in his answer to question No. 17 in the questionnaire sent him by the Subcommittee (*Compendium*, pp. 50–74), presented an extended discussion of Treasury-Federal Reserve relationships since the end of World War II and particularly during the period between the outbreak in Korea and the accord. Although the answer of the Chairman of the Board of Governors of the Federal Reserve System to the corresponding question asked him in the Subcommittee's questionnaire was fully responsive, it did not contain detail corresponding to that included in the Treasury's answer; neither was such detail presented by Chairman Martin in his testimony before the Subcommittee. A presentation of the Federal Reserve side of the relationship, although in somewhat less detail than Secretary Snyder's presentation was, however, included in the testimony of Allan Sproul, President of the Federal Reserve Bank of New York and Vice Chairman of the Federal Open Market Committee. His testimony will be found at pp. 506–552 of the *Hearings*. In addition, the Federal Reserve and the Treasury furnished, at the request of the Subcommittee, a file of their mutual correspondence and of the correspondence of the Federal Reserve with the President between June 1950 and March 1951, bearing on the principal issues of monetary policy and debt management. This file will be found at pp. 942–966 of the *Hearings*.

Marriner Eccles and Thomas B. McCabe, both former Chairmen of the Board of Governors of the Federal Reserve System, were each invited to appear before the Subcommittee. Mr. Eccles submitted a statement, which appears on pp. 907–909 of the *Hearings*, in which he discusses the merits of several issues before the Subcommittee but does not go into the matter of Treasury-Federal Reserve relationships. He stated:

> * * * these matters have been adequately covered, particularly in the testimony of Allan Sproul, President of the Federal Reserve Bank of New York, and I am in full agreement with what he had to say with respect to these subjects.

Mr. McCabe wrote the Subcommittee a letter in which he commended Mr. Sproul's testimony and the working of the Treasury-Federal Reserve accord, and said that he would prefer not to appear before the Subcommittee to cover once more ground which he believed had already been well covered by Mr. Sproul.

An examination of the information submitted to the Subcommittee seems to show that, on the whole, both the Treasury and the Federal Reserve were endeavoring during the entire period to serve the public interest as they saw it. During most of the period their differences were very small as seen from the outside and were concerned principally with short-term rates of interest.

During the first part of the period covered by the correspondence included in the file (which begins on July 12, 1950), the Federal Reserve was urging both an increase in short-term interest rates and the issu-

ance of a 2½ percent long-term nonmarketable bond, to be continuously available "on tap." The Treasury resisted both suggestions, although, possibly as a compromise measure, it opened the 2½ percent Series F and G savings bonds to large-scale institutional investment for limited periods during the fall. On October 30, 1950, Chairman McCabe wrote to Secretary Snyder:

> Since our meeting on Thursday, October 26, a meeting of the Federal Open Market Committee has been held. The Committee has been and is in complete agreement that under present conditions it is necessary to protect the 2½ percent rate (par) on the longest term Treasury bonds now outstanding. The Committee's policies have been determined in accordance with that conclusion.

The meeting referred to in Chairman McCabe's letter was presumptively with the President, as he (Chairman McCabe) said in a letter to the President, dated December 9, 1950:

> * * * You can rest assured that we are fully conscious of the magnitude of the financial problems that face us, and that we will do all in our power to insure the successful financing of the Government's needs.
>
> You will recall that I mailed you a copy of my letter of October 30 to John Snyder in which I outlined the policy to be pursued by the Open Market Committee in accordance with the assurance which I previously gave to you and John in your office on October 26.
>
> * * * * * * *
>
> * * * We have conducted our operations in strict accord with the policy which I outlined to you and John.

The first suggestion that the long-term interest rate should be increased appears in a memorandum submitted to Secretary Snyder on January 3, 1951 by Mr. Sproul, speaking for himself only. However, by February 7, 1951, this view seems to have been officially adopted by the Open Market Committee, as Chairman McCabe said in a letter to Secretary Snyder on that date:

> * * * We should like to discuss with you at an early date a coordinated credit policy and debt-management program which would assist in the highly important fight against inflation and improve public confidence in the market for Government securities. We would suggest as a basis for that discussion a program along the following lines:
>
> (1) The Federal Reserve, for the present, would purchase the longest-term restricted Treasury bonds now outstanding in amounts necessary to prevent them from falling below par.
>
> (2) If substantial Federal Reserve support of the longest-term restricted bond is required, you would be prepared to announce that at an appropriate time the Treasury would offer a longer-term bond with a coupon sufficiently attractive so that the bond would be accepted and held by investors. It would be announced that outstanding long-term restricted bonds would be exchangeable for the new bond and that the new bond would be offered for cash subscription by nonbank investors on a basis to be determined.
>
> We should like to discuss with you possible features for the new bond that would remove or reduce the need for Federal Reserve support of the market in the future.
>
> (3) For the purpose of restricting the creation of bank reserves through sales of short-term securities to the Federal Reserve, particularly by banks, the committee would keep its purchases of such securities to the minimum amounts needed to maintain an orderly money market.
>
> Under this policy, banks would be expected to obtain needed reserves primarily by borrowing from the Federal Reserve banks. If demands for expansion of bank credit and bank reserves should continue, short-term interest rates presumably would adjust to a level around the discount rate.

The proposals in this letter, of course, foreshadow the actual accord adopted about a month later.

On the whole, the correspondence is not that between two agencies each with an inflexible position, but shows a considerable amount of

give and take. It is of particular interest in this connection that the Federal Reserve itself did not reach the position reflected in the accord until some time around the turn of the year—well after the Chinese intervention in Korea.

The correspondence does show, however, a number of difficulties in procedure. The agencies were often dealing with one another at arm's length when more frequent face-to-face conferences, especially at the staff level, might have promoted greater understanding. It is also regrettable that several of the key conferences were attended by the principals only and left a misunderstanding as to what had been actually agreed on, which might have been avoided had there been adequate staff representation and a prompt preparation and interchange of official minutes.

There are two cases in which this lack of effective staff liaison was especially important. On the one hand, it appears that Secretary Snyder went to the hospital for an eye operation early in February 1951 believing, in good faith, that the other parties in interest had agreed on a moratorium of action until he returned to his office, while the members of the Open Market Committee had no such belief. Better staff work could have averted this misunderstanding. On the other hand, it is difficult to explain or to excuse the action of the White House secretariat in furnishing to the press a statement giving what purported to be the substance of an agreement reached at a White House conference on January 31, 1951, contrary to the understanding of the Federal Reserve participants in the conference and without prior clearance or discussion with the Chairman or any representative of the Board of Governors. These misunderstandings are deeply to be regretted, and it is hoped that the record appearing in the *Compendium* and *Hearings* of this Subcommittee may be of help to public officials and students of public administration in preventing similar occurrences in the future. Despite these misunderstandings, however, the Subcommittee believes that the record shows principally the actions of men of good will trying to work out a solution for an exceedingly complex problem.

3. *Monetary and Debt Management Policy Since March 1951.* The great majority of witnesses before the Subcommittee believed that the monetary and debt-management policies pursued since the accord have been appropriate to the underlying economic situation. This was true not merely of the official witnesses—who were responsible for the formulation of the policy and defended it of necessity—but also of the witnesses from both the financial and academic communities. This view is, on the whole, supported by the answers in the *Compendium*, as far as they bear on this subject and giving consideration to the earlier date at which they were prepared. While the predominant view appeared to be in favor of present policies, there was a considerable body of opinion to the effect that the Treasury should make a more strenuous effort to sell long-term securities at somewhat higher interest rates than those then prevailing and a rather more considerable dissatisfaction with the then terms of Series E Savings Bonds. Since the close of the hearings, the Treasury has met these criticisms in part by a revision in the terms of savings bonds of all series and by an additional offering of 2¾ percent nonmarketable bonds. Dissents on the easy money side were much fewer

than those on the tight money side, but this may have been due in part to the preponderance of witnesses directly or indirectly connected with the financial community.

The Subcommittee is, on the whole, satisfied with the monetary and debt management policies in the year following the accord. Wholesale prices declined slightly, the cost of living was fairly stable, and there were some deflationary factors in the business situation. On the other hand, with the major impact of defense expenditures still to come, the Subcommittee feels that it would be improvident to return to the monetary policies prevailing before the Korean outbreak. The Subcommittee commends both the Treasury and the Federal Reserve for their cooperation since the accord and trusts that they will continue a flexible policy adjusted to the situation as it develops. It makes no more specific recommendation on general monetary and debt-management policies for the immediate future. (A discussion of more general principles appears later in this report, see pp. 31-41.)

The Subcommittee believes that general monetary, credit, and fiscal policies should be the Government's primary and principal means of promoting the ends of price stability and high-level employment and that whenever possible reliance should be placed on these means in preference to devices such as price, wage, and allocation controls and, to a lesser extent, selective credit controls which involve intervention in particular markets. The Subcommittee cannot accept a system of price, wage, and allocation controls as a permanent feature of the American economy. Nevertheless, under present circumstances—in which we do not yet know what will be the full impact on the economy of the defense expenditure program—the Subcommittee feels that it would be improvident to repeal the legislative authority for price, wage, and allocation controls, and recommends that this authority be extended until the full effects of these expenditures have been felt. It makes the same recommendation with respect to the legislative authority for the existing selective credit controls, but expresses satisfaction that the administrative authorities have shown themselves ready to liberalize or eliminate these controls as soon as such action is, in their judgment, consistent with a policy of economic stability.

[Comment by Mr. Patman: I believe that the disadvantages of selective controls over consumer and housing credit, as set out on pp. 36–37, are so great that the authority for the imposition of these controls should be repealed immediately.]

II. FISCAL AND MONETARY POLICY FOR THE FUTURE

A. Over-All Role of Fiscal and Monetary Policy; Appropriate Fiscal Policy

The Subcommittee's mandate did not extend to a detailed consideration of fiscal policy, nor was the subject of fiscal policy covered other than incidentally in the *Compendium* or the *Hearings*. The Subcommittee would nevertheless like to express its conviction that sound fiscal policy—meaning by this sound policies with respect to Government receipts and expenditures—together with sound monetary policy must be the foundation stones of any over-all program seeking price stability and high-level employment. Four members of this Subcommittee were members of the previous subcommittee under the chairmanship of Senator Douglas, which considered the subject of fiscal policy at length, and all of us join in reaffirming the following two recommendations made by that subcommittee (*Report of the Subcommittee on Monetary, Credit, and Fiscal Policies*, Senate Document No. 129, 81st Cong., 2d sess., p. 1):

The Role of Monetary, Credit, and Fiscal Policies in Achieving the Purposes of the Employment Act

We recommend not only that appropriate, vigorous, and coordinated monetary, credit, and fiscal policies be employed to promote the purposes of the Employment Act, but also that such policies constitute the Government's primary and principal method of promoting those purposes.

Federal Fiscal Policies

We recommend that Federal fiscal policies be such as not only to avoid aggravating economic instability but also to make a positive and important contribution to stabilization, at the same time promoting equity and incentives in taxation and economy in expenditures. A policy based on the principle of an annually balanced budget regardless of fluctuations in the national income does not meet these tests; for, if actually followed, it would require drastic increases of tax rates or drastic reductions of Government expenditures during periods of deflation and unemployment, thereby aggravating the decline, and marked reductions of tax rates or increases of expenditures during periods of inflationary boom, thereby accentuating the inflation. A policy that will contribute to stability must produce a surplus of revenues over expenditures in periods of high prosperity and comparatively full employment and a surplus of expenditures over revenues in periods of deflation and abnormally high unemployment. Such a policy must, however, be based on a recognition that there are limits to the effectiveness of fiscal policy because economic forecasting is highly imperfect at present and tax and expenditure policies under present procedures are very inflexible.

* * * * * * *

B. Role of Monetary Policy

Monetary policy may be defined for the purpose of this discussion as that policy which has for its immediate objective the establishment of a desired degree of ease or tightness in the supply of credit and seeks through attaining this immediate objective to contribute to economic stability. As the Federal Reserve System is always pursuing some

type of monetary policy, the money market can never in the most literal sense of the term be "free." The best working definition of a "free" money market, therefore, may be a market which (a) is not firmly pegged and (b) in which the existing level of rates has been brought about by a monetary policy consistent with economic stability. Selective credit controls which restrict the availability of credit for special purposes will be considered separately.

A tight monetary policy makes money hard to get. Less money will be borrowed and less spending will occur from borrowed funds. When interest rates are higher (and bond prices lower), some persons holding liquid assets or fixed-interest-bearing obligations, who might otherwise have sold them and spent the proceeds, will prefer instead to continue to hold them. As the greater portion of our money supply consists of commercial bank deposits "created" by bank loans and investments, a less liberal lending policy on the part of banks will decrease the money supply and so increase the ratio between goods and money. A tight money policy tends, therefore, to combat inflation. Contrariwise, an easy money policy reverses the process just described and so tends to combat depression.[1]

These effects, it is true, will be offset to some extent by the effects of changes in interest rates as *costs*, in which aspect increased interest rates will tend to increase prices as would increases in any other element of cost—and vice versa for decreases in rates. But, except in industries where the ratio of capital to output is extremely high (e. g., hydroelectric plants), the net result is likely to be as previously stated.

The main lines of effect on the price level to be expected from monetary policy are therefore clear. But, before an unhesitating recommendation can be made that it be used with great vigor, account must be taken of many qualifications and refinements.

1. *Cost versus Availability of Credit.*—In determining the degree of ease or tightness existing in the money market at any particular time, two factors must be taken into consideration—(a) the cost, and (b) the availability of credit. The cost of credit is reflected in interest rates and in the other open or concealed charges made for the lending of money. The availability of credit, on the other hand, refers to the readiness with which a prospective borrower is able to obtain funds at the rates nominally quoted for the type of loan which he seeks. The Federal Reserve has urged that much greater emphasis than has generally been customary be placed on changes in the availability of credit as contrasted with changes in its cost.

Changes in the supply of loan funds relative to the demand, whether induced by the monetary authorities or occurring autonomously, are generally first reflected partly in the cost and partly in the availability of credit. Interest rates, like many other prices, are "sticky" and do not move readily over as wide an arc as might appear to be justified by changes in the underlying supply and demand situation. A tightening in the money market is therefore likely in its early stages to be reflected largely in increased difficulty in securing funds at the quoted rates. The quality of loans on which the same

[1] In traditional theory there was added to these considerations a supposed tendency on the part of individuals to save more out of their income when the reward of saving in the form of interest rates was higher. However, it is far from clear that this is true to a significant extent, except as higher interest rates encourage the holding of liquid assets and fixed-interest-bearing obligations—which has already been taken account of. No effect of monetary policy on savings is therefore assumed in this report. But even without this assumption, the general case for the efficacy of monetary policy is a powerful one.

interest rate is quoted varies considerably, and banks and other lenders tend to become more selective in their loans within each rate-bracket in periods of increasing monetary stringency. This is the basis for the claim that credit-tightening moves by the monetary authorities reduce the availability of funds (and hence combat inflation) more than is shown by changes in interest rates. This is true and significant, particularly in the short run—although it is not entirely to be welcomed, as a good case might be made that the available supply of credit would be utilized more effectively if it were distributed according to the criteria of the price system (i. e., to the highest bidders) rather than rationed in accordance with the personal preferences of the lenders. Lenders, however, are not likely indefinitely to pass up opportunities to raise their rates, nor—in the opposite situation—are they likely to refrain indefinitely from cutting them when this is necessary to secure business. Therefore, if any change in the underlying demand and supply situation (as affected by monetary policy) persists, it will come to be reflected more-and-more in the actual cost of borrowing money and less-and-less in changes in availability. This point was made very well by Professor Samuelson who said (*Hearings*, p. 696):

> * * * it is unthinkable that over a period of time, of a few months, let us say, or of over a year, or more than a year, that a banker should act so irrationally that when credit is scarce he will hold his rates perfectly inflexible, and arbitrarily make trouble for himself by refusing solid citizens in the community, and some who think they are solid citizens, credit, and thereby bring upon himself all the troubles that come from rationing.
>
> On the contrary, it seems to me that after the shortest run, what he will do will be what any normal prudent commercially minded man would do: namely, if a thing is in short supply, he will gradually raise the interest charges on it, and let the higher price help him do the rationing.

The time required for such a change in monetary conditions to "work through" to a change in interest rates doubtless differs a great deal from one type of lending activity to another and Professor Samuelson's estimate of the required time may be low. In some fields a number of years may be required. The important point, however, is that changes in the underlying supply and demand situation (always as modified by monetary policy) must be expected within a reasonable period to have their principal effect on the *cost* of borrowing money. Changes in "availability" probably should be considered largely as transition phenomena—although they are very useful in treating inflationary and deflationary pressures expected to persist for only a relatively short time.

2. *Private versus Public Credit.*—A tight money policy makes borrowing more costly and difficult while an easy money policy makes it cheaper and easier. The purpose of a tight money policy is to combat inflation by reducing the total demand for goods and services. The goods and services demanded by private borrowers (except in the case of consumer credit) consist principally of those required for capital formation. It follows that the principal effect (and principal object) of a tight money policy, as far as the private economy is concerned, is to reduce the volume of capital formation below what it would have been had an easier money policy been pursued.

The Federal Government, in terms of amount of securities outstanding, is the largest borrower in the money market by a wide margin—almost as large as all others combined. Other things being

equal, the cost of its borrowings will rise and fall in rough proportion with changes in the cost of borrowing to others.

Two attitudes with respect to such changes in the cost of money to the Federal Government are possible. The first possible attitude is that the Federal Government, like all other users of capital, should be subject to the discipline of the money market and that one of the functions of a tight money policy is to force the Federal Government to reduce its expenditures (or to increase taxes), while one of the functions of an easy money policy is to encourage it to increase its expenditures (or to decrease taxes). The other view is that the receipts and expenditures of the Federal Government are and should be determined by a democratic process at the levels most suitable to the national interest (including the national interest in combating inflation or deflation) rather than by the condition of the money market. If the second view is adopted—and the members of the subcommittee do adopt it—then it follows that an increase in the rate of interest paid by the Federal Government does nothing in and of itself to combat inflation; on the contrary, it is actually inflationary to the (minor) extent that it increases Government spending. An increase in the cost of Government borrowing should, consequently, be accepted only to the extent that it is a necessary concomitant of a corresponding increase in the dearness or difficulty of private borrowing. As the money market has a considerable degree of unity from the standpoint of the *lender*, who has the opportunity to choose between competing offers for his funds, the cost of money to the Federal Government must fluctuate considerably with changes in the ease and tightness of the private capital market. But a reasonable degree of insulation of part of the Government security market from the influences affecting private borrowing is desirable, other things being equal, both because of the resulting interest saving to the Government (and so to the taxpayers) and because the presence of some insulating devices is likely in practice to increase the flexibility of monetary policy. The most important insulating devices are selective credit controls and bank reserve requirements. These are discussed elsewhere in this report (pp. 36–37 and 43–48). While the Subcommittee does not believe that the introduction of new insulating devices is necessary at this time and is not sure that such devices would be practicable even under other conditions, it recommends that they be kept under continuing study by the monetary authorities.

3. *Government Lending and Loan Guarantee Agencies.*—It is, of course, obvious that monetary policy can influence the rate of capital formation only when it can have an effect on the cost and availability of credit. This is not the case if the influence of general monetary policy in any field is offset by the promotional activities of Government agencies in increasing capital formation and easing credit in that field. This has been true in several areas—of which by far the most important is housing—throughout most of the postwar period. It would have been futile to have endeavored to reduce the volume of new housing by a "strong" general monetary policy while at the same time encouraging it by direct credit aids. This is not to pass on the merits of the postwar housing finance program, which may be justified for other reasons. It is merely to point out that general monetary policy was thus deprived of one of the principal fields in which it might have exerted an anti-inflationary influence.

4. *Corporate Self-Financing.*—It should also be pointed out that the great majority of capital expenditures by corporations in the postwar period were financed from undistributed earnings and accrued depreciation and depletion rather than by new borrowing. As a consequence, the influence which a strong monetary policy might have had on these expenditures was greatly reduced.

This is in sharp contrast to the situation during the twenties and most earlier periods, when most corporate business was much more heavily dependent on bank financing. It is of great interest to note, in this connection, that the increase in prices and business activity since Korea has placed an increasing number of businesses in a position where they have to seek regular or occasional commercial bank accommodation, and has consequently strengthened the hand of monetary policy for the future.

5. *Interest Rates and Long-Term Bond Prices.*—Changes in long-term interest rates, which may appear moderate at first glance, result in remarkably large changes in the prices of long-term bonds. This is illustrated in Table 7, which shows the amount which a 20-year 2½ percent bond would fall in price with each successive one-half of 1 percent increase in its interest yield from 2½ to 5 percent. The table shows that such a bond would have to fall to about 79½ in order to increase its yield to 4 percent. The capital loss (realized or unrealized) which would be brought about by the resulting 20½ point decline is equal to the full coupon-carry on such a bond for more than eight years. If part of the gross interest return was taken in taxes (which cannot be entirely recouped by an allowance for a subsequent capital loss), such a capital loss would eat up much more than eight years' interest. Quite apart from the immediate effects of drastic declines in long-term bond prices upon the solvency of financial institutions—which cannot be dismissed as unimportant—such declines leave lasting scars behind them on the memories of conservative investors and make them much more hesitant to undertake commitments at modest interest rates in the future. This would not be a serious difficulty if there were a reasonable assurance that a new and substantially higher level of long-term interest rates would persist for a long time to come. However, far from there being such an assurance, the probability is that the desirable level of long-term interest rates in a high-saving high-investment economy such as ours will continue low for a long period. The Subcommittee, therefore, appreciates and concurs in the evident intention of the monetary authorities to avoid extreme changes in long-term interest rates.

TABLE 7.—*Effect of hypothetical increases in interest rates on the price of a 20-year 2½-percent bond*

Assumed yield: (*Percent*)	*Market price*
2½	100.00
3	92.52
3½	85.70
4	79.48
4½	73.81
5	68.62

6. *Efficacy of General Monetary Policy.*—After allowing for all of the qualifications and refinements just discussed, the Subcommittee believes that general monetary policy has an important role to play

in achieving and maintaining price stability and high-level employment. The Subcommittee, after taking into account the evidence submitted to it and the changed circumstances of the past two years, sees no reason to alter the recommendation on this point made by the earlier subcommittee under the chairmanship of Senator Douglas, which reads as follows (*Report of the Subcommittee on Monetary, Credit, and Fiscal Policies*, pp. 1–2):

Monetary and Debt-Management Policies

1. We recommend that an appropriate, flexible, and vigorous monetary policy, employed in coordination with fiscal and other policies, should be one of the principal methods used to achieve the purposes of the Employment Act. Timely flexibility toward easy credit at some times and credit restriction at other times is an essential characteristic of a monetary policy that will promote economic stability rather than instability. The vigorous use of a restrictive monetary policy as an anti-inflation measure has been inhibited since the war by considerations relating to holding down the yields and supporting the prices of United States Government securities. As a long run matter, we favor interest rates as low as they can be without inducing inflation, for low interest rates stimulate capital investment. But we believe that the advantages of avoiding inflation are so great and that a restrictive monetary policy can contribute so much to this end that the freedom of the Federal Reserve to restrict credit and raise interest rates for general stabilization purposes should be restored even if the cost should prove to be a significant increase in service charges on the Federal debt and a greater inconvenience to the Treasury in its sale of securities for new financing and refunding purposes.

* * * * * * *

C. Selective Credit Controls and the Voluntary Credit Restraint Program

1. *Selective Credit Controls.*—Selective credit controls endeavor to restrict the amount of credit granted for specific purposes. Three such controls, all administered or recently administered by the Federal Reserve System, are now authorized by law. They are those imbedded in Regulations T and U, which restrict credit for the purpose of purchasing or carrying marketable securities; Regulation X, which restricts credit for the purpose of purchasing new housing and certain other new construction; and Regulation W, which restricts instalment credit for the purchase of specified types of consumer goods. The operation of Regulation W was indefinitely suspended by the Board of Governors, effective May 7, 1952.

Regulations T and U were issued pursuant to the Securities and Exchange Act of 1934. They are generally accepted—and are accepted by the Subcommittee—as a part of our normal economic machinery. Regulations X and W were issued pursuant to the Defense Production Act and were generally considered to be temporary. The Board of Governors and the presidents of the Federal Reserve banks, in response to questions addressed to them and answered in the *Compendium*, stated that they did not believe that any types of selective credit control other than those over security credit, housing credit, and consumer credit would be practicable.

Selective credit controls reduce the amount of credit used for specific purposes without increasing the cost or decreasing the availability of credit generally. Insofar as this applies to Government borrowing, it constitutes a means of insulating the Government bond market from credit controls designed to restrict private borrowing and so is an advantage. But insofar as their repercussions apply to private

borrowing, selective credit controls have the *a priori* disadvantage that they tend to transfer the use of credit from more-wanted to less-wanted channels as measured by the normal criteria of the price system. It follows that they should be used only when the social or economic advantage of concentrating restraint on a selected type of credit is manifest, and that they should generally be "backed up" by some degree of general credit restriction to reduce the substitution effect to a minimum. Another reason for preferring general credit restraint to selective controls, other things being equal, is that the restraint arising from a generally restrictive credit policy is anonymous and is likely to be accepted as a "law of nature," while the restraint exercised by selective controls is far from anonymous and is apt to be extremely irritating to those restrained.

The selective regulation of consumer credit inevitably has important sumptuary and fair trade aspects. Many persons believe that people should be restrained from buying, say, television sets on too-long terms for "their own good" and that merchants should be restrained from selling them on too-long terms because it is unfair to other merchants. The Subcommittee doubts that these matters are a proper concern of the Federal Government. In any event, its concern is limited to the credit control aspects of the regulation. It cannot agree, however, with the opinion which has been expressed by the Federal Reserve [2] that selective credit controls should be administered primarily for their value in limiting the *total* amount of credit outstanding. *Selective* credit controls, the Subcommittee believes, should be administered as such and with a sympathetic regard for the interests of the industries and consumers involved and not as mere adjuncts of general credit control.

The Subcommittee does not believe that the authority of the Board of Governors to regulate consumer and real estate credit should be removed until it is certain that the full impact of defense expenditures has been felt. It expresses its satisfaction that the Board of Governors suspended the operation of Regulation W when, in the judgment of the Board, the selective restraint of consumer credit was no longer necessary, and expresses its confidence that the Board will continue to keep the situation under review in order to make sure that neither Regulation W (if reimposed) nor Regulation X is allowed at any time to interfere with the employment of resources for which no suitable market exists elsewhere (having regard, of course, to the need for converting convertible resources to national defense purposes).

[COMMENT BY MR. PATMAN: I believe that the disadvantages of selective controls over consumer and housing credit are so great that the authority for the imposition of these controls should be repealed immediately.]

2. *The Voluntary Credit Restraint Program.*—At the time of the hearings, the Voluntary Credit Restraint Program, authorized by the Defense Production Act and referred to earlier in this report, was still in effect. This program was terminated on May 12, 1952. The representatives of the Federal Reserve System and of the banking industry appearing at the hearings expressed the belief that this program was an important factor in holding down the expansion of credit

[2] See the letter of the Chairman of the Board of Governors of the Federal Reserve System to the Chairmen of the Senate and House Committees on Banking and Currency reprinted in the *Federal Reserve Bulletin* for July 1951, pp. 748–751.

in the year following its inauguration in March 1951. Each of them testified, however, that this impact was extremely difficult to measure.

The Subcommittee is disturbed by the longer-run implications of programs of this type. The Voluntary Credit Restraint Program was in essence a program for selective credit control, administered voluntarily by lenders in accordance with criteria which, in the nature of the case, must be vague and shifting. Such a program combines the disadvantages of selective credit control with the further danger of substituting the private prejudices of lenders for the criteria of the price system. The Subcommittee is impressed by the testimony presented to it that the program was most helpful in a difficult period and commends the spirit in which it was administered. It expresses satisfaction, however, that, in the opinion of the Board of Governors, the program is no longer necessary and the means for restraining credit can be confined to those more likely to be satisfactory in the long run.

D. Management of the Public Debt

1. *General Debt Management Policy.*—The Secretary of the Treasury is entrusted with the responsibility for the management of the public debt. This is a heavy operating responsibility. An unwise monetary policy can greatly weaken the economy even over a relatively short period of time. But an unwise step in debt management can cause great harm in a single day, as the confidence of the people in the credit of the United States is the foundation stone on which our whole financial structure is built.

The confidence in the public credit is not based upon any particular interest rate on public securities. It can be as great when Government borrowing takes place at 5 percent as it is when Government borrowing takes place at 2½ percent. But it is disrupted by disorderly changes in the prices of Government securities and depends on the ability of the Government to sell securities at rates which are generally considered to be fair and equitable.

It it also a responsibility of debt management to see that the cost of servicing the public debt is no greater than necessary to treat the holders of Government securities fairly and to meet the requirements of economic stability. The interest on the public debt must be paid ultimately from the proceeds of taxation, and tax moneys should not be expended except for an adequate consideration. This is true on grounds of equity alone. But there are additional reasons based on grounds of broad economic policy. As Secretary Snyder said in response to a question on the general economic objectives of the Treasury in the Subcommittee's questionnaire (*Compendium*, pp. 14–15):

> * * * I do not concur in the view that the level of interest payments on the public debt is of only minor significance for the economy as a whole. Some of those who hold this view argue, first, that the bulk of our interest payments represents only transfers of income from taxpayers to bondholders within the United States, rather than a consumption of real labor and materials; and, second, that those who receive the interest payments pay back a substantial portion of the amount in taxes.
>
> While acknowledging the element of truth that these views contain, I cannot conclude that the interest burden on the public debt is of negligible importance. In the first place, those who pay the taxes and those who hold the securities are not necessarily identical. In the second place, the transfer of income through collection of taxes and payment by the Government is never painless and costless,

however wise the Government may be in devising and administering tax policy. With taxes at their present high levels, it is increasingly difficult to find additional revenue sources that are reasonably equitable and that do not unduly impair the incentives necessary to the effective functioning of our free enterprise economic system. For these reasons, the Treasury always endeavors to hold interest costs on the public debt to the lowest level consistent with its other objectives.

Neither the problems of monetary policy nor those of debt management can be solved in isolation from each other. It is necessary that the Treasury and the Federal Reserve work together closely, and that the aims of debt management and monetary policy be correlated. This can be done only if the Treasury gives adequate consideration to the requirements of economic stability, and if the Federal Reserve gives adequate consideration to the need for maintaining confidence in the public credit and to that for economy in public expenditure. The Subcommittee believes that this will be best assured if the Treasury and the Federal Reserve continue to endeavor to find by mutual discussion the solutions most in the public interest for their common problems, with final appeal to Congress.

2. *Issuance of Purchasing Power Bonds.*—The Subcommittee does not believe that it would be wise to experiment with the issuance of securities the terms of repayment of which were determined partly or wholly by the purchasing power of the dollar. In this it concurs with the views of the Secretary of the Treasury and the Council of Economic Advisers as expressed in the *Compendium* (pp. 142–149 and 888–889), with the views of a large majority of the economists queried as expressed in the *Compendium* (pp. 1097–1114), and with the view of the Chairman of the Board of Governors of the Federal Reserve System as expressed in the *Hearings* (pp. 137–138). The principal arguments for and against issuing such a security are summarized on pp. 1097–1098 of the *Compendium*. The Subcommittee finds the negative arguments much more persuasive. The terms of repayment of such an obligation would be difficult or impossible to administer both fairly and to the public satisfaction. Its issuance would add yet another escalator clause to the large number already existing and so add to the causes of economic instability, and would be disruptive of private contracts, particularly those of savings institutions. Most important, it would undermine public confidence in the future purchasing power of the dollar by giving the impression that Congress had transferred its attention from preserving this purchasing power to protecting particular classes in the community from a decline which it considered inevitable. This is not the temper of this Subcommittee. It believes that contracts expressed in fixed numbers of dollars constitute a necessary and desirable part of the foundation for our social and economic system, and that the efforts of the Government must be devoted to preserving the integrity of this foundation rather than to endeavoring to provide a substitute.

E. Congressional Mandates on Economic Policy [3]

The Congressional mandates to the Treasury and the Federal Reserve System setting forth the economic objectives toward which they should strive are vague and diffuse. This is shown clearly in the replies of the Secretary of the Treasury and the Chairman of the Board

[3] This section is concerned exclusively with Congressional mandates dealing with the economic policies to be pursued by each agency. Questions relating to the subordination of one agency to another are handled elsewhere in this Report.

of Governors to questions asking them to describe the economic policy directives given them by Congress and the economic policies which they are actually following (*Compendium*, pp. 1–17 and 207–239). Each agency affirmed that, in addition to directives contained in legislation applying specifically to it, it considered itself bound by the Congressional declaration of policy set forth in the Employment Act of 1946. The great majority of witnesses, both governmental and nongovernmental, who appeared before the Subcommittee expressed their sympathy with the purposes of the Act and their belief that all governmental agencies, including the Federal Reserve System, were bound by the declaration of policy included in the Act. This declaration reads as follows:

> The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power.

The Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, and the Council of Economic Advisers were each asked in the questionnaire whether they considered this declaration to be balanced in its emphasis between price stability (which it does not mention directly) and high-level employment. Each of them replied in effect that, although its wording might not be clear in this respect, they believed that the declaration implied a concern for price stability and that they took this into account fully when interpreting it.

There was much disagreement among the witnesses before the Subcommittee concerning the practical importance of revising the Congressional mandates governing economic policy. Some believed that a revision of these directives was a matter of great urgency, while others believed that it was of little practical importance. As an example of opposing points of view, Professor Viner, who has had many years' experience in advising both the Treasury and the Federal Reserve System, said (*Hearings*, pp. 771–773):

> * * * I know of no evidence to the contrary that there is no legislation instructing any branch of the executive or instructing the Federal Reserve, which mentions the question of price level, which speaks of inflation, which speaks of deflation, or which clearly or unambiguously states that one of the primary objectives of the Federal Reserve is, to use the phrase that you [Senator Flanders] used, to maintain the purchasing power of the American dollar.
>
> * * * * * * *
>
> I want independence for the Federal Reserve, provided the Federal Reserve receives and acknowledges receipt of a genuine mandate to place great emphasis on the stability of the purchasing power of the dollar.
>
> * * * * * * *
>
> I have seen subordinates in an important agency of the Government speak with great authority and stand up against their own immediate chief on the ground that they had a statutory authorization or mandate. I want to bring into the picture the fact that what status a Government official has does not depend merely on his own personality; it does not even depend wholly on the scale and weight of his organization or on the degree of his intimacy with the President only. It depends greatly on these things, but also it depends on what Congress has given him a

mandate to do. In particular, if he can bring his counsel along and say, "My counsel tells me that this act of Congress does not permit me to do that," that man stands like the Rock of Gibraltar against any superior, including the President of the United States.

On the other hand, Dr. Goldenweiser, for many years Director of Research and Statistics of the Board of Governors, said (*Hearings*, pp. 787–788):

While I am speaking, I would like to say another word about the mandate that Dr. Viner is so enthusiastic about. I do not think anything of it at all. And I think that he is entirely incorrect in saying that all other agencies have mandates.

A great many institutions in the Government have only very general mandates.

I think that the mandate that the Federal Reserve has, both in the law and in the way the law has now been construed in connection with the Employment Act and in connection with general public understanding, is very clear, that they have a function to maintain economic stability, to the extent that it can be done by monetary means. That is very generally accepted. It is vague. That is its merit, because if you make it specific, if you make it rigid you are going to handicap it and you are going to be tied down tomorrow by the views that you hold today, which is bad.

And if you make it loose, as it has been, as it will be before people can agree on the formula or on a statement, then it becomes completely unimportant. And the argument about what to do is not going to be greatly changed.

I think there are very nice preambles to central bank organizations in a great many countries. And I still would like to see a government of a central bank that thinks about those preambles in the administration of the bank. They do not accomplish anything, because the general purposes are clear, and particular wording that sounds beautiful at some time in the history of the organization, sounds very foolish, maybe 5 years later.

Mr. Murphy told me at lunch that he wrote the preamble or an objective or a mandate for the Central Bank of Iceland in which he outlined four main considerations for that particular community. And he said when those considerations are in conflict, use your own judgment.

I would have no objection if we enumerated a lot of valuable objectives and then said, "When in conflict use your own judgment," which, in the final analysis, means just use your own judgment all the time. There is no escape from judgment, and you do much better to emphasize and expend your energies in getting the kind of people who will use good judgment than in trying to devise a formula that will make judgment unnecessary.

As a matter of good legislative practice, the Subcommittee believes that the economic policy directives given by Congress to both the Treasury and the Federal Reserve System should be clarified, but is inclined to hold with Dr. Goldenweiser that the matter is not one of great urgency. It also agrees with Dr. Goldenweiser that any directives must be in general terms, setting forth each of the principal desirable objectives of policy and leaving the solution of possible conflicts to the agencies, subject to ultimate appeal to and decision by Congress.

The Subcommittee believes that the best approach to clarifying Congressional policy directives to the Treasury and the Federal Reserve System would be through a revision of the Congressional declaration of policy in the Employment Act of 1946, which constitutes a directive to *all* agencies. Although it approves of the working interpretations put on this declaration by the principal governmental agencies, it feels that, on the face of its actual wording, there is an overemphasis on the maintenance of high-level employment and an underemphasis on the maintenance of price stability. It suggests that further studies be made of this wording with a view to securing a more balanced emphasis.

III. BANK RESERVE REQUIREMENTS

A. Functions of Bank Reserve Requirements; Changes in Requirements

Prudent bankers have always held a portion of their funds in liquid form in order to be sure that they would be able to meet their liabilities in accordance with their contractual or customary terms. In most countries the amount of such reserves has until very recent years been left to the bankers' discretion. In the United States, however, by long tradition, minimum reserves have been prescribed by law.

Prior to the establishment of the Federal Reserve System, national banks in the three Central Reserve cities (New York, Chicago, and St. Louis) held their reserves principally in specie, while banks in other cities held their reserves partially in this form and partially on deposit (directly or through banks in Reserve cities) in Central Reserve city banks. This system was not satisfactory for the reason, among others, that the reserves of the smaller banks were likely to be tied up in the event of a money-market panic affecting the Central Reserve cities. One purpose of the Federal Reserve Act was to provide a better way of mobilizing the reserves of the banking system. Since the early days of the System, required reserves of member banks have had to be held entirely in the form of deposits with their Federal Reserve banks.

The original purpose of establishing legal reserve requirements was to insure that all banks met a minimum standard of prudence in the amount of reserves they held. This was considered the only important purpose of reserve requirements at the time the Federal Reserve Act was passed.

Since the establishment of the Federal Reserve System, reserve requirements have come to be looked upon primarily as instruments of credit control, and this is their principal purpose today. Viewed in this manner, required reserves, the amount and character of which are prescribed by law, furnish the Federal Reserve System with a fulcrum upon which it can rest the lever of credit control. If, for example, required reserves must consist exclusively of deposits in Federal Reserve banks [1] and must amount to 20 percent of deposit liabilities, then open-market operations which reduce available reserves to, say, 18 percent of deposit liabilities will immediately put member banks in debt to their Federal Reserve banks and so initiate a wave of credit contraction. Contrariwise, an addition of, say, 2 percent to reserve funds will make the banks expansion-minded—although here the effect is not as certain as on the side of contraction. If such a fulcrum were not provided by legal requirements, a large portion of the reserve funds created or extinguished through Federal Reserve

[1] This would not be affected in principle if vault cash were permitted to be included in required reserves and there are other reasons—especially fairness to banks situated outside of Federal Reserve and Federal Reserve Branch cities (which must hold more vault cash than banks so situated)— why it might be advisable to do this.

action might be absorbed in changes in the amounts of reserves which individual banks thought it prudent to hold.

As the credit control function of reserves has come to be better understood, their liquidity function has decreased in importance because banks have come to realize that *required* reserves are not really reserves at all in the liquidity sense, as they cannot be used either to make loans or to meet the major portion of deposit withdrawals. (If the required reserve percentage is 20 perecnt, then only 20 cents of a $1 deposit withdrawal can be met from required reserves.) As a consequence, banks have come to rely increasingly upon secondary or excess reserves for their liquidity and the significance of legal reserve requirements has come to be more and more concentrated on the credit control function.

It should be noted that the primary credit control function of reserve requirements is to provide a fixed *fulcrum* upon which the other instruments of credit control—principally open-market operations and rediscount policy—can operate. Since the Banking Act of 1935, the Board of Governors has, in addition, been given considerable discretion in using *changes* in reserve requirements as a "moving part" in the credit control machinery. Reserve requirements as so prescribed are at the present time at their statutory maximum at all except Central Reserve city banks, and are near their maximum there, so the present discretionary authority of the Board of Governors is principally in a downward direction.

Changes in reserve requirements require corresponding changes in banking customs and have met with great resistance from the banking community. Their effects are hard to predict and experience with them has not been entirely happy. While the Subcommittee believes that a continuance, and perhaps an increase in the authority of the Board of Governors to change reserve requirements is necessary in order to insure that the monetary authorities will have adequate power to cope with economic instability, it expresses the view that changes in reserve requirements should not be made lightly, but should be reserved for rare occasions when major readjustments in the banking structure are necessary.

B. Extension of Requirements to Nonmember Banks

The reserve requirements established by Federal law and prescribed by the Board of Governors apply only to member banks. Nonmember banks must conform to reserve requirements set by State authority. These requirements are generally less onerous than those set by Federal authority. This is true not only because they are often lower in amount but because they can generally be met by balances held with correspondent banks and, occasionally, by holdings of prescribed securities. The securities, of course, yield a direct income, while the balances with correspondent banks yield an indirect income in the form of services, and member banks must maintain such balances *in addition* to their required reserves at the Federal Reserve banks. (For a discussion of nonmember bank reserve requirements, including detailed tables describing the requirements on a State-by-State basis, see *Compendium*, pp. 467–471.)

The present system is unfair to member banks and inadequate for purposes of credit control. Member banks hold about 85 percent of all deposits subject to reserve requirements (mutual savings banks are here omitted from the discussion altogether). Nonmember banks, which hold the remaining 15 percent of deposits, in effect get a free ride, or in any event a cut-rate ride, at the expense of the remainder of the banking system, as the cost of credit control (in the form of lost interest on required reserves) is principally borne by member banks. This is defended on the grounds (1) that it is necessary to preserve the dual banking system, (2) that 15 percent of total deposits is so small a proportion that it can be disregarded, and (3) that the credit control function of reserves is not important anyway.

Bankers were asked in the questionnaire whether, in their opinion, reserve requirements applying to member banks should be applied also to nonmember banks and the replies are summarized in the *Compendium* (pp. 1168–1176). Not enough replies were received from nonmember banks to provide a significant sample, but more than half of the member banks replying answered "Yes." Most of the bankers who believed that the extension should be made saw no threat to the dual banking system and thought that the present arrangement resulted in unfair competition from nonmember banks. Most bankers opposing the extension saw a threat to the dual banking system and felt that the possibility of member banks leaving the System to seek lower reserve requirements elsewhere was a safeguard against too-high reserve requirements being imposed by Congress or the Board of Governors. Each of these conclusions and sets of reasons is, of course, *ex parte* and the same would be true of arguments by nonmember banks, who presumably would have opposed the extension. It is equally understandable that such an extension was opposed by all State Supervisors of Banking answering the questionnaire (*Compendium*, pp. 978–983).

Few of these replies took serious account of the credit control function of reserve requirements. But Congress, which has the responsibility for maintaining economic stability, as well as that for making provision for a sound monetary and banking system, must give primary attention to that function. The Subcommittee sees no threat to the dual banking system in extending reserve requirements to nonmember banks. Extending deposit insurance to these banks constituted no threat, and there will be no threat as long as Congress continues to believe that the dual banking system serves the best interests of the country. The Subcommittee therefore reaffirms the recommendation of its predecessor subcommittee under the chairmanship of Senator Douglas, which reads as follows (*Report of the Subcommittee on Monetary, Credit, and Fiscal Policies*, pp. 2–3): [2]

> We recommend that all banks which accept demand deposits, including both member and nonmember banks, be made subject to the same set of reserve requirements and that all such banks be given access to loans at the Federal Reserve banks.

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[2] Mr. Wolcott appended the following note to this recommendation: "Mr. Wolcott dissents from this recommendation. It is his opinion that the so-called dual banking system should be preserved in order that possible checks and balances may be maintained to prevent unwise concentration of credit and economic controls. He contends that any such centralization of banking authority might well be interpreted as a step toward the nationalization of all banking and credit. That, instead, there should be full cooperation between the State banking authorities and the Federal Reserve Board to remove any discriminations which might seem to give advantage or disadvantage to either the Federal or State systems."

C. New Forms of Reserve Requirements

The questionnaire addressed by the Subcommittee to the Chairman of the Board of Governors and the presidents of the Federal Reserve banks asked a number of questions with respect to proposed changes in the form of reserve requirements. The proposals on which comment was requested included proposals that reserve requirements be based on type of deposit rather than on the location of the bank, that secondary reserves be required in the form of United States securities, that higher (possibly 100 percent) reserves be maintained against *increases* in either loans and investments or in deposits during periods of national emergency, and that reserve requirements generally be based on classes of assets rather than on classes of deposits. The Chairman of the Board of Governors and the presidents of the Federal Reserve banks were not asked to take a position on these proposals but merely to discuss their advantages and disadvantages. These discussions appear on pp. 463–489 and pp. 719–731 of the *Compendium*. Discussions of some of these proposals by the Council of Economic Advisers and by bankers replying to the questionnaire appear on pp. 875–878 and 1176–1184, respectively, of the *Compendium*.

The Board of Governors has on a number of earlier occasions, both in its annual reports and through representatives appearing before committees of Congress, requested authority to require reserves additional to those otherwise required, which additional reserves could be held in the form of specified types of interest-bearing United States securities. The pros and cons of this proposal are discussed in the references just cited.

The President, in a memorandum dated February 26, 1951, addressed to the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Director of Defense Mobilization, and the Chairman of the Council of Economic Advisers, asked this group to constitute itself a committee under the chairmanship of the Director of Defense Mobilization for the consideration of a number of proposals for controlling inflation. He said in this memorandum:

> Among other things, I ask that you consider specifically the desirability of measures * * * (2) to provide the Federal Reserve System with powers to impose additional reserve requirements on banks.

The Committee, which reported to the President on May 17, 1951,[3] said with respect to this point:

* * * * * * *

> (c) Reserve requirements of commercial banks have been raised virtually to the limits of existing authority.
>
> It is recommended that, as an emergency measure, legislation be sought to empower the Reserve authorities for a limited period to impose additional reserve requirements, either increasing the authorized percentages or in some other appropriate way that will have a minimum adverse effect on the Government security market. The refunding and new issue operations of the Treasury in the last half of this calendar year alone amount to in the neighborhood of $50 billion. Under these circumstances, it is imperative that any additional requirements for bank reserves imposed by the Federal Reserve should be such that they do not have a disruptive effect on the market for Government securities. In view of the emergency such requirements should apply to all insured banks. The feasi-

[3] This report appears, together with the memorandum of the President, on pp. 125–133 of the *Hearings*; the quoted portion of the memorandum is on p. 127 and the quoted portion of the report on pp. 131–132.

bility of permitting nonmember insured banks to hold the additional reserves in balances with their correspondents should be explored.

The task force on supplementary reserve requirements has considered various plans for reenforcing existing bank reserve requirements and has reported that two plans offer the greatest promise, namely: (1) The loan-expansion reserve plan and (2) the primary (securities feature) reserve plan, which provides for additional required reserves and gives a bank, under conditions to be prescribed by regulation, the option of holding the additional reserves in the form of cash or Government securities.

The provisions of these plans may be summarized as follows:

Loan-expansion reserves.—Every insured bank receiving demand deposits, other than a mutual savings bank, would be required to maintain additional reserves equal to a percentage to be prescribed by the Board of Governors of the Federal Reserve System, of that part of its loans and investments in excess of a certain prescribed base.

In computing loans and investments, all assets of the bank would be included except (1) cash, (2) balances due from banks, (3) direct obligations of the United States, and (4) such special types of assets as the Board might prescribe from time to time.

Primary reserves and Government securities.—Either in substitution for or in addition to the requirement discussed above, an insured bank receiving demand deposits, other than a mutual savings bank, might be required to maintain additional reserves equal to a limited percentage of its demand deposits, in addition to the deposit balances now required.

Such percentages could be different with respect to banks in central reserve cities, reserve cities, or elsewhere.

In lieu of such a deposit balance, a bank under certain conditions, could count Government securities either at an amount equal to the dollar amount of the deposit balance which the securities replace or at some lesser figure. For example, the Board might prescribe that, for reserve purposes, $1.50, or $2 or $2.50 in securities might be equivalent to $1 of cash.

Within a few days the Board of Governors will ask the Congress to consider definitive legislation providing for supplementary requirements.

The request referred to in the last sentence of the quoted material was never made. When Mr. Martin was asked the reason for this at the hearings, he replied:

> . . . the best made plans of mice and men "gang aft agley."

In the subsequent questioning by members of the Subcommittee, Mr. Martin indicated that the Board's change of heart had occurred partly because it had found that the more flexible open-market policy which it had adopted following its accord with the Treasury was adequate for its present purposes, partly because the inflationary situation was not then active, and partly because, with the public debt rising instead of falling, it was afraid that the imposition of additional reserve requirements expressed in terms of United States securities might be considered primarily a measure for the compulsory holding of such securities rather than for credit control.

The Subcommittee finds these reasons moderately persuasive with respect to the immediate future, but believes that the entire subject of reserve requirements needs much additional consideration from a long-term point of view. It has been our experience since the outbreak of the war in Europe in 1939 that each wave or incipient wave of inflationary pressure has caused the Administration to appear before Congress to ask for additional price control authority and the Federal Reserve System to appear to ask for additional authority over credit in order to combat existing or expected pressures. In order to obtain this authority from Congress, they have had to dramatize and emphasize the extent of the pressures. This process, necessary as it may have been under the circumstances, has contributed to inflationary

expectations and so made the situation worse. The repugnance of even stand-by price and wage controls to our fundamental economic system may make a repetition of this unavoidable if it is necessary to reimpose such controls in the future. But, as far as credit control measures are concerned, it might be avoided if the Reserve System were given the necessary powers in advance and had them ready to use when occasion warranted. With this in mind the Subcommittee, while it is unable to make a definite recommendation at the present time, suggests that further consideration be given to the adoption of legislation providing the Federal Reserve System with additional powers over bank reserve requirements for use at its discretion.

IV. THE MACHINERY FOR THE DETERMINATION OF MONETARY POLICY

A. Legal Status of the Federal Reserve System

The United States Constitution gives Congress the power "to borrow money on the credit of the United States" (Art. I, sec. 8 (2) and "to coin money, regulate the value thereof, and of foreign coin . . ." (Art. I, sec. 8 (5)). These and other provisions of the Constitution, as judicially interpreted and developed through years of precedent and adaptation to changing economic conditions, have vested in the Congress the power to determine what we now call the monetary policy of the United States. This does not mean that Congress itself can or should administer the monetary affairs of the Nation. Many powers are given to Congress by the Constitution. Congress determines the policies pursuant to which these powers shall be exercised, but relies upon the Executive to put them into actual effect. As Mr. Lucius Wilmerding said in his testimony to the Subcommittee (*Hearings*, p. 753):

> The question of the status of the Federal Reserve Board is a difficult one to answer. It depends at bottom upon the view which one takes—or rather which the Supreme Court might take—of the power of Congress, under the Constitution, to create agencies for the administration of its laws which are responsible directly to itself and not to the President.
>
> The idea that Congress has such a power has frequently been entertained. Back in Jackson's administration, Henry Clay and many others contended that the Treasury Department was not an executive department but an administrative department—an agent of Congress. They argued that, since the Constitution had given Congress the power to collect taxes—not simply to provide for their collection—Congress could collect them through an agent of its own. In like manner, one might now contend that, since the Constitution has given Congress the power of regulating the value of money, Congress may carry that power into execution itself, either directly or through an agent responsible only to it. For my own part I should consider such a proposition absurd. Congress can ordain a rule; the Constitution has pointed out what branch of Government is to put into practical operation the rules which Congress has ordained and it has made that branch independent of Congress. When Congress created the Federal Reserve Board and assigned it its duties, it did all that it could do toward carrying into execution its power of regulating the value of money. It is neither called upon nor empowered to carry into effect the provisions of its own laws.

Acting on this sound principle of delegation, Congress has entrusted the power and duty of executing its monetary policy to a number of agencies. Important monetary powers have been delegated to the Secretary of the Treasury (see *Compendium*, pp. 35–47), while other powers of a monetary or quasi-monetary nature have been delegated to the Federal Deposit Insurance Corporation, the Reconstruction Finance Corporation, and possibly other agencies. The principal monetary powers, however, have been delegated to the Federal Reserve System.

In its questionnaire the Subcommittee asked the Chairman of the Board of Governors and the presidents of the Federal Reserve banks whether they considered their respective organizations to be a part of

the Executive Branch of the Government (*Compendium*, pp. 239–248 and 648–653), and much discussion was had on this matter at the hearings.

As far as the Board of Governors is concerned, there seems to be no clearly adjudicated answer to this question. But, while the question itself is an open one, it appears that the practical issues usually debated under this head have been judicially determined, so that the question is not really an important one. The Subcommittee was much impressed in this connection by the testimony of Mr. Wilmerding, who, after stating that "* * * it is impossible to return a clear answer to the question * * * about the Board's status," continued (*Hearings*, pp. 753–754):

> Fortunately, from a practical standpoint it is not important that a clear answer be given. Let it be conceded for purposes of argument that the Federal Reserve Board, unlike the Federal Trade Commission, is a part of the executive branch. Would such a status alter in any practical way the relationship which has been established by statute between the Board and the President of the United States? In particular, would it give to the President, under the Constitution, a power to interfere with, set aside, correct, or revise, the decision of the Board in any matter which has been committed by Congress to the Board's exclusive jurisdiction?
>
> This question, I submit, can be answered with a categorical negative. A long line of opinions by the Attorneys General, acquiesced in by the Presidents, corroborated by the action of Congress, and the proposition that, when the execution of a law has been committed by Congress to the exclusive jurisdiction of a subordinate department or officer of the Executive, the interference of the President with such execution, either in the form of direction beforehand or revision and reversal afterward, so far from being permitted by the Constitution, would be a usurpation on the part of the President which the subordinate department or officer would not be bound to respect. In such cases the duty of the President to take care that the laws be faithfully executed extends no further than to see that the officers to whom Congress has given an exclusive jurisdiction perform their duties honestly and capably. If they do not, he must, under the Constitution, remove them and appoint others in their stead, but, in the words of one of the Presidents, "he cannot override their decisions and ought not to interfere in their deliberations."
>
> In the light of these considerations it is evident that the question of the status of the Federal Reserve Board is purely academic. Congress has committed certain business to the exclusive jurisdiction of that Board, and this business it must perform under the responsibility of its trust and not by direction of the President. The case is the same whether the Board be considered in or out of the executive branch.

The case of the Federal Reserve banks is harder to define. The presidents of the Federal Reserve banks, in answer to a question whether they considered the banks to be part of the United States Government or part of the private economy, said (*Compendium*, p. 649):

> In our opinion Federal Reserve banks are partially part of the private economy and are part of the functioning of the Government (although not technically a part of the Government).

Much evidence was introduced on this subject and appears in the *Compendium* and the *Hearings*. There are many things to be taken into consideration. The stock of the Federal Reserve banks is owned by their member banks. But the capital so contributed is a negligible proportion of the assets of the banks and is limited to a fixed return, however great may be the profits of the Reserve banks. The Reserve banks are given sweeping exemptions from taxation. But, Congress can and has given equally sweeping exemptions to private corporations. The majority of the directors of each Federal Reserve bank is elected by its member banks. But, the power of the directors to

direct is limited; the principal policy decisions are made or dominated by the Board of Governors, which is appointed by the President with the consent of the Senate. On the whole, the Subcommittee sees no objection to this hard-to-define position of the Federal Reserve banks. The Federal Reserve System has been a helpful institutional development. Its roots are sunk deeply in the American economy and it has borne good fruit. This is more important than that each portion of it be subject to classification by species and genus according to the rules of a textbook on public administration.

But, one fact with respect to the legal status of the Federal Reserve banks stands out, and it is the only fact of importance. Congress created the Federal Reserve banks and Congress can dissolve them or can change their constitution at will. On dissolution the entire surplus of the banks would become by law the property of the United States. Ultimately they are creatures of Congress.

B. Independence of the Federal Reserve System

The first question which must be raised in any discussion of the independence of the Federal Reserve System is "independence from what?" It is sometimes contended that the Federal Reserve System, like a 19th Century central bank, should be, at least formally, independent of its government. It was possible to make a plausible case for this position when the principal trading nations of the world were on a gold standard and the "rules of the game" under this standard were conceived to be automatic—requiring much technical skill but no judgment concerning the ultimate ends of economic policy for their successful operation. It is not necessary to inquire whether this concept was ever valid. The United States is now the only large nation in the world on an international gold standard, and neither the United States nor any other country is going to allow its monetary policy—i. e., its internal price level and its internal level of employment—to be determined by the "automatic" requirements of an international standard. To permit this would be tantamount to renouncing the responsibility of the Federal Government, recognized by it in the Employment Act of 1946, for maintaining conditions conducive to high-level employment.

The Subcommittee, therefore, rejects the idea that the Federal Reserve System should be independent of the Government. It agrees with Mr. Sproul, who said in a letter to the Subcommittee (*Hearings*, p. 983):

> * * * I think it should be continuously borne in mind that whenever stress is placed upon the need for the independence of the Federal Reserve System it does not mean independence *from* the Government but independence *within* the Government. (Emphasis supplied.)

The Federal Reserve System is, and should be, in close and continuous contact with the financial and business communities. The financial and business communities should participate to the fullest extent possible in the formulation of monetary policy. But, they must be junior partners. There can be no independence from the Government.

The independence of the Federal Reserve System, which remains to be considered, is, therefore, to use Mr. Sproul's words "independence within the Government." This independence is of two kinds—independence from the President and independence from Congress.

The question of independence from Congress is a very special one and discussion of it will be reserved for the section on "The Finances of the Federal Reserve System."

It has already been pointed out that, irrespective of whether the Board of Governors is or is not a part of the Executive branch, Congress can and has endowed it with a substantial degree of independence from the President. The President appoints the members of the Board of Governors, subject to the confirmation of the Senate, and designates the Board's Chairman. Pursuant to his inherent powers as Chief Executive, he may remove any member of the Board for malfeasance, incompetence, or neglect of duty. Some powers of the Board have been delegated to it by the President, pursuant to acts of Congress vesting the powers originally in him. The President can supervise the execution of these powers and can redelegate them if he sees fit. But, aside from this, the Board is formally independent in the exercise of its judgment and can made such decisions as it believes to be in the public interest. This was agreed by a great majority of the persons replying to the questionnaires or testifying at the hearings.

But, the formal independence of the Board of Governors from the President is inevitably limited by the hard fact that fiscal and monetary policy must be coordinated with each other and with the other policies and objectives of the Government if the Government is to be of the greatest service to the Nation. As the Council of Economic Advisers says (*Compendium*, p. 850):

> A problem of greater practical importance, however, is presented by the fact that stability is only one of the objectives of the Government, and monetary policy is only one of the methods of achieving stability. When various objectives must be promoted simultaneously, a combination of policies needs to be chosen that will promote these different objectives without tearing down one to build up another.

This means that the Board of Governors must inevitably discuss and endeavor to reconcile its differences with the Executive agencies. What is needed is not the best *monetary* policy or the best *fiscal* policy, each as ends in themselves, but the best over-all *economic* policy. This is naturally most likely to be attained, from the point of view of the Federal Reserve System, when its influence in Government policy formation is at a maximum. A good case was made at the hearings that the over-all influence of the Federal Reserve System would be increased if it were less independent and more highly integrated with the Executive branch. (See especially the testimony of G. L. Bach, *Hearings*, pp. 748–752.) Dr. Goldenweiser had earlier supported this view in part in his book, *American Monetary Policy*, but modified his position materially in his testimony before the Subcommittee.

The final aim, of course, is not that the Federal Reserve System should be independent, but that the country should have a sound economic policy. The independence of the Federal Reserve System is a relative, not an absolute, concept. It is good insofar as it contributes to the formulation of sound policy, and bad insofar as it detracts from it. Measured by this standard, the Subcommittee is inclined to believe that a degree of independence of the Board of Governors about equal to that now enjoyed is desirable. Many of the policies which the Federal Reserve must advocate to maintain

the soundness of the dollar during times of inflationary pressures are unpopular; yet it is necessary that they have a strong advocate in order to avoid a built-in inflationary bias in the economy. This end is best served by endowing the Board of Governors with a considerable degree of independence—thereby enhancing its bargaining power in the determination of over-all policy. But, the Board of Governors, like all other parts of Government, must play as part of a team, not as an outside umpire, and must ultimately abide by the decisions which are made by Congress.

C. The Position of the Federal Reserve Banks and the Federal Open Market Committee

The previous discussion of the independence of the Federal Reserve System has been principally in terms of the independence of the Board of Governors from the President. But, the Federal Reserve banks also have a considerable degree of independence from the Board of Governors. At one time this idependence was much greater. The original Federal Reserve Act appears to have conceived the individual Federal Reserve banks as important policy-making agencies and the Board of Governors (then the Federal Reserve Board) as principally a regulatory agency, like the Interstate Commerce Commission. The subsequent trend has been toward a somewhat greater degree of independence of the central board from the President but a much diminished autonomy for the individual banks. The most important changes in this direction were made by the Banking Act of 1935, but it has been the trend for the whole period since the adoption of the original Act and is, for the most part, merely a reflection of the growth in the importance of monetary policy and the recognition of the fact that this policy cannot be determined by regions but must apply over an entire currency area.

The directors of the individual Federal Reserve banks have a large degree of responsibility with respect to the business management of their institutions but relatively little authority in the determination of monetary policy. They are, for the most part, men with a large amount of business experience and a broad point of view with respect to the public interest. They are an invaluable link between the Government and the business community. Because of them, the Government is better able to understand the point of view of business and business is better able to understand the point of view of Government. The Subcommittee believes that it is important that their responsibility, not merely in the business management of their banks but also in the formulation of monetary policy, should be kept sufficiently great to attract men of high caliber. In the absence of affirmative evidence to the contrary, it is inclined to believe that the present degree of responsibility is satisfactory.

Class A and B directors of the Federal Reserve banks are by law elected by, and members of, the financial and business communities. Class C directors, comprising a third of the whole, are appointed by by Board of Governors to represent the public interest. The Subcommittee commends the Board of Governors on the appointments which it has made to class C directorships of members of the academic community and others in an especially advantageous position to take a view detached from the particular interests of business and finance.

It expresses some concern, however, with respect to the complete absence of any representation of labor, despite the fact that labor is so vitally affected by monetary policy. This lack is, in large part, a remnant of the thinking of a generation or more ago, when the Federal Reserve System was conceived simply as an aid to commerce and industry and not as an agency for formulating monetary policy for the benefit of the whole people. The Subcommittee suggests, in this connection, that the Board of Governors give consideration to including representatives of labor among those whom it considers eligible for appointment as Class C directors.

> [COMMENT BY SENATOR FLANDERS: I believe that class C directors should represent the broad public interest and to this end well-qualified representatives of labor should be eligible. However, I am opposed to any requirements which would tend to make these directorships partisan by parcelling them out to members of special-interest groups, whether business, agriculture, or labor.]

The influence of the directors of the Federal Reserve banks on the formulation of monetary policy is in large part intangible and is both difficult and unrewarding to measure and to define. But, the most important single way in wbich the directors have an impact on central policy decisions is through the participation of the presidents whom they have elected in the deliberations of the Federal Open Market Committee. (This Committee, established by statute, consists of all members of the Board of Governors and the presidents of five of the twelve Federal Reserve banks serving, except for the president of the New York bank, in rotation. The presidents are elected by the directors of the respective banks subject to the approval of the Board of Governors. The Committee has final authority over all purchases and sales of Government securities and acceptances by the Federal Reserve banks.)

The three principal instruments of Federal Reserve policy are the determination of rediscount rates, the variation of reserve requirements, and open-market operations. These three instruments must be used in conjunction to serve a common end, and there is no rational basis for the assignment of the most important of them, open-market operations, to a body different from that controlling the other two. (The Board of Governors has final authority over both variations in reserve requirements and the determination of discount rates. See *Compendium*, pp. 275–279.) The explanation of the present System is therefore historical and not logical. Its justification is that it provides an important link between the directors and managements of the individual Federal Reserve banks and the formulation of monetary policy. Its danger is that it might result on some future occasion in the adoption of an open-market policy not compatible with the over-all economic policy of the United States as approved by Congress. This would be more likely to happen during a period of deflation than during one of inflation, and need not occur at all if both Congress and the Open Market Committee are endeavoring to effectuate the objectives of the Employment Act. If the decisions of the Open Market Committee should ever serve as an obstacle to the implementation of the economic policy of Congress, its separate existence should be reconsidered. Barring such an event, however, the present arrangement serves a useful purpose and the Subcommittee sees no reason to disturb it.

D. The Composition of the Board of Governors

1. *Tenure of Members.*—Members of the Board of Governors are appointed for fourteen-year terms of office and are not eligible for reappointment after they have served a complete term. This tenure and ineligibility for reappointment was originally provided for by the Banking Act of 1935, and was based in part upon a concept of the Board as the "Supreme Court of Finance." It was a natural corollary of this concept that the Board should be insulated from all outside influences likely to affect its impartiality. This was sought to be accomplished by long terms of office and ineligibility for reappointment.

The Subcommittee does not believe that the analogy of the Board of Governors with the Supreme Court is valid. The Board of Governors is primarily a *policy-making*, not a judicial or quasi-judicial body; and, as the ends of economic policy are matters of judgment, it should have its mandate from the people (expressed through appointment and confirmation by the elected officers of the Government) periodically renewed. On the other hand, it is especially important that the Board of Governors maintain a continuity of policy and not be easily affected by passing currents of public opinion. The founding fathers recognized the necessity of a compromise between the objectives of responsiveness and of continuity in their provision for staggered terms for the members of the Senate, and it is upon this analogy rather than upon that of the Supreme Court that we should base our views with respect to the appropriate tenure for members of the Board of Governors.

Chairman Martin suggested (*Compendium*, pp. 301–302) that the term of members of the Board of Governors be reduced to six years and that the prohibition against reappointment be removed. The Subcommittee is impressed with this suggestion and recommends that it be given consideration by the appropriate legislative committees.

[Comment by Senator Flanders: I favor a reduction in the term of office of members of the Board of Governors from 14 to 10 years, a reduction in the number of members of the Board from 7 to 5, and the removal of the limitation on eligibility for reappointment. This would permit two appointments to the Board in each Presidential term but would not permit a President to appoint a majority of the Board in a single term (except through appointments due to deaths and resignations). This arrangement, it seems to me, would achieve the best balance between the objectives described in the text.]

2. *Number and Compensation of Members.*—It is of great importance that the chairman and members of the Board of Governors should be persons of the highest possible caliber. In order to help achieve this end, the earlier subcommittee, under the chairmanship of Senator Douglas, recommended (*Report of the Subcommittee on Monetary, Credit, and Fiscal Policies*, p. 31):

> * * * (a) decreasing the number of members of the Board of Governors from seven to not more than five in order to make the position attractive to more capable men and to lessen the temptation to appoint men of lesser stature, and (b) raising the salary of the Chairman of the Board of Governors to the same level as the salaries of Cabinet members—namely, $22,500—and raising the salaries of other Board members to $20,000 a year.

We reaffirm this recommendation and commend it to the attention of the appropriate legislative committees. We also recommend that any reduction in the number of members of the Board of Governors be accompanied by a pro rata reduction in the number of Federal Reserve bank president members of the Federal Open Market Committee so as to preserve, as far as possible, the present ratio between members of the Board of Governors and presidents of the Federal Reserve banks in the composition of the Committee.

3. *Designation of chairman.*—The President now has the power to designate a member of the Board to be Chairman and one to be Vice Chairman, each to serve for a term of four years. This designation has not worked satisfactorily in practice, however, because the term of designation does not at present coincide with the term of office of a President but may end at any time during a presidential term. The Committee is impressed, therefore, with Chairman Martin's suggestion (*Compendium*, p. 302) that the law be amended so that the designations may run for terms beginning shortly after the commencement of each presidential term.

4. *Qualifications for membership.*—The statute at present provides that—

> In selecting the members of the Board, not more than one of whom shall be selected from any one Federal Reserve district, the President shall have due regard to a fair representation of the financial, agricultural, industrial and commercial interests and geographical divisions of the country.

The geographic portions of this provision have reduced the flexibility of the appointing authority in seeking the best possible membership for the Board, while its non-geographical portions reflect in part the older concept of the Federal Reserve System as simply an organization for the "accommodation of commerce and industry" rather than one whose primary responsibility is the formulation of monetary policy in the public interest. It is, of course, important that the Board include in its membership persons understanding of and sympathetic to the various interests in the county, and the President and the Senate may be expected to insist upon this, but it is also important that men be appointed with a broad understanding of the economic bases of monetary policy. The Subcommittee believes that, in the long run, the quality of membership of the Board would be improved if the present qualifications were removed and the appointments left to the full discretion of the President and the Senate.

E. Coordination of Fiscal and Monetary Policy

As already stated, the Subcommittee believes on the one hand that the present degree of independence of the Federal Reserve System should be maintained and, on the other hand, that neither the Treasury nor the Board of Governors should be subordinated to the other. It is vitally necessary, however, that monetary policy, fiscal policy, and all of the other economic policies of the Government should be coordinated so that they will make a meaningful whole, working in the direction of price stability, high-level employment, and a dynamic, free-enterprise economy. It is not merely the right but the duty of the President to seek to effect this coordination—by direction with respect to the agencies under his control and by persuasion with respect to the agencies which are not. The Secretary of the Treasury

expressed this duty of the President very clearly when he said, in his answer to an inquiry in the questionnaire concerning the settlement of policy conflicts between the President and the Federal Reserve (*Compendium*, p. 30):

> I think one of the most important steps toward providing a quick means of settling such disputes would be a public, and a congressional, recognition of the fact that it is natural, proper, and desirable for the President to seek to settle them by having all the interested parties sit around a table to discuss their differences with him. That would seem to be an almost axiomatic method of solution of a dispute. Yet, in some quarters, if the President should ask the Chairman or any other member of the Board of Governors to come to the White House to discuss differences of policy which were having some effect on Government objectives, there would be loud objections and charges of attempted domination or dictation. I do not think that any President, in the present state of the law, would seek to dictate to or interfere with the Federal Reserve. But since the two—the President and the Board—are assumed to be independent of each other, the very essence of that independence should be recognized—that they should each have the right—and the duty—to discuss the problem freely around a table together. This should be encouraged by the Congress and the public, rather than discouraged. Discouragement comes from charges or insinuations that such conferences amount to attempted dictation. It would encourage such discussions and conferences if this committee of the Congress would publicly recommend them.

The Secretary of the Treasury also suggested, in his reply to the Subcommittee's questionnaire and in his testimony before the Subcommittee, that the coordination of fiscal and monetary policy would be further facilitated by the establishment of an interagency consultative committee. He said (*Compendium*, pp. 31–32):

> The creation of a small consultative and discussion group within the Government, to consist of the Secretary of the Treasury, the Chairman of the Board of Governors, the Director of the Budget, the Chairman of the Council of Economic Advisers to the President, and the Chairman of the Securities and Exchange Commission. I would have this group meet informally but regularly and frequently for the purpose of discussing domestic monetary and fiscal matters with each other. Heads of the lending agencies would be called in for these meetings from time to time when the discussions involved their programs. This group would in a way be a kind of parallel to the National Advisory Council which works in the field of foreign financial matters. It would also be akin to the Council suggested by the Commission on Organization of the Executive Branch of the Government (the Hoover Commission) in its report on the Treasury Department. The Council there suggested (Recommendation No. 9) was to advise on policies and coordinate the operations of the domestic lending and Government financial guarantees.

This recommendation resembles in many respects the recommendation of the earlier subcommittee under the chairmanship of Senator Douglas, which said [1] (*Report of the Subcommittee on Monetary, Credit, and Fiscal Policies*, p. 4):

> We recommend the creation of a National Monetary and Credit Council which would include the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Chairman of the Federal Deposit Insurance Corporation, and the heads of the other principal Federal agencies that lend and guarantee loans. This Council should be established by legislative action, should be required to make periodic reports to Congress, and should be headed by the Chairman of the Council of Economic Advisers. Its purpose should be purely consultative and advisory, and it should not have directive power over its members.

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[1] Mr. Wolcott appended the following note to this recommendation: "Mr. Wolcott joins in recommending the creation of a National Monetary and Credit Council, but disagrees with the recommendation that it should be headed by the Chairman of the Council of Economic Advisers. In his opinion, this would concentrate too much power in the Executive over the volume and cost of credit. He recommends, instead, that the Chairman of the Credit Council be a person of neutral interests removed as much as possible from the direct influence of either the Executive or the Federal Reserve Board. He also agrees that periodic reports should be made to Congress by the Council."

Much discussion of this recommendation of the Secretary of the Treasury was had during the course of the hearings. It was strongly supported by some witnesses and strongly opposed by others. The opposition was based principally on the ground that it might be used as an instrument for bringing undue pressure on the Federal Reserve. Chairman Martin took no position on the recommendation in his statement to the Subcommittee. In the subsequent questioning he indicated a marked lack of enthusiasm for it, but expressed no active opposition. Mr. Beardsley Ruml made the support of such a council the principal point in his statement to the Subcommittee, but went further than Secretary Snyder by insisting that such a council, if it were to be effective, must be established by statute and must have at least a small staff of its own rather than depending exclusively on the staffs of the member agencies.

The Subcommittee is impressed with Secretary Snyder's recommendation. It notes that the council which he proposes would be consultative and advisory only and would have no directive powers over its members. It would consist of a small number of persons, each with a program to administer (sometimes on his own responsibility and sometimes in conjunction with colleagues) and each with the right and duty of advising the President. The increased understanding of each other's problems which participation in such a council would bring to each of its members might make an important contribution to the practical administration of the several programs and might also improve the quality of the advice given to the President by each of its members individually. The functions of such a council would not overlap those of the Council of Economic Advisers—the primary responsibility of which is to advise the President of its *first* choice on each of the economic issues with which he is confronted, unfettered by any implied commitments arising from attempted mediation between operating agencies.

While the Subcommittee sees merit in Mr. Ruml's proposal that the proposed council should be established by legislation and should have a small staff of its own, it believes that such action would be premature. It would prefer that the council be established on an experimental basis by executive order and demonstrate its usefulness in actual operation before Congress is called upon to legislate with respect to its permanence and future status.

The problems of coordination of fiscal and monetary policy are not entirely those of the executive agencies and the Federal Reserve. They are also the problems of Congress. The Employment Act of 1946 set up a coordinating agency on the Congressional side in the Joint Committee on the Economic Report. Like the proposed consultative council and the Council of Economic Advisers, its powers are consultative and advisory only, but it is the only committee of Congress whose mandate extends to the entire field of fiscal and monetary policy and its relationship to economic policy generally. The Subcommittee believes that the Joint Committee on the Economic Report, either through frequent meetings of the full Committee or through the appointment of a standing subcommittee, as the Chairman may see fit, should maintain more active liaison at the top level with the Federal Reserve and the executive agencies, including the proposed consultative council. It commends the liaison now existing at the staff level.

Finally, if correct decisions on problems of economic policy are to be reached at the highest levels, it is essential that the groundwork be well laid and that the implications, advantages, and disadvantages of each proposed avenue of policy be thoroughly explored. The special structure of the Federal Reserve System insures that the claims and advantages of monetary policy will always secure proper attention at the staff level. The funds for this purpose are independent of Congressional appropriation, and the Subcommittee is recommending that this independence be continued. This presents the danger, unless provision is made for adequate staff work in other agencies, that the advantages of monetary policy, especially restrictive monetary policy, may be overemphasized due to an unconscious "institutional bias" on the part of the Federal Reserve staff. This danger can best be avoided if adequate provision for staff work is also made in the Council of Economic Advisers, the Treasury Department, and the Department of Commerce—which have different and partially offsetting institutional preconceptions. The staffs of these agencies are dependent on appropriation procedure and the Subcommittee urges that they should be provided with funds sufficient to insure, as far as possible, that a well-rounded view of the implications, advantages, and disadvantages of fiscal, monetary, and other economic policies will always be available at the top-policy level.

F. Finances of the Federal Reserve System

The independence of the Federal Reserve System from the President has been discussed earlier. But, the concern of the Subcommittee with the detailed finances of the System derives principally from the significance of these finances in giving it a substantial degree of independence from Congress itself. This independence has an impact on the formulation of monetary policy and hence is of direct interest to the Subcommittee.

1. *Private Ownership of the Stock of the Federal Reserve Banks.*—The stock of the Federal Reserve banks is owned by the member banks. The total amount of capital so supplied to the Federal Reserve banks amounted at the end of March 1952 to $242 million, or about ½ of 1 percent of their total resources of $48.6 billion. (The surplus of the Reserve banks on the same date amounted to $565 million, but the shareholders have no ownership interest in this surplus, which would revert to the United States if the banks were dissolved, see below, p. 61.) It is clear, therefore, that the capital provided by the private shareholders of the Reserve banks is not a substantial factor either in assisting in their operations or in insuring their solvency. If the Federal Reserve banks depended upon their capital for their solvency, we would be confronted with the paradox that the institutions upon which the solvency of the entire financial structure of the country rests would be themselves the most narrowly and precariously financed institutions in the whole structure. In fact, this is not the case and we are confronted with no such paradox. The solvency of the Federal Reserve banks depends, not upon their capital structure, but upon their legal status, upon the lucrative (and exclusive) functions which have been entrusted to them, and, above all, upon the fact that they may issue money which is a liability of the United States.

What, then, is the significance of the private ownership of the stock of the Federal Reserve banks? This question is answered in part in the following colloquy between Senator Flanders and Dr. Goldenweiser (*Hearings*, pp. 774–775):

Senator FLANDERS. I would like to ask some questions of Dr. Goldenweiser.

You addressed yourself to the question, "What should be the role of the private financial community in the formulation of monetary policy," and in that connection I was interested in the implications of the stock ownership feature of the Federal Reserve System and the independence of its supply of funds. At least ownership has some significance, it seems to me, in the independence of the Federal Reserve System of the Federal budget.

Do you think that is a fortunate or unfortunate feature?

Mr. GOLDENWEISER. I think its independence of the budget is vital, vitally important to the Federal Reserve because the sort of functions it performs it could not perform effectively if it had to have appropriations.

I think that if it had to have appropriations its organization would be subject to a great deal more political pressures than it has been.

You have here an organization that over the years has built up the best economic staff in the world. You have the kind of service that arises from the possibility of cutting red tape, of complete freedom from pressure for political appointments, and it would be highly undesirable and destructive of the public interest to interfere with the functioning of the Federal Reserve in that way.

Now, the ownership of the stock, as everyone here seems to agree, has become a very minor matter. It is not a source of funds. I do not remember what the capital is now, but it is in the minor hundreds of millions, whereas the resources of the Federal Reserve are in the tens of billions, so that you can see that the ratio is negligible.

I think that it is of no particular consequence in that respect, and I think that if one were revising the banking system, that stock ought to be abolished, because I think it stands for a wrong principle, but, as I said at some length, I think it has lost all practical importance, and I think this is—

Senator FLANDERS. You do not believe in changing things simply because they are illogical as long as they are working all right?

Mr. GOLDENWEISER. That is right. I think that the most effective things in the world are illogical, and that logic can be one of the most destructive things in the world.

The private ownership of the stock of the Federal Reserve banks, then, is one of those anachronisms which, although it has lost its original significance, lives on because it continues to be practically useful. One of its functions is to serve as a memo from Congress to itself that it has chosen to leave to the System a great deal of autonomy in its day-by-day and year-by-year operations. This is so because, as long as the private ownership continues, the System will not be amenable to the ordinary techniques of detailed Congressional control.

The private ownership of the stock of the Federal Reserve banks also serves as a practical and well-understood link between the System and the private business community, and has been of great help in obtaining the services of able men as directors of the Federal Reserve banks. In theory, an equally effective link might be established by other means—as by the election of local advisory committees—but a newly-established link would not enjoy the sanction of tradition and it would be difficult to devise one which would conform so well to the mores of the business and financial communities. As Mr. A. L. M. Wiggins said so ably on this point (*Hearings*, pp. 220–221):

The question has been raised as to whether or not the stock of the Federal Reserve banks should be owned by the Government instead of by the member banks. In my opinion it should not be owned by the Government.

The Federal Reserve banks represent a combination of Government and private business under which the control is vested in the Government. But it is through the ownership of the stock by the banks that the Reserve System mobilizes the

services of able individuals as directors. These men represent private enterprise and represent the public, and while the control is vested in the Board of Governors almost entirely, at the same time these directors bring the viewpoint of business, industry, and agriculture and banking to the officers of their banks. I think that it is highly important for the Reserve banks to maintain close touch with conditions prevailing in their respective districts, and this is the only official relationship of the Federal Reserve System with business, agriculture, and industry.

The members elect, it is true, part of the board, the Board of Governors appoint part of the board, and if the Government owned the stock there would be no particular basis on which member banks would select men to serve on the boards of these respective banks. In fact, I think the relationship should be encouraged rather than discouraged, and I have been able to find no sound reason for the Government to acquire the stock in the Federal Reserve banks unless the ultimate objective is to destroy the independence of the System and make it merely a Government bureau.

The Subcommittee accordingly sees no reason why this memo and link should be disturbed as long as it continues to serve a useful purpose.

2. *Disposition of the Earnings of the Federal Reserve Banks.*—The gross earnings of the Federal Reserve banks are derived from the exercise, under exclusive privilege granted by Congress, of public functions (including the issuance of money) of an intrinsically lucrative character. After the payment of necessary expenses and of dividends on private capital, they are the property of the Federal Government, subject to the disposition of Congress. No stockholder of the Federal Reserve banks or any other person has any legal or moral interest in these earnings beyond his right to receive dividends in the amount determined by statute.

At the present time the Federal Reserve banks pay 90 percent of their net earnings after dividends to the Treasury in accordance with an order of the Board of Governors issued pursuant to an obscure and long-dormant provision of law (Sec. 16 of the Federal Reserve Act, 4th paragraph) authorizing the levy of interest on the amount of Federal Reserve notes not covered by gold. While the Subcommittee approves of the action of the Board of Governors by which this return of earnings to the Treasury is now being made, it believes that it would be better if provision for such return were made by straightforward legislative action. It recommends, therefore, that legislation be enacted providing that 90 percent of the earnings of the Federal Reserve banks after expenses and statutory dividends be paid to the Treasury as a franchise tax. It recommends that the remaining 10 percent of earnings be allowed, for the time being, to accumulate in the surpluses of the several banks in order to permit the capital funds of the System to increase with the economic growth of the country and to provide a buffer against possible losses in future open-market operations.

3. *Tax Exemption of the Dividends on Federal Reserve Bank Stock.*—Dividends paid on the stock of the Federal Reserve banks are at the present time tax exempt, provided that the stock was issued on or before March 28, 1942. Otherwise, such dividends are taxable in the same manner as other income (*Hearings*, p. 911). This differentiation is presumably (the Committee Reports are not explicit) based on that in the Public Debt Act of 1941, which provided that the interest on United States securities issued after February 28, 1941, should be subject to Federal income taxation but did not disturb the exemption of securities outstanding on that date.

The Subcommittee does not believe that the analogy between the contractual tax-exemption provisions of United States securities and the statutory tax exemption of dividends on stock of the Federal Reserve banks is well taken, and recommends that the appropriate legislative committees consider the subjection of all dividends on Federal Reserve bank stock to Federal income taxation, either by direct legislation or by provision for the recall and reissue of all outstanding stock of the Federal Reserve banks.

4. *Budgetary and Auditing Procedures.*—The principle that the gross earnings of the Federal Reserve banks after the payment of necessary expenses and dividends are the property of the Federal Government implies the further principle that these funds should be prudently handled and that the expenses charged against them should be no greater than necessary to accomplish the public purposes of the System. This, in turn, leads to a consideration of budgetary and auditing procedure.

The Chairman of the Board of Governors urged very strongly in his testimony to the Subcommittee that the independence of the System depended on its right to use its earnings to pay its expenses as it saw fit, without appropriation from Congress. The Subcommittee is inclined to agree with this observation, *noting that the independence in question is an independence from Congress, not from the Chief Executive:*

As previously indicated, such degree of independence from Congress as the Federal Reserve System enjoys is due to the judgment of Congress that *its own* long-run purposes—which are those of the United States as a whole—will be best served by such a temporary self-denial of a portion of its inherent prerogative. The Subcommittee believes that this policy of Congressional self-denial should be continued, as it is fearful that if the Federal Reserve System were subjected to standard appropriation procedure—with all the structural changes in the System which this would imply—the role of monetary policy in the economic affairs of the Government would inevitably be curtailed and an important bulwark against inflation would be weakened. It does suggest, however, that the Board of Governors should each year submit its budget and the budgets of each of the twelve Federal Reserve banks, together with a statement of performance on the budgets for the previous year, to the Banking and Currency Committees of each House for their information and such action and consideration as they may consider suitable. (The effect of the procedure here recommended would be confined to improving the information of the legislative committees. In the absence of further legislation—which is not here recommended—the Board of Governors and the Federal Reserve banks would continue to conduct their finances without Congressional approval.)

[COMMENT BY SENATOR FLANDERS: I dissent from this recommendation. While the recommendation, if adopted, would, in itself, make no change in the present independence of the Federal Reserve System in the management of its finances, I believe that the necessity for this closer surveillance has not been demonstrated and that it might prove an entering wedge for a subsequent impairment of the System's independence.]

The Subcommittee's questionnaire asked the Chairman of the Board of Governors to describe the auditing procedures of the Federal Reserve System. This description appears on pp. 307–314 of the *Com-*

pendium. It consists briefly of provision for internal audit in each of the twelve Federal Reserve banks, an annual audit of each bank by examiners from the staff of the Board of Governors, and a semi-annual audit of the Board of Governors by examiners from the staff of one of the Federal Reserve banks designated for this purpose by the Board. The Subcommittee made no further examination of the details of this procedure, but is inclined to question the adequacy of what is essentially a self-audit. It, therefore, commends the action of the Board of Governors (taken before the submission of the answers to the questionnaire) in employing an outside firm of public accountants to audit the accounts of the Board. It does not consider this action sufficient, however, and recommends that the law be amended to provide that an annual audit of the accounts of the Board be made by the General Accounting Office. It recommends, however, that this should be a post-audit only and that the authority of the Comptroller General should be limited to reporting to Congress any expenditures or other actions of the Board which he considers to be improper and making such suggestions as he considers appropriate. It believes that a full copy of such audit, including all confidential sections, should be filed with the Committees on Banking and Currency of each House for consideration in executive session, directly or through subcommittees, and for such subsequent action as they consider appropriate. It does not see how such an audit could in any way impair the desirable degree of independence of the Board of Governors.

The audit of the individual Federal Reserve banks is more important and involves greater problems. The Chairman of the Board of Governors urged upon the Subcommittee (in executive session) that a mandatory audit of the individual banks by the Comptroller General would be an affront to the directors of the twelve banks and would alter essentially the present character of the System. The Subcommittee has given sympathetic consideration to this plea on the part of the Chairman, but is nevertheless not satisfied with the present procedure. It suggests as a possible compromise that the law be amended to require that each Federal Reserve bank be audited at least annually by an outside auditor nominated by its Board of Directors and approved by the Board of Governors, and that the law be further amended to authorize the General Accounting Office to perform such audits, if requested, charging therefor a fee equal to their actual cost including overhead expenses as (finally) determined by it. The report resulting from each audit of a Federal Reserve bank, by whomsoever performed, including all confidential sections, should be filed with the Banking and Currency Committees of each House in the same manner as previously suggested for audits of the Board.

[Comment by Senator Flanders: I concur in this recommendation so far as it applies to the audit of the Federal Reserve banks. I believe, however, that the Board of Governors should have the same freedom as here proposed for the Federal Reserve banks in choosing its auditor.]

V. THE GOLD STANDARD

Since the passage of the Gold Reserve Act of 1934, the international value of the United States dollar has been definitely tied to a fixed amount of gold. This amount of gold has been 1/35th of a fine ounce continuously since January 31, 1934. According to a legal opinion submitted to the Subcommittee by the counsel for the Board of Governors of the Federal Reserve System (*Hearings*, p. 139), it cannot be changed except by act of Congress, nor can the corresponding price of gold ($35 an ounce) be changed without act of Congress except for a narrow margin between the authorized buying and selling price set by the International Monetary Fund in accordance with the Articles of Agreement of that organization as approved by Congress in the Bretton Woods Agreements Act of 1945. This international value of the dollar is implemented by the willingness of the United States Treasury to sell gold to, and buy gold from, foreign governments and central banks in such amounts as may be necessary to maintain the international value of the dollar. As a consequence, the dollar is a "hard currency" acceptable throughout the world and is convertible into all other currencies at not less than its par value.[1] There can be no question of the continuing ability of the United States to make good on its commitment to preserve this convertibility because of the strength of our export trade and because our official gold stock is much larger than our quick liabilities abroad plus any balance of payments deficits which we might incur and have to meet in gold.

United States currency, however, is not redeemable in gold coin or bullion, either for domestic holding or for private holding abroad (as far as the latter comes directly under the purview of the United States at the time of export). This matter was considered by the predecessor subcommittee under the chairmanship of Senator Douglas, which said (*Report of the Subcommittee on Monetary, Credit, and Fiscal Policies*, p. 3):

> We believe that to restore the free domestic convertibility of money into gold coin or gold bullion at this time would militate against, rather than promote, the purposes of the Employment Act, and we recommend that no action in this direction be taken * * *.

This Subcommittee has given further consideration to the advisability of restoring the free domestic convertibility of money into gold coin or gold bullion and concludes that such a policy would be unwise either at the present time or as an ideal for future action.

[1] The Canadian dollar at the time of writing stands at a premium of over 2 cents relative to the United States dollar. This premium is, of course, much greater than the cost of shipping gold from New York to Montreal or from Washington to Ottawa (greater, that is, than the "gold export point" under the traditional gold standard) and it may, therefore, appear that the United States dollar is not convertible into the Canadian dollar at par. The difficulty, however, is that, while the United States has declared a legal par value for its dollar in terms of gold to the International Monetary Fund in accordance with the Articles of Agreement, and is willing to buy and sell gold in any amounts necessary to implement this par value, the Canadian government at the present time has no *legal* par value for its dollar in terms of gold and is not willing to buy or sell gold (in the present case buy gold) in order to implement the *traditional* par value of 100 Canadian cents equals 100 American cents.

The official gold stock of the United States amounted at the end of March 1952 to about $23.3 billion. This is less than 13 percent of the total privately-held money supply (deposits adjusted plus currency outside of banks) of $182.9 billion on the same date. This means that an undertaking to redeem money in gold would be one which the Government could meet only in fair weather when persons having the right to demand gold were not disposed to do so. As the ratio between gold and money supply is not likely to change radically in future years (the total gold stock of the world, including that in private hoards as well as in official reserves, is probably less than one-third of the present United States money supply[2]), a return to the free domestic convertibility of money into gold would represent as much of a gamble at any future date as it would now.

The advantages of the United States continuing on an international gold standard are manifest. Gold is the most generally acceptable medium for the settlement of international balances that the world has yet been able to devise, and the certainty that the United States will always pay or accept any balances due on international account in gold makes the dollar a universally acceptable means of payment in world trade. It is a major aim of the international economic policy of the United States to promote the sound growth of multilateral trade and to discourage bilateral and discriminatory trade practices. These are fostered by non-convertible currencies, and one of the most important things which the United States can do to promote multilateral trade is to continue the international gold convertibility of its own currency and to encourage and assist other countries in making their currencies convertible. This is the effect of the present international gold standard of the dollar. The restoration of domestic convertibility—which would tend to draw additional gold stocks to the United States—would increase the difficulties in the way of other countries which are now striving to restore the external convertibility of their currencies and so would place further obstacles in the way of the healthy growth of multilateral world trade.

In the domestic field, however, the risks of gold convertibility are high and the advantages are questionable. It has already been pointed out that the present gold stocks of the United States are less than 13 percent of the privately-held money supply and that there is little prospect of this proportion increasing materially in the future. It is true that this proportion was often even smaller in past years. At the end of June 1929, for example, the monetary gold stock of the United States amounted to only 7.3 percent of the money supply on that date.

The limited stock of gold relative to the possible demands on it if we should return to domestic convertibility is in fact the heart of the argument *in favor of* such a return, as the case is often put. A return to domestic gold convertibility is meant as a means of disciplining the Government. As Professor Walter E. Spahr said in his answer to a question of the earlier subcommittee under the chairmanship of Senator Douglas.[3]

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[2] The total world stock of refined gold is estimated at about $60 billion (at $35 a fine ounce) of which somewhat less than $40 billion is in official stocks and about $20 billion is in private hands. The gold in private hands includes that in the form of jewelry, etc., and other *bona fide* industrial and artistic forms, as well as that held in private hoards.

[3] *A Compendium of Materials on Monetary, Credit, and Fiscal Policies*, pp. 361-362 (Senate Document No. 132, 81st Cong., 2d sess.); quoted in the *Report of the Subcommittee on Monetary, Credit, and Fiscal Policies*, p. 42.

The gold standard with provision for redemption in effect provides a system of golden wires to every individual with dollars, over which he can send messages of approval or disapproval to the central signal board. When our Government took the people's gold and thrust irredeemable promises to pay on them, it cut all these wires to the central signal box. The people were cut off. The lights went out on the central signal system and the people were left helpless. Thus absolute control of the people's gold and public purse passed to their government. The latter had freed itself from receipt of signals of disapproval and from any effective check. The spending orgy is the result. Vote-buying goes on and can go on without let or hindrance. The people are helpless; the Government is the boss; irresponsibility is in the saddle and it cannot be checked. The understanding, concerned, and responsible men in Congress are in the minority and are helpless. Government spending and bureaucracy are out of control. Apparently this course cannot be brought to a halt except by restoring to our people control over their purse. That can be done only by the institution of redeemability of the promises to pay of the Treasury and banks.

The Subcommittee rejects the view that the Government of the United States should be controlled by "a system of golden wires" and reaffirms its faith in the ballot box.

Experience shows, moreover, that these golden wires are more likely to be pulled to prevent the Government from relieving distress in a period of depression than to restrain inflation in periods of prosperity. Attention has already been called to the fact that the monetary gold stock of the United States amounted to only 7.3 percent of the money supply in mid-1929. A serious drain on this gold stock would, through the operation of the fractional reserve system, have caused a disastrous multiple contraction in the money supply. But no one worried about that at the time because no one wanted gold. Confidence was high and people preferred goods and stocks and real estate. The internal convertibility of the dollar in no way restrained the inflationary stock and real estate markets of the twenties. It was not until the deepest part of the depression, just prior to the Bank Holiday, that the internal drain on gold gained momentum and contributed to the collapse of our monetary system. In the meantime, the necessity of being prepared for such a drain had contributed materially to the inactivity of the monetary policy of the Federal Reserve System—which had, for the most part, stood idly by watching the monetary base of our economic system ebb away.

The messages coming over the golden wires were not helpful during either the twenties or the thirties. They had often been wrong before. Wide extremes of boom and depression and of high and low prices occurred repeatedly during the many years of gold convertibility. During periods of expansion the messages coming over the wires were usually those of approval of expansionary policies; during periods of depression the messages were those of disapproval of all expansionary efforts toward recovery. Gold convertibility when we had it did not contribute to sound monetary policy, and it is sound monetary policy which promotes economic stability.

As Mr. Allan Sproul, President of the Federal Reserve Bank of New York, said to the Annual Convention of the American Bankers Association in San Francisco in November, 1949:[4]

* * * We had an embarrassing practical experience with gold coin convertibility as recently as 1933 when lines of people finally stormed the Federal Reserve banks seeking gold, and our whole banking mechanism came to a dead stop. The gold-coin standard was abandoned, an international gold bullion standard adopted, because repeated experience has shown that internal converti-

[4] Mr. Sproul stated at the *Hearings* (p. 539) that his views on this matter were exactly the same as in 1949. The address is reprinted on pp. 543–552 of the *Hearings;* the quoted portion is on p. 548.

bility of the currency, at best, was no longer exerting a stabilizing infiuence on the economy and, at worst, was perverse in its effects. Discipline is necessary in these matters but it should be the discipline of competent and responsible men; not the automatic discipline of a harsh and perverse mechanism. If you are not willing to trust men with the management of money, history has proved that you will not get protection from a mechanical control. Ignorant, weak, or irresponsible men will pervert that which is already perverse.

The Subcommittee agrees with Mr. Sproul; a return to the domestic convertibility of gold would be equivalent to a vote of no confidence in the monetary authorities of this country, including both the Treasury and the Federal Reserve System. It would represent an abandonment of the policy of the Employment Act of 1946 and the ideals for which it stands. It would turn the monetary navigation of the United States over to an automatic pilot which took no account in its computations of human suffering and unemployment. The Subcommittee does not believe either that a return to domestic convertibility is now opportune or that it should be accepted as an ideal for the future.

STATEMENT OF VIEWS BY SENATOR DOUGLAS

The work of the Subcommittee on General Credit Control and Debt Management has made a valuable contribution to the understanding of problems in the fields of monetary policy and the national debt. I count it an honor to have been a member of the Subcommittee and wish to acknowledge the splendid accomplishment of its Chairman, Representative Wright Patman, and the highly competent services of its staff. Let me also acknowledge with a sense of appreciation the generous treatment that the Subcommittee's present report accords to the work of the Subcommittee on Monetary, Credit, and Fiscal Policies, of which I served as Chairman, now somewhat more than two years ago.

There is much in the present report with which I am in cordial agreement. There is also much to which I take so little exception that special comment is not in point. However, there are at least two points in the analysis that seem to me to be erroneous in their implications, one point of suggested policy that seems to me certain to prove mischievous, and several recommendations that tend in a general direction contrary to my own point of view. There is sufficient difference of emphasis between the report and my own thinking that I believe my best contribution to the work of the Subcommittee can be made by this separate statement, in part reviewing and restating, and in part clarifying my own position.

Two Matters of Analysis

1. In the report's review of events since the outbreak of the North Korean attack, attention is drawn to the world-wide rise in the prices of certain volatile, internationally-traded raw materials.

Internal versus external factors after Korea

It is said that the intention is merely to indicate the magnitude of the inflation problem. But the effect of the emphasis appears to involve an implicit argument not so much about the magnitude as about the nature of the problem. It is assumed that some factor was operative *outside* the United States inevitably making for a rise of prices *within* the United States, and that our own monetary policy, therefore, probably had but a minor influence in producing the inflation. If I correctly appraise its implications, this emphasis minimizes the efficacy of the restraining monetary policy, which we might have adopted, and condones the unrestrained policy that we actually pursued.

There is doubtless some truth in the allegation that the outbreak of the Korean war necessarily created world-wide excitements and fears, which in a degree, were unrelated to the United States monetary policy of the moment. It must be remembered, however, that the United States is a dominant buyer in the world market for most internationally traded raw materials. A flight from the American

dollar into goods and commodities, therefore, would have an extremely important causative influence on the world prices of these materials. An inflation of credit in the United States, which permitted and encouraged such a flight from the dollar, either domestically or internationally, would therefore seem to me to be a powerful contributing factor to the world-wide inflation noted in the report.

Short-run versus long-run considerations

2. The report concedes that changes in the money supply have a decisive influence on the price level, but it qualifies this by saying that this principle is true only in the long-run. The implication would thus be that monetary policy is relatively unimportant in the short-run.

This implication, if I sense it correctly from the Subcommittee's report, is one that I cannot accept. The long-run, after all, is made up of short-runs. If it be assumed that monetary policy has *no* effect in each of a series of short-runs, then it can have no effect in the long-run.

Money supply and the willingness to save or spend

I would admit, of course, that the willingness of people to use or hold money is not entirely dependent on increases or decreases in the supply of it. A war scare, for instance, might well cause people to spend money that they would not spend in the absence of such an influence. However, even though such a factor might, if powerful enough, cause prices for a time actually to move contrary to changes in the supply of money, I am strongly of the opinion that increasing or decreasing the money supply would nevertheless materially affect the expectations of people with respect to the value of their money and, hence, would materially affect the magnitude, and usually the direction, of short-run price level oscillations.

The discussion of this point is important because of its bearing upon monetary policy. If the report's contention is true, that there is no direct relation between money supply and prices in the short run, then we would be precluded from ever using monetary policy to curb an inflation, for in practice we are always confronted, in fact, only with the short run.

Actually, at any particular point in time, we must act with respect to monetary policy on one of three possible assumptions. If it is assumed that there is *no* probable, direct, short-run relation between the money supply and prices, then we would be wasting time, when confronted with an immediate situation, in giving any consideration at all to the possible effects of changes in the money supply. On such an assumption, reliance would necessarily have to be placed on the direct control of the economic system rather than on general monetary and credit controls, which the report says should be the principal and primary means of achieving stability.

Or, it may be assumed that there is an *inverse* relationship between money and prices. If this were true as a general proposition, we would be led into such absurd policies as, on the one hand, contracting the money supply when prices are falling, in order to raise the price level, or, on the other hand, flooding the country with money when prices are rising, in order to prevent an inflation.

There remains, then, only one sensible assumption. This is the assumption that even in the short run the probabilities are overwhelmingly in favor of prices moving directly with changes in the

money supply, although, perhaps, with some occasional time lag. If we thus act on a sensible assumption in each and every short run, I am sure we would also, as short runs inevitably succeed each other, make sense in the long run.

Flight from money after Korea influenced by previous monetary policy

In the situation immediately following the North Korean attack, I would willingly agree that restraint on the money supply alone might not have completely controlled the rise of prices. The memory of war shortages was everywhere in the minds of consumers and producers. The people of the United States, and the peoples of the world, had experienced more than a decade of inflationary finance. The American economy was awash with money, as a number of witnesses in the Hearings observed. In such a situation, I can agree with the Subcommittee report that a certain rise in the general price level, as people fled from money to goods, was probably inevitable. This circumstance, however, does not minimize but emphasizes the importance of monetary policy.

The readiness of the American people to fly frantically from their money was itself importantly conditioned by the preceding inflationary monetary policy—a policy that was in some measure necessary during the war years but was, to my mind, inexcusable in the postwar period. In large part the American people fled from their money after Korea because they had learned from many years' experience that nothing effective ever seemed to be done to protect the holders and savers of money by restraining an inordinate increase in its supply. Precisely because of the preceding lax, confused, and imprudent monetary record, the immediate post-Korean situation demanded prompt monetary restraints.

I believe that prompt and determined action, quite within the range of practical policy, would have materially altered people's expectations regarding the desirability of holding or saving money, even granting the preceding experience, and would thus have materially dampened down the inflationary oscillation that actually occurred. The failure to take restraining measures promptly, and the actual supplying of more than a billion dollars of additional bank reserves, which further encouraged the flight from money to goods, was in my judgment a gross blunder, which far outweighed any offsetting gains to the American economic system.

A Matter of Policy

The Subcommittee clearly stresses the fact that there are two attitudes of mind with regard to the Government bond market—one being that the Government should borrow at rates established by the market, submitting itself to the same disciplines as private borrowers; the other being that the Government, in its borrowing activities, should have an insulated market. This problem goes to the very heart of many issues but receives less attention in the Subcommittee's report than it deserves.

We had, in fact, for many years been giving the Government a protected market for its borrowings, a policy that was discontinued only recently. As a direct result, we produced a serious inflation. Indeed, it was the inflation growing out of this effort to insulate and protect the

Government's market that originally gave pertinence to this inquiry and to the deep public concern for the value of the dollar.

The word "insulation," as used in the Subcommittee's report, is soft, pleasant, and enticing, and the report is quick to point out that it wants the insulation to be reasonable. The word "rigging" would be harsh, brutal, and repulsive. Yet I think the truth is, if we are not very careful, that the principle of insulation will become the practice of rigging. We will have the creation of an artificial market by devices resolutely denied to private firms but eagerly adopted, in the future as they have been in the past, by the Government itself.

The evils of a protected bond market

The principle of insulation presents the grave danger of evils that are catastrophic in their realization. One danger is that the Government cannot, in the end, produce rigged markets for its own securities and then hold the private economy to a standard of financial morality that it refuses for itself. The end result of such a double standard of financial morality is simply the destruction of confidence in the integrity and purposes of Government. A particular phase of this destruction of confidence relates to the Government's credit: insulated and rigged markets do not in the long run maintain but rather destroy the credit of the Government.

Another evil of an insulated and rigged market is that the Congress and the Executive in their financial planning, not merely with regard to the total of expenditures but especially in weighing the advantages of taxation versus those of borrowing, become deceived regarding the cost of borrowing. Another great evil, finally, is the one we have already experienced. In practice, the principle of insulation simply means that whenever the public is unwilling to surrender its money voluntarily on the terms and conditions that the Government offers, the "insulation" comes to consist merely in the creation of new and additional supplies of money to take the Government's securities off the market.

The process of bank credit expansion

Let us remember the process by which this comes about. When the Federal Reserve System feels compelled to support the price of Government securities in the interest of maintaining yields below the market rate, it does so by purchasing Government securities with its own newly created credit. This credit appears in the form of enlarged reserve balances of commercial banks. In this form it provides the basis for a multiple expansion of loans and investments by the banks. When this new money, created by the banks on the basis of their enlarged reserve balances, goes into the hands of the borrowing public, it is used to buy goods and services. If the resources of the country are already fully employed, the expenditure of this new money can have little or no effect in increasing production. It serves, rather, merely to bid up the prices of the relatively fixed supply of existing goods and services and thus generates inflation.

It seems to me that this process of creating bank reserves and new money, merely for the purpose of giving the Government a protected securities market, often in contradiction of more fundamental considerations, has gone quite far enough in our country. There is one method of protecting the market for its securities that the Government properly possesses: the power to tax. I believe this is a

sufficient protection, since it gives the Federal Government a prodigious advantage over any private borrower, and we will do well resolutely to avoid all enticements looking to other kinds of insulation, rigging, and pegging. I would regard stability of the price level as far more important to the economic and social well being of the country than any artificially maintained stability of the interest rate.

Government should compete in the money market

The Government is quite able to compete in the money market. If it will but do so, allowing itself only the advantage accruing to Government as the ultimate taxing power, we shall then be in a position to permit our monetary authorities to reduce or restrain the growth of the money supply when a plethora of money is producing an inflation and, by the same token, to increase the money supply in a deflationary situation—when the increased money would not only affect prices but also call into use idle manpower, plant, and materials, and hence increase the real national income iteself.

The market for Government securities would thus obviously be affected from time to time, both directly and indirectly, by the monetary policy pursued by the System. But the purposes, criteria of success, and tests of action by the System would differ fundamentally from those that would be applicable if we followed the principle of insulating the Government securities market. The Executive and Congressional branches of Government, moreover, would thus be in an obviously better position to use intelligently a compensatory fiscal policy, which was discussed in considerable detail in our report of 2 years ago.

The Recommendations

It has seemed to me urgently necessary that the Federal Reserve System, if it is to have its present or increased monetary powers, must also have (*a*) an independence clearly sufficient to prevent its coercion, of course, by any private interest or, what is equally important, by the Executive Branch of Government; (*b*) its monetary responsibilities sufficiently fixed in law, and sufficiently differentiated from those of other agencies of Government that the monetary responsibilities of the System are clear to other agencies, to the public, to Congress, and to itself; and (*c*) the principles of its action also sufficiently fixed in law that they will be known to the Executive, the Congress, the public, and, above all and most important, to the Federal Reserve System. It is only in these terms that I am able to think of the independence of the System and to judge proposals for its reorganization; for, as the report correctly observes, the problem of independence cannot be discussed in a vacuum but can only be meaningfully discussed in terms of independence to do what, when, and how; and, I must insistently add, in terms of *responsibility* for doing what, when, and how.

The several recommendations of the Subcommittee, in the light of my preoccupation with independence for the Federal Reserve System in the terms I have stated, fail to go to the heart of the problem. The report, for instance, suggests increased powers over bank reserves; a smaller Board of Governors; a consultative council on monetary problems, established by Executive Order; a closer and clearer dependence of the Chairmanship of the Board on the term of the

President; and shortened terms for the members of the Board of Governors.

Individually the recommendations are not of fundamental importance

These recommendations, with the probable exception of the one regarding reserve requirements, are not, to my way of thinking, matters of any great substance. None of them represents a point that I would care at this time to argue individually or at length. In the present state of confusion regarding responsibilities and principles of action, however, the total effect of these recommendations is not, as the report asserts, to leave the System "about as it is" with regard to independence, but they actually serve to weaken it substantially.

For instance, power over reserve requirements is a useful tool and supplementary instrument of monetary policy. If used to "insulate" the Government bond market, however—in short, if used to create a captive and coerced market—it could prove utterly mischievous. A smaller Board, with shortened terms, might be a more effective working body if the principles and responsibilities of monetary policy were clear. Lacking such clarity, however, these recommendations, together with the clearly indicated dependence of the Chairmanship upon the Presidency, and the proposed abolition of geographical qualifications for Board members, would simply mean that in practice the Board of Governors would be effectively brought into subservience to the currently ruling Executive and his political purposes.

The proposal for a consultative council (though I am shocked at the suggestion that the Council be established by Executive order) could be a most useful instrument if, again, there were clarity regarding responsibilities and principles. In the absence of such clarity it would be, to all intents and purposes, simply another method of bringing the System under the domination of the President and of the party in power.

Collectively they can be dangerous in absence of a policy mandate

As I appraise them, then, these recommendations might, under other circumstances, represent desirable but minor changes. Nevertheless, I believe them to be dangerous in the absence of a clear mandate making the Board of Governors fully responsible for the monetary policies it pursues and in the absence of a statement of the general principles of monetary policy for which the System is accountable. This, to be sure, is simply a reaffirmation of my opinion, which I want unequivocally known, that the most urgent and paramount business in the field of monetary policy is that of a clear Congressional directive to the Federal Reserve System, to wit, a mandate, as we have come to call it. Without such a clear mandate, setting forth responsibilities and the general terms of policy, there can be no such thing as accountability or evaluation of performance.

I would concede the difficulty of writing a mandate. But if it is alleged that the difficulties are so great that they cannot be surmounted, then that contention is tantamount to saying that we do not know what kind of a general monetary policy we desire; and, if we do not know what kind of a monetary policy we want, then we had better simply abolish the instruments of monetary policy, for they are entirely too dangerous to be used for ill-considered purposes.

What a mandate should consider

A mandate must involve certain considerations:

(*a*) In my opinion, it should make a clear differentiation between the responsibilities of the Federal Reserve System and the responsibilities of other agencies, the Treasury, for instance, because, since both are dealing with money, there is likely to be great confusion regarding the differing responsibilities of each agency.

Treasury-Federal Reserve responsibilities

I note this point for two reasons. The first relates to a most elementary principle of administration: without differentiation of responsibility there can be no accountability. The second reason is the fact that there was a pervasive tendency on the part of some witnesses to adopt the "common responsibility" theory of Treasury-Federal Reserve System relations.

I have noted with care the testimony of Mr. Snyder, the Secretary of the Treasury, and of Mr. Martin, the Chairman of the Board of Governors. I would like to compliment them on the ability and good will shown in their oral testimony and on the contributions that their staffs have made to the work of this inquiry. But I strongly urge that the "common responsibility" theory of Treasury-System relations can, in the end, only result in confusion, misunderstanding, and the avoidance of responsibility. With the best will in the world, this theory leads inevitably to recrimination, to mutual admonition, and to repeated investigations, such as this one, which arises so largely out of the painful and exhausting effort to discover *who* did what, when, why, and to whom.

Fortunately, the necessary differentiation between the responsibilities of the Treasury and of the Federal Reserve System is easily made. The Secretary of the Treasury has a very great responsibility in advising the Congress with regard to problems in the fields of taxation and borrowing. He has a profound responsibility in arranging the maturities of the public debt, the terms and conditions of debt instruments, the coupons that he will offer to the market, and related matters. The Secretary of the Treasury should be (as I believe he is) solely and exclusively accountable in these fields, and he should not be admonished, cajoled, or heckled with volunteered advice by the Federal Reserve System.

On the other hand, the problem of the Federal Reserve System is to regulate the quantity of reserve money that it creates, either through its own investment account or lending activities, and to do so, as I believe necessary, in accordance with principles established in law. It, in turn, should not be admonished, cajoled, or heckled by volunteered advice from the Treasury.

I make these points insistently because I sense in the record of the past several years a tendency for each of the two agencies to be as much interested in the affairs of the other as in its own, to the confusion and detriment of both. In voicing this opinion, I want to make it clear that I am by no means accusing the Treasury and acquitting the System.

"Good fences make good neighbors"

I want to observe that there is a fundamental and unavoidable difficulty in the giving of advice to the System by the Secretary: he

cannot possibly divorce himself from his borrowing problems, and the advice he gives the System will tend to be largely *ex parte*. The System, of course, is in precisely the same position vis-à-vis the Secretary: its advice on terms, maturities, coupons, and so forth, will inevitably be conditioned by its abiding concern with the problem of whether or not the Treasury's action makes more or less difficult the System's regulation of the money supply. The advice given by the System to the Secretary will also tend to be *ex parte*.

In short, I make the point of differentiation of responsibility, and make it insistently, because it seems clear to me that we will have a better end result, and that the Treasury and the System will be better neighbors in the long run, the less they invite themselves in to play in each others' backyards. The proper principle is, "Good fences make good neighbors!"

A norm of action for the Federal Reserve

(*b*) A mandate to the Federal Reserve System must also establish a norm of action in terms of general principles. The norm of action for the Federal Reserve System need not and should not be detailed. No one is nowadays so naive as to imagine that monetary policy by itself can totally abolish the business cycle; but the terms of such a mandate, as I see it, should be clearly written around the intent of Congress that monetary policy be used as a counterweight to cyclical economic fluctuations. That is, it should be the clear intent of the Congress, I believe, that the System shall use its powers to increase the money supply in times of depression and to diminish or restrict the expansion of the money supply in times of boom. The recognition of boom and depression, at least in their grosser symptoms, is surely not now beyond the Board of Governors and its staff, if they are not bewildered by other and irrelevant considerations. The levels of employment, production, and substantial stability of the general price level: These will suffice.

If it is said, as I am sure it will be, that a monetary policy based upon such a mandate may not be perfect, then I want to say quite emphatically that it will be infinitely better than what we have been treated to these past several decades, and that the Congress will have, at the very least, a benchmark for judging the performance of the Federal Reserve System and a basis for adjusting Congressional policy directives to the System in the light of experience.

Mandate should be in Federal Reserve Act

(*c*) In my opinion, a mandate to the Federal Reserve System regarding monetary policy should be placed directly in the Federal Reserve Act. The mandate should not be inferential, implicit, or interpretative.

Inferences and interpretations are subject to change without notice and are quite certain to be given a secondary significance. The monetary confusions of these latter years seem to me to have carried us far beyond the place in history where a mandate might satisfactorily have rested on interpretation of the Full Employment Act or be subordinated within the language of that law.

If there is to be a mandate to the Federal Reserve System—and I have made it clear that I believe there must be—then I urge that we should have the forthrightness to tell the Federal Reserve System,

directly, in its own legislative charter, what it is that we expect—what we expect the System to contribute toward the maintenance of stable price levels, and high-level employment, and by what means.

On the record of the past several years it seems quite clear to me that the Federal Reserve System—through no basic fault of organization, structure, or personnel—has been quite confused regarding its responsibilities and the fundamental reason for its being. I do not believe that this situation can now be corrected by inference or indirection.

Let me close by a further word of congratulation to an esteemed colleague, Representative Wright Patman, whose conduct of the hearings was the very model of fairness.

PAUL H. DOUGLAS.

I concur in the views expressed by Senator Douglas.

JESSE P. WOLCOTT.

STATEMENT BY MR. WOLCOTT

I concur with the views expressed by Senator Douglas and find them to be quite consistent with the report of the Monetary Subcommittee of 2 years ago to which I agreed, with certain "footnote" exceptions and reservations.

In regard to the current report, there are a number of items on which I desire to take exception or to express supplementary comment. These, I believe, cannot be adequately treated by footnotes in the text and will require some time on my part to formulate them. I shall therefore avail myself of the privilege offered by the chairman to issue a statement of views at a later date.

I regret that pressure of work in the Banking and Currency Committee and on the House floor for some weeks past has made it impossible to present my additional views at this time. Moreover, I feel that the questions of monetary policy and debt management are of such major importance that I do not wish to express myself on them in report form without careful and adequate consideration of the committee's report as well as the formulation of such differing or supplementary views as I may feel to be justified.

Since it is indicated that the committee's report is to go to the printers tomorrow (June 26), I do not desire to delay its publication. When the current pressure of work of the House is completed, I shall then have the opportunity to consider the report carefully and formulate my statement on these matters for release as soon as possible thereafter.

JESSE P. WOLCOTT.

APPENDIX

Treasury-Federal Reserve Accord

The Treasury-Federal Reserve accord of March 4, 1951, was described to the Subcommittee in identical language by the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System. This description is as follows (*Compendium*, pp. 74–76 and 349–351):

Throughout the period from August 1950 to February 1951, there were frequent consultations between Federal Reserve and Treasury officials, and on some occasions with the President, concerning the coordination of monetary and debt management policies. These discussions preceded the working out of the accord between the Treasury and the Federal Reserve concerning policies that deal with their related problems.

The following joint announcement was made on March 3, 1951, for publication March 4, by the Secretary of the Treasury and the Chairman of the Board of Governors and of the Federal Open Market Committee of the Federal Reserve System:

"The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt."

This statement reflected agreements that had been reached, following extended discussion between representatives of the two agencies, regarding their mutual and related problems. The presumed area of difference had become greatly magnified in the newspaper and other public discussion and there was urgent need to reassure the public that the Treasury and the Federal Reserve were in agreement as to proper debt management and monetary policies in the situation then existing.

The Treasury and Federal Reserve felt that everything possible should be done to terminate the unwholesome situation that had developed and to coordinate the debt management responsibility of the Treasury with the Federal Reserve responsibility for restraining credit expansion. It was the immediate object of the Treasury to restore conditions in the market that would be favorable to refinancing the large volume of maturing obligations, as well as financing several billions of new money required during the remainder of the year. It was the immediate object of the Federal Reserve to endeavor to curb the unprecedented inflationary loan expansion that had continued uninterruptedly since Korea by minimizing the monetization of the public debt and by making it necessary for member banks to borrow from the Federal Reserve in order to obtain additional reserves. With these basic objectives in view, representatives of the fiscal and technical staffs of the Treasury and the Federal Reserve had been designated to engage in a series of discussions and to formulate a proposal which might serve as a basis for policy decision.

The discussions between the Treasury and the Federal Reserve had made it clear that there were many areas of agreement between the Federal Reserve and the Treasury with respect to the solution of these problems; that the cooperation between the Treasury and the Federal Reserve had been of exceptionally high order on most matters of mutual concern; that there are bound to be differences of opinion now and then between agencies, as there are between individuals in the same agencies; but that such differences could be diminished by closer, regularized liaison with respect to mutual 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, and 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 sale daily 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 2¾ percent, 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 the monetization of the public debt through liquidation of outstanding holdings of the Treasury bonds of 1967–72. The Federal Reserve agreed to help the Treasury in explaining to large institutional investors the nature and purpose of this new issue. The extent of the acceptance of the offering testified to the success of this joint endeavor.

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; and that if sales on the market were excessive, the situation would be assessed daily, the market would be kept orderly, and open market purchases, 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 both for the Treasury and for the Federal Reserve. 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. This contemplated a level of short-term interest rates which, in response to market forces, would fluctuate around the Federal Reserve discount rate. It was expected that during the remainder of the year the Federal Reserve discount rate, in the absence of compelling circumstances not then foreseen, would remain at 1¾ percent and that the Federal Reserve would operate to assure a satisfactory volume of exchanges in the refunding of maturing Treasury issues.

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 that it would be some time before such funds would accumulate. It was agreed that more frequent conferences between the Treasury and Federal Reserve 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.

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