Monetary Policy for United States Rearmament

by

L. V. CHANDLER

1. — For more than a year prior to the invasion of South Korea in June 1950, the controversy over monetary policy in the United States had been quiescent. While inflationary pressures were in abeyance and many feared a deepening depression, few opposed an easy-money policy. The maintenance of low interest rates and high prices for both government and private debt obligations did not conflict with the objective of general economic stabilization. But the situation changed abruptly after the Korean outbreak and the United States decision to intervence. The ensuing rush of consumer and business buying was financed partly by a more rapid turnover of existing money and partly by an expansion of the money supply. Between May 1950 and the end of the year the money supply rose by $ 8 billion, due almost entirely to the expansion of bank loans. Dishoardings out of idle money balances also contributed to the increase of expenditures. In response to this rise of private spending, augmented after late 1950 by an expansion of government purchases, the cost of living rose 9 per cent and wholesale prices 16 per cent between June 1950 and March 1951.

With the resurgence of inflationary pressures the controversy over monetary policy, which had been continuous from 1945 through 1948, flared anew. And the major issue was the same as that in the earlier period: Should general monetary policy be made more restrictive to combat inflation, or should an easy-money policy be continued to promote other objectives? The popular press dramatized the controversy as an institutional conflict between the Federal Reserve and the Treasury, with the former championing a more restrictive policy and the latter insisting on a continuance of low interest rates and stable prices for government debt obligations. Though the institutional conflict was important, the issues were more fundamental. The principal questions were these: What should be the dominant objectives of monetary policy? How effective is general monetary restriction as an anti-inflationary device? What should be the relative roles of general monetary restriction, selective credit controls, fiscal policy, and direct price and wage controls in an over-all economic mobilization and stabilization program?

I

2. — During the period since the Korean outbreak, as during the 1945-1948 inflation, the general monetary policy of the United States has been shaped by three major, and often conflicting, considerations: (a) Prevention of inflation, (b) facilitation of Treasury finance, and (c) promotion of maximum production and employment.

(a) Those favoring what may be called « the conventional type of peacetime monetary policy » demanded a restrictive credit policy to prevent or at least retard inflation and insisted that the availability of credit could not be effectively curtailed unless interest rates were free to rise to some extent. They therefore insisted that the Federal Reserve terminate its policy of stabilizing the prices and yields on federal obligations by passively purchasing all offered to it.

(b) Such proposals for a more restrictive general credit policy were vigorously opposed by those concerned with Treasury finances; the latter wanted a continuously easy-money policy to facilitate the government's financing and refinancing operations. They pointed out that higher interest rates would increase carrying charges on the federal debt, but they were even more concerned about the effects of fluctuating government security prices on the success of the Treasury's refunding and new borrowing operations. Many feared that declining bond prices would set off an avalanche of panicky selling, and that the Treasury would encounter difficulty in refunding its maturing obligations and in selling new issues to cover any deficits that might appear during the rearmament period. The possibility that the limited Korean outbreak might widen into a third world war enhanced these fears. Thus, considerations relating to stabilizing the prices and yields on government debt obligations and facilitating Treasury finance have been a powerful deterrent to the adoption of more restrictive monetary policies to prevent or control inflation.

(c) Considerations relating to the promotion of maximum production and employment have been the second major obstacle to the adoption of a more restrictive monetary policy. During the 1945-1948 inflation, when many Americans still feared a return to the deflationary conditions of the 1930's, the opponents of monetary policy restrictive enough to halt price inflation might touch off a spiralling deflation. Since the Korean outbreak this argument has been modified. Few now fear a serious deflation during the rearmament period. The argument now is that a restrictive general monetary policy would reduce the availability of money not only for « nonessentials » but also for rearmament and essential civilian purposes, thereby damaging the entire defense program. What is needed, many have claimed, is a continued easy-money policy to assure plenty of low-cost money for rearmament, essential types of private capital formation, and essential types of consumer goods, but with special selective controls to hold down spending for nonessentials.

3. — Though the basic source of the controversy over monetary policy in the United States is to be found in the conflict among the objectives of preventing inflation, of facilitating Treasury finance, and of promoting production and employment, the controversy has been intensified by disagreements as to the *modus operandi* and effectiveness of monetary policy. On this important and difficult subject there are many shades of opinion. At one extreme are numerous economists, Treasury officials, and others who believe that monetary restriction can exert a significant anti-inflationary effect only if it produces very large increases in interest rates. Those who take this position usually assume that restrictive policies operate only through increases in interest rates, and that very large increases in interest rates are required to decrease significantly the effective demand for credit. Moreover, many of them believe that a policy restrictive enough to halt inflation, or even retard it to an appreciable extent, will seriously upset security markets and decrease employment and production. It is easy to see why those adhering to this position oppose the use of general credit restriction. Many others, however, are much more optimistic as to the usefulness and feasibility of a restrictive policy. They believe that a restrictive policy can be an effective restraint on inflation without large increases in interest rates, without large declines in the prices of outstanding debt obligations, and without serious downward pressures on real output and employment. Though insisting that a restrictive policy can be successful only if interest rates are free to rise, they contend that the actual anti-inflationary effects are achieved largely through various credit-rationing devices used by lenders to reduce the availability of credit rather than through the rise of interest rates as a cost of borrowing. Federal Reserve officials and others who share their belief have therefore maintained that monetary restriction can have beneficial effects as an inflation preventative without intolerably large increases in interest rates and without serious declines in the prices of outstanding debt obligations. There is still far from unanimous agreement on this issue, but general opinion seems to have shifted toward the Federal Reserve point of view since 1950.

4. — General monetary policy during the rearmament period has also been strongly influenced by the continuing controversy over the relative roles of general monetary policy,

selective credit controls, fiscal policy, and direct price and wage controls in the overall economic mobilization and stabilization program. All parties to the controversy have repeatedly affirmed their opposition to inflation and have insisted that their conflicts reflect only differences of opinion as to the most appropriate means of coping with the inflation problem. But they have differed widely as to the relative importance that they accorded to the various methods. Some would rely largely on one method; others would use two or more of them in combination. Selective credit controls have been urged both as a substitute for general monetary restriction and as a supplement to it. For example, the Council of Economic Advisors urged the continuation of a policy of low interest rates and a highly liberal total supply of credit but proposed the use of selective controls to hold down spending for nonessential purposes. The Federal Reserve, on the other hand, favors selective credit controls but only as a complement to general credit restriction. The same is true of fiscal policy. To some a restrictive fiscal policy is an adequate substitute for other anti-inflation measures; to others it is but one part, though an essential part, of a broader program. And competing with all these monetary and fiscal measures to hold down total money demand are direct price and wage controls and other direct governmental controls over the production and use of goods and services. A few extremists consider these direct controls to be appropriate and adequate substitutes for anti-inflationary fiscal and monetary measures; others make less extreme claims for them. There can be little doubt that the widespread advocacy of selective credit controls, fiscal policy, and direct controls over prices and wages has tended to make a more restrictive general monetary policy appear less urgently needed, thereby favoring the continuance of an easy-money policy.

5. — In summary, monetary policy in the United States since mid-1950 has been developing amidst many multi-faceted controversies. These have included: (1) Controversies as to the objectives of monetary policies — the relative weights to be accorded to inflation prevention, to holding down interest charges on the national debt and facilitating Treasury flotations, and to assuring plenty of low-cost money to promote munitions production and essential types of private capital formation and consumer goods. (2) Controversies as to the *modus operandi* and effects of a restrictive monetary policy — the extent to which interest rates would have to be increased to retard inflation to a significant degree and the effects of such a policy on security prices and on output and employment. And (3) controversies as to the relative roles of monetary policy and various other types of measures in the overall economic mobilization and stabilization program. The monetary policies of the United States cannot be understood without reference to these continuing controversies.

II

6. — As would be expected in such a controversial situation, the policies actually adopted have been compromises and they have shifted as conditions changed. It will be useful to sketch briefly the development of these policies, dealing first with general monetary policies and leaving selective credit controls for later treatment.

At the time of the Korean outbreak, as during the entire period since about 1941, the Federal Reserve was implementing its monetary policy primarily through its purchases and sales of government securities in the open-market. In general, it bought and sold in such a way as to maintain the prices and yields on these obligations at levels agreed upon with the Treasury. With respect to the long-term marketable issues, it pegged their prices at a level somewhat above par; the long-term issues had not been permitted to fall as low as par at any time since before World War II, nor had the yields on any marketable issue been allowed to rise above 2½ per cent during the period. With respect to short-term government obligations, the Federal Reserve held yields at a level agreed upon with the Treasury. In June 1950 the yield on 12-month maturities was about 1¼ per cent. Almost immediately after the Korean outbreak the Federal Reserve

and the Treasury began to differ over the level of short-term rates. The Federal Reserve wanted to allow these rates to rise somewhat in order to combat the expansion of credit and the price inflation that were already under way. The Treasury adamantly refused, insisting that rates should be stabilized at their existing level, that the Federal Reserve should avoid « any course which would give rise to a belief that significant changes in the pattern of rates were under consideration », and that it should avoid « introducing any factor which would run the risk of producing unsettlement in the broad market for federal securities ». The Federal Reserve reluctantly acquiesced and the impasse continued, with no rise of interest rates, until mid-August of 1950. At that time, however, the controversy broke into the open when almost simultaneously the Federal Reserve stated that it would use all powers at its disposal to combat inflation and the Treasury announced its intention of offering $ 13½ billion of new short-term securities at no rise of yields. Neither side retreated. To prevent the Treasury issue from failing, the Federal Reserve purchased all of it that was not taken by private purchasers, which proved to be the major part, and sold in the open-market large amounts of its other holdings at prices which represented higher yields. By the end of 1950 yields on 12-month Treasury issues had risen from 1¼ to about 1.45 per cent. Faced with higher market rates as a *fait accompli*, the Treasury raised yields on its later short-term issues.

During the latter half of 1950, and apparently into January, 1951, the controversy between the Federal Reserve and the Treasury was confined to short-term interest rates. Though pressing for higher short-term yields, the Federal Reserve did not at any time during this period suggest that long-term federal bonds be permitted to fall below par or that yields on the longest-term issues be permitted to rise above 2½ per cent. But as the general level of prices continued to rise the Federal Reserve in early 1951 became restive; it proposed for the first time that prices on long-term governments be permitted to fall below par. To this both the Treasury and the president were strongly opposed. The Secretary of the Treasury publicly announced that no marketable issue during the rearmament period would yield more than 2½ per cent, and the president personally requested the Federal Reserve to cooperate with the Treasury. However, the Federal Reserve continued to insist that some rise of long-term as well as short-term yields was required. This controversy culminated in the now-famous Federal Reserve-Treasury accord of March 3, 1951.

The principal terms of this accord were as follows: (1) In order to retire a part of the longest-term 2½ per cent marketable issues that were overhanging the market, the Treasury offered to exchange for them a new 2¾ per cent, 29-year bond, redeemable at the holder's option before maturity only by conversion into a 5-year marketable Treasury note bearing 1½ per cent interest. The purpose of this was, of course, to encourage long-term investors to retain their holdings of government securities and to reduce the monetization of the public debt. (2) It was agreed that for a period after the exchange offering was made public the Federal Reserve would purchase a limited volume of the long-term securities, and would maintain orderly market conditions, but that such open-market purchases as were made would be on a scale-down of prices. (3) The two agencies agreed that, in order to minimize monetization of the debt, the Federal Reserve would immediately reduce or discontinue its purchases of short-term government securities and permit the short-term market to adjust to a position at which banks would depend on borrowing at the Federal Reserve to make needed adjustments in their reserve positions. It was expected that during the remainder of 1951 the Federal Reserve discount rate, in the absence of compelling circumstances not them foreseen, would remain at 1¾ per cent and that the Federal Reserve would operate in such a way as to assure a satisfactory volume of exchanges in the refunding of maturing Treasury issues. (4) Both agencies agreed to hold more frequent conferences between their officers and staffs in order to work out a joint program of government financing and of maintaining orderly markets for government obligations.

7. — This accord has been an important turning-point in American monetary policy. Under it the Federal Reserve has not abandoned its concern for the government security market and it will not permit any Treasury financing operation to fail. But gone are the old fetishes of par support and almost inflexibly low interest rates. It has been shown that a decline of bond prices below par is not inevitably followed by a panicky wave of private selling and that some rise of interest rates need not be ruinous to the Treasury. But most important of all is the acceptance by the Treasury, however reluctantly, of the idea that a restrictive general monetary policy is a useful device for combatting inflation. As a method of promoting general economic stabilization, general monetary policy has a least partially regained the position that it had lost during the preceding decade. In the absence of total war it seems highly unlikely that the Federal Reserve will revert to a policy of pegging security prices at par or above — or at any other fixed level — and of holding yields within such narrow limits as characterized the 1942-1950 period. Further comments on this subject will be made later.

8. — Along with the rediscovery of general monetary policy has come a decreased emphasis on selective credit controls. In 1950 and early 1951 selective credit controls had many proponents. Some, like the Federal Reserve, wanted them as supplements to general credit restriction; they did not consider them to be complete substitutes for more general restrictive measures. Others, like the Council of Economic Advisers, considered these selective controls together with fiscal policy and direct price and wage controls to be adequate substitutes for general monetary restriction. Three types of these selective credit controls have actually been employed. In the autumn of 1950 regulations on consumer credit were reimposed. These established maximum loan values and maximum periods of repayment for instalment credit used to purchase selected types of consumer durable goods. Similarly, the Federal Reserve set maximum loan values and maximum maturities on credit extended for the purchase of new residential construction. In addition to promulgating these two regulations which had the force of law, the Federal Reserve gave its blessing to a voluntary credit restraint program in which the principal participants were the commercial banks, insurance companies, mutual savings banks, investment banks, and savings and loan associations. This was essentially a selective credit control program. On the one hand, it encouraged its members to make productive loans for « essential » purposes, assuring them that an expansion of such productive loans could not be inflationary. On the other hand, lenders were implored to refuse loans for unproductive purposes and for the production of « nonessentials ».

The three programs outlined above were actually adopted and put into operation. In addition, however, there were in 1950 and early 1951 many proposals for other selective credit controls. Some of these were aimed at discouraging banks from selling government securities in order to expand their loans to private borrowers. For example, one set of proposals would have required banks to hold government securities equal to at least a stated percentage of their deposits. Another would have required banks to hold reserves against their assets, with lower reserve requirements against assets in the form of government securities. Some other proposals would have imposed much more detailed controls over the types of private loans made by banks. One member of the Council of Economic Advisers went so far as to suggest that every bank be brought under official credit rationing, with not only the total amount of its credit but also the types of its credit subject to strict direct control by the government. Though these proposals were not adopted they do indicate the great importance attached to selective credit controls in 1950 and early 1951.

Since about March 1951 the status of selective credit controls has declined markedly. Support for additional selective measures has virtually disappeared, some of the selective controls imposed earlier have been removed, and those remaining are viewed with less approval. For this there have been several reasons. Most important, of course, has been the decline of inflationary pressures and the relatively plentiful supply of civilian goods. The period since March 1951 has been one of relative price stability and the expansion of military production has not been accompanied by the expected decrease of goods and services for private consumption and investment purposes. Under these conditions there has been less need for selective controls either to prevent inflation or to divert resources to military purposes. A renewal of inflationary pressures may well lead to renewed support for selective credit controls. But the decreased emphasis on selective measures has not been due exclusively to the decline of inflationary pressures. Another important factor has been the renewed availability of general monetary policy as an anti-inflation weapon. Just as the failure to use general monetary restriction was an important reason for the heavy emphasis on selective credit controls in the earlier period, the freeing of general monetary policy from its earlier shackles has reduced the emphasis on the more selective measures. Still another force has been the practical difficulty encountered in administering selective controls. These controls are opposed by political powerful economic groups who feel their direct impact — dealers in automobiles and other consumer durables, financial institutions extending consumer and housing credit, the housing industry, and some consumers who feel that this type of regulation is unfair to the lower-income groups who wish to borrow and buy. These pressures have materialized in legislation limiting the scope of the Federal Reserve power to utilize selective credit restriction, and in other ways they make the System reluctant to employ this device. In addition, serious administrative difficulties are encountered in trying to enforce selective controls on thousands of dealers who are not accustomed to such regulations and are out of sympathy with them.

It would be dangerous to conclude from the experience since early 1951 that selective credit controls will not play a significant role in future American monetary policy. A renewal of inflationary pressures would probably bring greater recourse to these controls, especially if the renewed inflation were accompanied by conspicuous shortages of consumer durable goods and housing. But it appears unlikely that these will again be proposed as complete substitutes for general credit restriction; at most they are likely to be considered as supplements.

III

9. — Having surveyed briefly some of the principal aspects of United States monetary policy during the rearmament period, we can now turn to two more difficult questions. To what extent has the general restriction of credit been responsible for the arrest of inflation? What will be the nature of United States monetary policy in the future?

As a matter of fact, the upsurge of prices in the United States halted at almost exactly the same time that the Treasury and the Federal Reserve reached their accord in early March, 1951 and the Federal Reserve began to initiate a more restrictive credit policy. Between June 1950 and the date of the accord, the consumer price index had risen 9 per cent and wholesale prices 16 per cent. But during the following year consumer prices rose only 3 per cent while wholesale prices actually declined 3 per cent from their peak. A few enthusiasts contend that this was due solely to the new restrictive credit policy. This is claiming too much for the mild credit restriction; many other forces were also at work. Even before March 1951, business inventories had increased to such an extent that some manufacturers and merchants were becoming nervous about them. Inventories of new durable goods in the hands of consumers had also grown, and many consumers were in a highly illiquid position as a result of their earlier buying spree. The continued availability of large quantities of civilian goods decreased fears of acute shortages. The comprehensive wage and price freeze in early 1951 reduced fears of a rapid wage-price spiral. To this combination of developments must go at least some part of the credit for halting the price inflation and for preventing its resurgence during the following year. Nevertheless, it seems likely that the new restrictive credit policy has been helpful, not only in raising the cost and decreasing the availability of credit but also in creating a more cautious attitude among businessmen. Having said this, however, one should add

that the inflationary pressures with which monetary policy has had to cope have not been strong in the period since March 1951. The effectiveness of monetary policy as a means of dealing with strong inflationary pressures has yet to be tested in the United States.

10. — What will be the nature of United States monetary policy in the future, assuming that we succeed in avoiding all-out war? To a large degree this will depend on the extent of inflationary pressures. If inflationary pressures are quite weak, and especially if conditions should become even mildly diflationary, one can be fairly sure that a relatively easy-money policy will be followed. Because of the Treasury's desire for low interest rates and the national emphasis on maintaining full employment, promoting capital formation, and expanding productivity, any error that is made is likely to be on the easy-money side.

It is more difficult to predict what will happen if there should be a resurgence of inflationary pressures. That general credit restriction will be invoked sooner and more vigorously than in the period immediately following the Korean outbreak seems highly likely. This is partly because the March 1951 accord destroyed, or at least weakened markedly, the fetish of par support, partly because the restrictive credit policy is believed to have been helpful in stopping the inflation and holding it under control, and partly because of a weakened faith in the desirability and efficacy of competing methods of coping with inflationary pressures. Selective credit controls will probably be employed under these conditions, but their popularity has declined to such an extent that they will be considered only as supplements to, rather than as substitutes for, general credit restriction. With taxes already at levels considered very high for this country, the Congress will be reluctant to cope with inflation by enacting further tax increases. And the dangers and disadvantages of relying largely on direct price and wage controls are becoming increasingly evident. Because of these circumstances general credit restriction will probably be called upon to play an active role in controlling any new upsurge of inflationary pressures.

But how far are the Treasury and Federal Reserve willing to go in restricting credit and permitting a rise of interest rates? In speculating on this question it is well to remember that inflationary pressures since the accord have been relatively weak and that the rise of interest rates and the decrease of bond prices have been, up to this time, within rather narrow limits. Yields on 12-month Treasury obligations have ranged between 1.25 and 1.9 per cent, those on the longest term marketable issues have ranged between 2.45 and 2.75 per cent, and the price of non marketable government bond has declined by as much as 5 per cent below par. Larger changes have not been needed up to this time. Many Federal Reserve officials, especially those of the New York Federal Reserve Bank, have repeatedly stated their belief that large changes in interest rates and bond prices are not needed to cope with inflationary pressures. They believe that relatively small actual changes, coupled with a freedom of rates to move still higher if necessary, can generate enough uncertainty in the market to reduce the availability of credit to the required extent. It is to be hoped that this theory will prove to be correct. If so, the Federal Reserve will be able to achieve its purpose of restricting adequately the availability of credit for private uses without increasing greatly the Treasury's interest costs and without large decreases in the capital values of bonds. But this theory has not yet been put to the acid test; since regaining its freedom to allow bond prices to fall below par the Federal Reserve has not had to deal with really strong inflationary pressures. If and when it does it may find that much larger changes in interest rates and bond prices will be required to make credit restriction adequately effective. In this case the Treasury-Federal Reserve accord would face a severe test. The Treasury is still charged with the responsibility of fixing the interest rates and other terms of its new issues, and it continues to concern itself with the behavior of the prices and yields of its outstanding obligations. The Federal Reserve can not afford to allow any new Treasury issue to fail, and it has repeatedly stated its intention of maintaining an « orderly » market for government securities. But no one knows how far the Treasury would agree

to go in raising interest rates, and the definition of an « orderly » market remains somewhat vague. The latter clearly requires the prevention of erratic and panicky movements that serve no useful purpose. But does it also include setting a lower limit below which bond prices will not be allowed to decline even though the Federal Reserve would have to make large net purchases over a period of time? If there is such a lower limit, how far below par will it be? Only future developments can answer these questions.

IV

11. — In summary, the rearmament period has witnessed in the United States, as in many other countries, the rediscovery of general credit restriction as a method of coping with inflationary pressures. During the months following the Korean outbreak the Federal Reserve struggled laboriously, and finally successfully, to free itself from the easy-monery policy that it had followed continuously for more than a decade. Under the accord of March 1951, the Federal Reserve gained much more freedon to restrict credit. This it has used to a moderate extent to cope with only moderately powerful inflationary pressures. But the extent of this freedom and the willingness of the Federal Reserve to use it to restrict credit remain to be tested by a resurgence of inflationary pressures. Considerations relating to Treasury financing and to the promotion of full employment, a high rate of private investment, and rising productivity remain as important limitations on the use of general credit restriction to fight price inflation.