Monetary Policy for United States Re disarmment

by

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1. — 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 quite serious. 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 intervene. 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. Dishonings 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 favoring a more restrictive policy and the latter insisting on a continuation 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?

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 refinance operations. They pointed out that higher interest rates would increase carrying charges on the federal debt, and 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 panic 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 impossibly 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 liberal total supply of credit but proposed the use of selective controls to hold down spending for non-essential 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 yet, patching in 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 of goods and services. Many economists 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 lowering the continuation of easy-money policy.

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 yields on 13-month Treasury bills was about 1½ 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 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 lower yielding securities at prices which represented higher yields. By the end of 1950 yields on 12-month Treasury issues had risen from 1½ to about 1½ 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 continued 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 government obligations 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 2½ per cent, 20-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 then foreseen, would remain at 1½ 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.
to the public and the banking system, which has become more sensitive to changes in the interest rate. This can lead to fluctuations in the value of the dollar in foreign exchange markets.

In summary, the domestic components of monetary policy have evolved over time to reflect changes in economic conditions and the need for greater flexibility. The Federal Reserve, for example, has used a mix of open market operations, reserve requirements, and discount rate adjustments to manage the money supply. These tools have been refined and expanded over time to better align with the broader goals of maintaining price stability and promoting maximum employment.

The global context has also played a role in shaping monetary policy, particularly in the aftermath of the 2008 financial crisis. The Federal Reserve, alongside other central banks, implemented unconventional monetary policies such as quantitative easing to stimulate economic growth. These policies have had significant implications for asset prices and the transmission of monetary policy to the real economy.

Looking ahead, the challenge for monetary policymakers is to navigate a complex economic landscape while maintaining price stability and supporting economic growth. This requires a keen understanding of both domestic and international factors, as well as a willingness to adapt and innovate in the face of changing circumstances. The evolution of monetary policy, including the domestic components, continues to be a dynamic and evolving field.
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 deflationary, 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 was not fully implemented, or at least weakened markedly, the field 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 supplementary 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 answering 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 2.25 and 2.9 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 panic-like 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.

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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-money policy that it had followed continuously for more than a decade. Under the accord of March 1951, the Federal Reserve gained much more freedom 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.