

INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

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ANALYSIS OF HEARINGS

BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
EIGHTY-SIXTH CONGRESS
FIRST SESSION

PART 7

AN ANALYSIS OF PARTS 1 THROUGH 6 HELD DURING
THE 85TH CONGRESS

Prepared and submitted for the use of the Committee

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CHAPTER I

ANALYSIS OF HEARINGS ON INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES HELD BY THE COMMITTEE ON FINANCE PREPARED BY DR. JAMES E. FORD, ASSOCIATE PROFESSOR OF ECONOMICS AT OHIO STATE UNIVERSITY

INTRODUCTION

The following analysis of the hearings held by the Committee on Finance on the investigation of the financial condition of the United States was prepared for the assistance of the committee by Dr. James W. Ford, temporarily assigned to the staff of the Joint Committee on Internal Revenue Taxation.

Dr. Ford received his A.B. degree from Oberlin College, Oberlin, Ohio, in 1947 and his M.A. degree from Harvard University in 1949. From 1949 to 1951 Dr. Ford studied at Cambridge, England, on a Fulbright grant. He received his Ph. D. degree in economics from Harvard University in 1954.

Dr. Ford was assistant professor of economics at Vanderbilt University, Nashville, Tenn., in 1953, and was associate professor of economics at Ohio State University when temporarily assigned to the staff of the Joint Committee on Internal Revenue Taxation.

Dr. Ford's special fields are: monetary theory and policy, commercial banking and other short-term credit, price theory, income theory, history of thought, industrial organization and market structure, business, price and related policies. He is a member of the American Economic Association and is the author of the following books:

The U.S.A., 1943-1946.

Monetary Theory; the Financial System of the U.S.

Effect of Reserve Requirements on Bank Profits.

Although this material was compiled for informational purposes and has not been considered by the Committee on Finance, it is my opinion that it represents an accurate and constructive analysis of the testimony presented to the Committee on Finance in connection with the hearings on the investigation of the financial condition of the United States. Dr. Ford's comments as to the weight to be given to the testimony are extremely helpful and I am in complete agreement with his conclusions.

HARRY F. BYRD, *Chairman.*

PART I

A REVIEW OF THE RECORD

A. THE NATURE OF THE INVESTIGATION

When the Committee on Finance of the United States Senate began hearings in its investigation of the financial condition of the United States, in June 1957, the dominant condition was inflation, but when the last hearings were held, in April 1958, the country was in a recession. In his opening statement in 1957 the chairman of the committee, Senator Byrd, said:

The immediate occasion for this study is the existing credit and interest situation and, more important, inflation which has started again with its ominous threat to fiscal solvency, sound money, and individual welfare.¹

In later stages of the hearings, the recession claimed a major share of attention but concern over the possibility of renewed inflation also shaped the course of the investigation.

The printed record of the investigation consists of 2,090 pages of testimony—by 8 witnesses—and accompanying exhibits, and of 67 replies to a questionnaire that the committee sent to the presidents of the Federal Reserve banks, businessmen, trade association officials, and economists. The main theme that runs through this long record is the problem of short-run economic instability, inflation, and depression, but much attention was given also to the question of the effects of a long-run rise in the price level.

The projected scope of the study was very broad: To study, in the words of the chairman's opening statement—

- (1) The revenue, bonded indebtedness, and interest rates on all public obligations, including contingent liabilities;
- (2) Policies and procedures employed in the management of the public debt and the effect thereof on credit, interest rates, and the Nation's economy and welfare; and
- (3) Factors which influence the availability and distribution of credit and interest rates thereon as they apply to public and private debt.²

Many different aspects of these subjects were explored; however, three general questions came to be the main focus of the study:

- (1) What were causes of the inflation that began in 1955, and of the recession that followed. In particular—
 - (a) Was the financial condition of the private economy sound?
 - (b) Did the price-setting power of big business firms or labor unions cause the inflation?
 - (c) Did the financial and monetary policies of the Federal Government exert a stabilizing influence on the economy?
 - (d) Did the Federal Reserve's tight money policy in 1956 and 1957 cause the recession?

¹ U. S. Congress, Senate, 85th Cong., 1st sess., Hearings Before the Committee on Finance, Investigation of the Financial Condition of the United States, p. 1. This document is referred to below as hearings.

² Hearings, p. 1.

(2) Were the monetary policies of the Federal Government, including the policies of the Federal Reserve System, soundly conceived and effectively carried out? In particular—

(a) What were the objectives of Federal Reserve policy?

(b) How was monetary policy related to Treasury debt management and the other financial policies of the administration?

(c) Did the restrictive monetary policy create special difficulties for particular economic activities—such as housebuilding—or particular business groups—such as farmers and small firms?

(d) Would the monetary system be improved by restoring gold redemption of the currency? Should the statutory directives to the Federal Reserve be supplemented or revised?

(3) What were the objectives of fiscal policy and debt management? Were Federal financial policies effectively coordinated and successfully carried out? In particular—

(a) Did fiscal policy contribute to the stability of the economy?

(b) What were the objectives of debt management? How were specific operations decided upon? Were debt operations harmonious with Federal Reserve policy?

(c) Was the public borrowing of such agencies as the Federal National Mortgage Association coordinated with the Treasury's debt management?

(d) Did rapid amortization allowances and the new leeway in depreciation accounting for tax purposes allowed business firms in the 1954 tax law contribute to inflationary levels of business spending in 1955 and 1956?

The following detailed review of the record of the investigation falls into 3 parts, corresponding to the 3 main headings above.

B. CAUSES OF THE 1955-57 INFLATION AND THE SUBSEQUENT RECESSION

The period of inflation and the beginning of recession

The Consumer Price Index began to rise in September 1956 but a better date to take as the beginning of inflation is September 1955, when the Index of Wholesale Prices began to rise markedly. The peak in business activity is now tentatively dated by the National Bureau of Economic Research at July 1957. However, employment did not begin to fall off significantly until the autumn of 1957, so that the beginning of the recession may be placed in the late summer or early autumn of that year.

The meaning of "inflation" and "deflation"

Inflation means a general rise in prices, and is therefore a term descriptive of an economic condition. The condition has a name because it has long been observed that when many prices rise at the same time important economic changes result. Upward movements in price index numbers—in the United States mainly the Wholesale Price Index and the Consumer Price Index—which measure the average change in large groups of prices are usually taken to measure the extent of inflation. Of course, it is never true that all prices change together in the same proportion and therefore price indexes cannot measure unambiguously change in the limited group of prices each

represents, let alone change in all prices. Nevertheless, the main shortcoming of the price indexes as measures of inflation during short periods is not inadequate coverage or the ambiguity of the underlying idea of "average change in prices"; it is rather that the observations of changes in individual prices are not satisfactory. As business conditions change, discounts from list prices, the "extras" included in a sale, and other features of the sale vary, so that changes in list prices are a poor guide to changes in prices actually paid. Compilers of price indexes are aware of this, of course, and they attempt to get information on prices actually paid, but this is sometimes difficult to do and there is no doubt that price indexes are to some extent based on fictitious prices. The result is that upward movements in price index numbers cannot be interpreted without qualification as measuring the magnitude of inflation in any period.

The word "inflationary" is sometimes used not to describe an actual rise in prices but to characterize a force that will make prices rise, or will tend to make them rise. Thus an increase in the money supply or a rise in Government spending is sometimes called inflationary, which means not that these increases in themselves constitute inflation but rather that they will cause prices to rise, or will do this unless some counteracting force holds prices down. There is an important difference between saying that a given force—say, an increase in the money supply—will cause prices to rise and saying that it would cause prices to rise if other conditions were different. Yet it is not always clear which is meant, for example, when an increase in the money supply is said to be "always inflationary."

A further problem about the meaning of these words arises because they sometimes are used very loosely as synonyms for expansion and expansionary, when, for example, any general upward movement in the economy is called inflation, whether it includes price increases or not. This usage is exceptional but the opposite meaning—a general economic decline—is the one usually given to the word "deflation." Deflation once meant a general fall in prices; with the increased attention given to unemployment and declining production in the downswing of a business cycle, deflation has come to mean usually a general short-run economic contraction, and not simply the fall in prices that forms a part of it. With reference to long-run economic change, however, deflation is ordinarily used in its original sense—to mean a general fall in prices.

Inflation and recession, 1955-58

Viewed against the background of the war and postwar period, the behavior of money and prices during the recent inflation and recession have attracted special attention. As the figures in table I show, consumer prices increased more rapidly from the middle of 1955 until the middle of 1957, the period of "creeping inflation," than they had increased on the average during the previous 3 years, the period of "stable prices" from 1952 until 1955. But the experience of the past year shows that this comparison is misleading. For the "creeping inflation" period was the greater part of an expansion phase of a business cycle while the "stable prices" period spanned a much smaller part of an expansion (the preceding cyclical upswing had begun in

October 1949, and consumer prices rose considerably even after the Korea boom stopped in 1951), and all of the ensuing contraction, when prices were falling and the countercyclical action of the Federal Reserve was causing the money supply to increase. It is true that consumer prices continued to increase during the year following the general downturn in business in the summer of 1957 and this makes it appear that the recent period is different from earlier postwar years—a period of steady inflation impervious to monetary control. However, this interpretation, too, is false. In part, the continued “general” price rise in recession is an illusion created by looking only at consumer prices. It was mainly business demand for those commodities other than food that declined during the recession, and the wholesale prices of such goods, which are much more sensitive than consumer prices to changes in business demand, did decline. And the behavior of this part of the wholesale price index is specially vulnerable to the quotation of fictitious list prices, so that it surely understates the actual decline in prices that occurred after the middle of 1957.

TABLE 1.—Annual percentage rate of growth of money supply, consumer prices, and gross national product in constant dollars, selected periods, 1941-57

Period	Money ¹	Consumer prices ²	Deflated gross national products ³
1941-45 average.....	20	5	7
1945-52 average.....	3	6	2
1952-55 average.....	2	0	3
1955-57 average.....	0	2	2

¹ Demand deposits adjusted plus currency held by the public, Board of Governors, Federal Reserve System.

² Consumer Price Index, Bureau of Labor Statistics.

³ Gross national product in 1947 prices, Department of Commerce.

Source: Economic Report of the President, 1958.

The statistical illusion of a general rise in prices during the recession is, however, only a minor reason for saying that the behavior of prices in relation to the changes in money and output has not been markedly different since the middle of 1955. Throughout the postwar period, the velocity of money—the rate at which money is spent—has shown a rising trend, which is sharply at variance with the falling trend that prevailed for at least the 70 years prior to the 1930's. The two big economic disturbances of the past 30 years—severe depression in the 1930's and war in the 1940's—broke off the gradual long-run downward trend. The wartime change in velocity is especially striking—velocity fell very sharply to a figure far below the level that would have been produced by continuation of the long-run trend. It may be that the rising trend of velocity since the war is merely a recovery from wartime disturbance. There is good reason to think that the earlier falling trend in the rate at which money was spent was produced by a general desire to hold a higher proportion of cash as real incomes were increased by general economic growth.³ As growth continues, then, this falling trend of velocity may be resumed. But regardless of whether that will be the case or not, the sharp rise in velocity that

³ The foregoing information on the behavior of the velocity of money was taken from a paper by Milton Friedman in the Joint Economic Committee's Compendium of Papers on prices and economic growth and stability. See M. Friedman, *The Supply of Money and Changes in Prices and Output*, in U. S. Congress, 85th Cong., 2d sess., *The Relationship of Prices to Economic Stability and Growth*, papers submitted to the Joint Economic Committee (1958).

took place during the inflation of 1955-57 was generally similar to parts of earlier postwar fluctuations around the prevailing rising trend. Prices did rise at a high rate while the increase in the money supply was slowed and brought virtually to a halt, but this has happened more than once since the end of World War II. In short, the relations among money, prices, and output during the recent period of inflation—and the recession that followed—are much like those observed during the other business cycles of the postwar period.

Current theories of inflation

One view of the causes of inflation in the postwar years puts the blame for rising prices on the abandonment of the gold standard in 1934 and the continued though intermittent resort to deficit finance during the past 25 years. According to this view, discretionary management of the money supply and of Federal Government finance is bound to permit inflation, if not actually to cause it through monetary expansion, because business and labor will expect that the money supply will be increased if over price increases threaten to cause unemployment.

A second explanation of the inflation stresses the importance of private debt, especially consumer debt. According to this view, easier credit terms led to a large increase in consumer purchases of houses, cars, and other durable goods and thus to a general boom. Furthermore, consumer debt grew to unsound proportions and this precipitated the recession.

A quite different view, one that has been popular in recent years, is that the cause of modern inflation is not monetary but instead is to be found in the power of big business firms—as some have it—or labor unions—as others argue—to set higher prices that are subject to very weak competitive pressure, if any. Those who hold that labor unions cause inflation by obtaining wage increases in excess of increases in productivity say that unions have thereby forced business firms to raise prices in order to cover the increased costs. The other variant of the monopoly theory of inflation holds that the market power of big business firms precludes competition and allows these firms to “administer prices”; that is, to set and maintain them above competitive levels. Administered prices have been increased by more than costs have increased, it is argued, and since many of the products whose prices are administered—steel, for example—are used in the production of other goods, the market power of big producers has brought about general price increases. Though the two variants of the monopoly theory of inflation differ on the source of the power that causes prices to rise, they agree on the existence of a wage-price spiral, a process in which cost increases push up the prices of finished goods and these price increases in turn lead to wage increases, which set off another round of price increases.

The three theories of contemporary inflation just described—the managed money theory, the consumer debt theory, and the wage-price spiral theory—challenge, each in a different way, the doctrine that active monetary and fiscal policy can make the economy highly stable, vulnerable to neither inflation nor mass unemployment. This conclusion has been widely accepted and the statement of it in the 1950 report of the Douglas committee⁴ was regarded as setting out the main

⁴ U. S. Congress, Senate, 81st Cong., 2d sess., Monetary, Credit and Fiscal Policies, report of the Subcommittee on Monetary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report (1950).

lines of stabilization policy and predicting the results that could be expected from its operation. In the Senate Finance Committee's study, the Chairman of the Federal Reserve Board, among others, upheld this view, attributing the recent inflation not to a mistaken diagnosis of the causes of inflation but rather to faults in the execution of monetary and fiscal policy. The inflation was set off by excessively easy money in the counterrecession effort of 1954, he said, and it continued because limitation of the money supply came too late and fiscal restraint was not strong enough; management of stabilization policy was primarily responsible for the inflation.

Disagreement on the causes of the inflation and recession thus encompasses a number of different issues. One of these, the question how different types of monetary systems affect prices, can best be discussed together with other questions about the monetary system in the next section of this review. The remainder of this section will examine the contentions that a wage-price spiral caused the inflation, and the contention that excessive growth of consumer debt was responsible for it.

The wage-price spiral

From 1955 to 1957, wages, the prices of raw materials and intermediate goods, and the prices of finished consumer goods and business plant and equipment items rose together. But this fact is not, of course, sufficient to establish that it was the push of labor costs or other costs that forced prices up. It is plausible that union pressures forced wage concessions in collective bargaining and indirectly drove up wages in competitive markets so that costs increased and businessmen were driven to protect profit margins by raising prices even at the risk of reducing sales volume. But it is equally plausible that employers agreed to higher pay scales, or offered higher pay in competitive markets because they had experienced, or expected to experience, a rising demand for goods and services and it was necessary to compete for the available labor supply. Which of these two possibilities was actually the case can only be established by further examination of the facts. Table 2 presents some comparisons of changes in prices and changes in expenditures for certain categories of goods. The larger price increases—and those accounting for the main part of the movement in the Consumer Price Index—are associated with still larger increases in dollar expenditures, indicating an increase in the quantities purchased. In other words, the rise in prices was mainly a rise in the prices of goods that were in greater demand. The subgroups of goods and services shown in table 2 were selected because they are the only groups for which both separate price indexes and expenditure figures are available. Even for these subgroups there is only a rough correspondence between the group of goods to which the price index applies and the group of goods for which the Department of Commerce estimates the amount of total expenditures. Nevertheless, there is a strongly marked association, for subgroups and for the four main groups, between expenditure changes and price changes. It is not likely that such a pattern is produced by the statistical crudity of this comparison. Detailed figures for hourly wage rates in various industries (published in the *Monthly Labor Review*) allow rough comparisons to be made of the pattern of wage increases and the pattern of price increases. These

comparisons are less satisfactory than those shown in table 2, but what they show is that average hourly wage rates in nondurable manufacturing increased, from 1955 to 1957, by a slightly higher percentage than wages in durable manufacturing, which, in turn, increased by more than wages in industries producing services. In detail, there is little or no difference, in general, between the percentage increases of wages in industries whose product prices rose considerably and the increases in industries whose prices rose only slightly.

TABLE 2.—Percentage increases in prices and expenditures, 1955-56 and 1956-57

Goods and services	Prices, 1955-56 (percent in- crement of 1956 average over 1955 average) ¹	Expendi- tures, 1955-56 (percent in- crement of 1956 total over 1955 total) ²	Prices, 1956-57 (percent in- crement of 1957 average over 1956 average) ¹	Expendi- tures, 1956-57 (percent in- crement of 1957 total over 1956 total) ²
Consumer durable goods.....	0	(-3.0)	3.5	3.9
Household furnishings.....	(-1.1)	4.8	1.6	(-.0)
Private transportation.....	1.5	(-14.0)	5.9	10.0
Consumer nondurables.....	1.3	5.3	3.3	5.0
Food.....	.7	4.9	3.3	6.2
Apparel.....	1.7	4.7	1.3	.4
Men's and boys' apparel.....	1.6	5.9	1.5	(0)
Women's and girls' apparel.....	.7	6.1	.5	(0)
Footwear.....	5.3	4.1	3.2	(0)
Solid fuel.....	4.4	2.7	5.1	(0)
Consumer services.....	2.2	7.0	3.8	6.9
Rent.....	1.8	2.3	1.0	(0)
Gas and electricity.....	1.0	10.7	1.1	(0)
Household operation.....	3.2	9.0	3.7	6.8
Public transportation.....	3.0	3.6	3.3	4.7
Medical care.....	3.6	6.1	4.1	(0)
Producer finished goods.....	7.5	14.4	6.2	3.3

¹ Source: Consumer Price Index and Wholesale Price Index, Monthly Labor Review.

² Source: National Income and Expenditure, Survey of Current Business.

³ Not available.

This pattern of wage, price, and expenditure changes casts doubt on the assertion that rising labor costs pushed prices up. But there is another sense in which rising wages are sometimes said to cause rising prices. Higher wages, it is said, cause higher wage incomes, higher demand, and hence higher prices, i. e., there is "wage-income inflation" rather than "wage-cost inflation." It is difficult to find direct evidence that bears—one way or another—on this assertion but there is indirect evidence against it. First, wage increases in themselves cannot raise the total of incomes; at the most they redistribute the total. To say that such a redistribution in 1956 and 1957 led to increased demand and ultimately to higher total income does not fit the fact that business demand for plant and equipment increased as much or more than any other category of demand. Secondly, "wage-income inflation" could operate only if each employer individually either believed that if he agreed to a wage increase the demand for his product would increase, or would pay higher wages at the expense of his profits. The first is highly implausible and the second is ruled out by the fact that profit rates have not fallen as wages and prices have risen.

It cannot be shown conclusively that the recent inflation was not either "cost inflation" or "wage-income inflation" but the foregoing analysis gives reasons for thinking that neither of these explanations fits and that it was a rising demand for goods and services—not originating in wage increases—that caused prices to rise.

This leaves unanswered the question, What caused the general increase of demand in 1955 and the fall in 1957? Many different answers were advanced in the oral and written replies to the Finance Committee's questions: easy money and low interest rates followed by monetary stringency; an increase, and a reduction 2 years later, in the rate of Federal expenditures; business optimism, later checked by tight money; and so on. It is significant that no one claimed to give a simple and clearly correct answer to this question; all the factors mentioned were advanced as tentative and partial answers. This is an accurate reflection of the state of knowledge on the subject, and it shows how important is the basic research that is carried on in this field.

Private debt in the inflation and recession

The implications of the rapid rise in private debt since 1954, consumer debt in particular, have attracted much discussion. In the Senate Finance Committee's study, the question was repeatedly asked whether an unsound increase in debt had been an immediate cause of the inflation and, later, had set the stage for recession. It seems clear that, for business debt at least, the answer to this question is "No." The increase during 1955 in business debt was mainly an increase in short-term debt, of which about half represented not additional borrowing but an increase in income-tax liability and other accruals. Business borrowing from banks did increase unusually much, however, in both 1955 and 1956 and these funds, together with the proceeds of an increased volume of bond issues, were an important source of finance for rising business investment outlays. But internal sources of business funds—retained profits and depreciation quotas—also increased substantially, so that the boom in business investment spending was by no means financed exclusively by borrowed money. Nor does it appear that the volume of debt to banks on the books of business firms rose to critical proportions. Bank loans to business grew only moderately in 1957, as the volume of new bond issues increased, and there was no liquidation crisis, but only a moderate reduction of bank loans, accompanying the recession. In brief, the sharp rise in business investment spending in 1955 and 1956 was financed partly out of borrowed money. Undoubtedly the easier terms on which business was able to raise both debt and equity funds stimulated business spending but it is doubtful that restrictions on the amount or terms of business borrowing would have moderated either the inflation or the recession.

With respect to consumer debt, the conclusion from the figures themselves is not so clear. Noncorporate debt—the indebtedness of families, farms, and unincorporated businesses and institutions—increased by more than corporate debt in 1955 and the largest increases were in family borrowing—consumer debt and mortgages on 1- to 4-family houses. Although this latter type of debt had increased in every year since 1951, the 1955 increases were unusually

large, amounting to nearly \$20 billion, as against \$11.6 billion in 1952, the largest previous annual total. In 1955 consumers in the aggregate apparently borrowed a larger portion than in previous years of the purchase price of the goods and services they bought. There are no comprehensive figures that show directly the fraction of consumer expenditures financed by borrowing but there are strong indirect indications that this fraction rose in 1955. Consumer debt increased in that year by an amount equal to 2.5 percent of the year's consumption expenditures; during the previous 5 years the yearly increase in debt had averaged 1.4 percent of annual consumption expenditures. This is not conclusive evidence that consumer borrowing constituted a bigger fraction of expenditures, because the larger net increase in debt during 1955 may have reflected mainly lower repayments of debt in that year. It is not likely that this was the case, however, and there is little reason to doubt that increased borrowing, attributable at least in part to easier credit terms and lower interest rates in 1954 and 1955, stimulated consumer purchases of houses and durable goods. Purchases of durable goods increased from 12 percent of total consumer expenditures in 1954 to 14 percent in 1955.

While it seems clear that increased consumer borrowing affected the composition of total expenditures, it is not so certain that the amount of expenditures, and hence the upward pressure on prices, would have been less if consumers had somehow been prevented from borrowing as much as they did borrow. If they had not borrowed and bought durable goods, consumers might well have spent more for other kinds of goods, or have exchanged more of their liquid assets for durable goods. A lower volume of consumer borrowing would have meant more favorable conditions for business borrowers, so that business investment might have been still larger. Inflationary booms in the past have been based on many different patterns of expenditure: commodity speculation, security speculation, construction booms, and so on. There is no reason to conclude that inflationary booms can no longer arise in these ways, and therefore no reason to conclude that contemporary inflation is caused by consumer borrowing, in the sense that without an increase in consumer debt inflation would never occur. Nor is there any evidence that a particular inflationary episode, such as the recent one, could not have happened with a different pattern of expenditure.

The belief that inflation would not happen, or would be less severe, if the terms or volume of consumer borrowing were explicitly controlled has led to suggestions that controls be adopted. Such controls would be more difficult to administer than present monetary controls and they are advocated mainly because it is thought that present controls are not adequate to prevent inflation. This conclusion is premature in the present state of knowledge about business fluctuations. The evidence from the recent inflation and recession is at least as strong for the opposite conclusion: that present controls can be operated to make the economy more stable than it has been. Neither conclusion can be firmly established without further fundamental study of business fluctuations. For the present it would seem to be good policy to attempt to make a simpler set of controls work better rather than to adopt more elaborate controls, when the need for them is not clear and their effects difficult to predict.

C. THE FEDERAL RESERVE SYSTEM, 1955-58

The basis of the Federal Reserve's powers

The Finance Committee's investigation raised fundamental questions about the Federal Government's use of its monetary powers, as well as questions about Federal Reserve policy itself. The committee questioned Treasury officials, Federal Reserve officials, and others about the present place of gold in the monetary system; about the scope of the discretionary power held by the Federal Reserve Board of Governors, and by the paid officers and the directors of the 12 Federal Reserve banks; about the effectiveness of Congress' control of the Federal Reserve; about relations between the Treasury, the fiscal agency of the Government, and the Federal Reserve, the monetary agency. These are perennial questions about the proper exercise of monetary powers and they have often been raised at a time of monetary disturbance. That these questions continue to resist final settlement is not surprising since a choice among alternative monetary arrangements must be based on experience under different types of monetary standards and rules. Such experience continues to accumulate and, as it does, to demand new evaluations of existing monetary arrangements and possible alternatives. In the present inquiry the views expressed by Government officials and others did not support the contention that a differently constituted monetary system would have moderated or avoided altogether recent monetary disturbances. Nevertheless, it may be that further experience will change the prevailing view, so that a strong demand arises for, say, a return to the stricter discipline of pre-1933 gold arrangements, or, on the other hand, for relaxation of the present centralized system of discretionary control.

Restoration of gold redemption of the currency

Under present international monetary arrangements, it is unlikely that either restoring the circulation of gold coin or requiring the Treasury to buy and sell gold bullion on demand at a fixed price would make monetary policy very different from what it has been in recent years. If the currency were redeemable in gold, the public could affect Federal Reserve policy and the amount of money in circulation by exchanging currency for gold, or vice versa, and thus changing the gold reserve. In particular, if, when prices were rising, people decided that holding gold was better than holding money, the demand for gold in exchange for currency would compel the Federal Reserve to take restrictive action. But under present international monetary conditions, the world price of gold is dominated by the United States Treasury's official price and it would pay to hold gold rather than money only if an increase in the official price were likely. Only a very large monetary expansion—much larger than any experienced since World War II—is likely to create the expectation that the Treasury would be forced to raise its gold price. Therefore, it is only a very large monetary expansion in normal times—in the extraordinary circumstances of a war or a deep depression, it is likely that gold redemption would be suspended—that would be ruled out if the currency were redeemable in gold.

The essential effect of gold redemption is that it sets a limit on the discretionary powers of the monetary authorities; gold redemption is only one among many different way of doing this. It is an interesting

fact that gold redemption would not work as well as would other systems of more or less automatic control to prevent sharp changes in the money supply. For example, the simple rule that the rate of increase of the money supply should be kept within fairly narrow bounds, say 3 to 5 percent per year, would avoid the larger movements likely to occur occasionally under a gold standard, and would therefore have better stabilizing effects.

The question of restoring gold redemption of the currency in the United States is often dismissed as an out-of-date and unnecessary question. But the essential issue raised—automatic versus discretionary control of the money supply—is an issue of great importance. Therefore, serious consideration ought to be given to two questions: (1) Would the economy be more stable if the element of discretion in monetary policy were reduced or eliminated altogether? (2) If the answer to (1) is "yes," which is a better system of automatic regulation of money, one that is widely known but has technical drawbacks or one that has better technical features but no popular appeal?

Federal Reserve policy, 1955-57

General concern over rising prices during the 1955-57 period evoked much discussion of Government economic policy, especially monetary and fiscal policy. Criticism of monetary policy ranged from the view, at one extreme, that since the middle 1930's the Federal Reserve has allowed the creation of too much money in the name of economic growth, to the nearly opposite criticism, that tight money in the recent period has been ineffective against inflation, if anything it has made inflation worse, and has raised interest rates, reducing residential construction, and hurting small business by raising loan costs to small firms more than to big firms. The first of these extreme views overlooks the fact, pointed out by the Chairman of the Federal Reserve Board and others, that a growing money supply does not necessarily lead to inflation in a growing economy, and the fact that prices in general have not increased continuously during the past 20 years. The criticism of tight money during 1955-57 makes several different points. One is that tight money had no effect against inflation. This contention derives mainly from the belief, discussed in the previous section of this review, that cost increases were responsible for the inflation. But that belief is very likely wrong, for reasons given above; in any case, the fact that increased demand for goods and services was part of the process of inflation carries the necessary implication that Federal Reserve control must have been partly effective against inflation. As it was, the volume of bank loans expanded sharply; had the banks been permitted to add more to their loans and investments, clearly they would have done so and the resulting increase in the money supply would have allowed prices to rise more. There is abundant evidence from other experiences of a similar kind that a greater rise in the money supply is associated with a greater increase in prices. The conclusion is clear that the tight money policy did restrain inflation. This is not to say, however, that the choice of measures and their timing was perfect, but only that what was done did work in the intended direction at the time it was done. The timing of Federal Reserve action is discussed below.

A closely related issue is the question of the effects of tight money on interest rates. Increased demand for bank loans and for funds

raised in financial markets forced interest rates to rise. Could the Federal Reserve have prevented the rise in interest rates by permitting the money supply to expand more rapidly? A more rapid expansion of money would have, at least initially, prevented or moderated the rise in interest rates, but only at the cost of a more rapid rise in prices than actually occurred. Furthermore, once the expectation of increasing prices was established, additional upward pressure would have been exerted on interest rates as lenders sought compensation for the declining value of the dollars lent, and the rate at which money and prices grew would have had to be increased further. It is questionable whether in fact the money supply could have been increased fast enough to prevent interest rates from rising when the demand for borrowed funds was increasing. The huge increase in money and prices resulting from the Federal Reserve's support of Government security prices during and after World War II was not sufficient to keep interest rates from rising. Interest rates rose during the 3 years after the end of the war despite the fact that a \$25 billion reduction in the national debt offset in part the increased demands of other borrowers. It is a characteristic of inflations that interest rates rise; in 1956 and 1957 more money would have meant more inflation and, in all likelihood, no reduction in interest rates.

As for the contention that the tight money policy had discriminatory effects, it is undoubtedly true that rising interest rates priced some consumers and businesses out of the market for borrowed money and reduced the amounts that others could afford to borrow. And it may be true that the rates paid by certain groups—small business firms, for example—rose by more than rates paid by other groups, big firms taken together. Whatever the facts are, however, they do not help to decide whether the tight money policy was sound. On the evidence from previous episodes of "cheap money" policy, expansion of the money supply might have failed to keep interest rates from rising, and, in any case, would have caused more inflation. Critics of the tight money policy who say that its effects were discriminatory are certainly not prepared to argue that the only alternative, a policy of inflation, would have been more fair. The critics have not taken sufficient notice of the facts that market pressures were forcing interest rates up and the Federal Reserve could have affected the situation, if at all, only at the cost of more inflation.

The same comment applies to the contention that tight money needlessly raised the costs of the national debt.

Federal Reserve policy in the 1955-57 period is more vulnerable to the criticism that its timing was faulty. In his testimony, the Chairman of the Federal Reserve Board of Governors said that in his view the Federal Reserve had in 1954 made money too easy and had waited too long in 1955 to take opposite action. Other witnesses criticized the Federal Reserve for keeping money tight too long in 1957, after signs of falling demand had begun to appear. In fact, as can now (October 1958) be seen, business reached a turning point in the summer of 1957, whereas it was October before the Federal Reserve began open market operations designed to make money easier. Hindsight validates these criticisms of the Federal Reserve; at the time that the decisions had to be made, it was not easy to know which way the economy was going. However, the very fact that assessment of the

current situation is difficult gives strong reason to question the soundness of a policy of alternating tightness and ease as the immediate situation seems to require. Moreover, it is very likely, as Chairman Martin said, that easy money in 1954 and early 1955 acted with a delay on the economy, keeping inflation going in 1956 and 1957 even while the growth of the money supply was reduced almost to nothing. It is also likely that the spell of tight money exerted a delayed influence during the recession, even while the money supply was growing at an annual rate of 5 percent or more. Analysis of business cycles in the United States shows that turning points in general economic activity follow with a lag of many months, changes in the rate of growth of the money supply.⁵ Apparently, the first effects of Federal Reserve action are regularly felt some months after the action is taken; this seems to have happened during the most recent business cycle.

The goals of Federal Reserve policy

In the Senate Finance Committee's study, as in many recent discussions of monetary policy, questions were raised about the general objectives or goals of Federal Reserve policy: What are these goals? Where are they specified? And what ought they to be? In answering these questions, Chairman Martin referred usually to the Employment Act of 1946, which declares that a principal objective of Federal economic policy is the securing of "maximum production, employment, and purchasing power." The Federal Reserve Act of 1914 states the purposes of establishing the Federal Reserve System but the objective stated there of providing an elastic currency seems outdated and is seldom if ever referred to in discussions of monetary policy. In today's discussions, the question most frequently asked is which of two goals that are said to be conflicting—full employment or price stability—the Federal Reserve ought to pursue. The Federal Reserve's own view, expressed in the testimony of Chairman Martin and in the joint reply of the Federal Reserve bank presidents to the Finance Committee's questionnaire, is that the two goals are not conflicting. Mr. Martin said:

There is no validity whatever in the idea that any inflation, once accepted, can be confined to moderate proportions * * *. In the past, an inflation once started, has continued until it was stopped, usually either by appropriate monetary and fiscal policy or, failing the adoption of such policies, until it collapsed from imbalances it had generated. * * * Prices as well as employment are likely to react when an inflation stops as the result of major imbalances.⁶

In fact, it is not true that moderate inflations, unless stopped by monetary or fiscal restraint, have always ended in runaway prices and a crash. The United States experienced a 20-year period of "creeping inflation," from 1895 to 1914. It is true that the period was interrupted by business-cycle downswings, but so also have been the periods of long-run declining prices or constant prices—1873-95 and 1921-29. Historically, creeping inflation has not been an unstable condition. Nevertheless, the Federal Reserve is certainly right that if the monetary authorities were willing to permit prices to increase at any rate so long as unemployment was low, the economy would experience a crash. There is abundant evidence that periods of sharply rising prices, such as 1919 and the first half of 1920 in the United States, end in crisis and slump. The strongest proponents of

⁵ See the paper by Milton Friedman cited above.

⁶ Hearings, pp. 1228, 1267.

full employment as a goal of monetary policy recognize this and agree that the price level cannot be left altogether out of account. On the other hand, those who argue that price stability ought to be the prime goal of monetary policy recognize the importance of stabilizing employment; their position is that stable prices would insure full employment. A useful way to interpret the controversy is to say that the disagreement is not about goals but about the best strategy to use in trying to achieve goals that both sides accept. The issue is not whether unemployment of 6 percent is "too much," or whether a price increase of 4 percent a year is "too much." The issue is whether short-run business fluctuations, which are certain to occur in a predominantly free enterprise economy, can best be limited by monetary—and fiscal—action aimed at preventing unemployment from ever exceeding a predetermined figure, or by action aimed at preventing prices from ever changing by more than some predetermined annual rate, or by action guided by some other criterion. What is needed to resolve the issue is not some kind of formula expressing the relative importance of stable prices and full employment but rather more knowledge about the probable effects of different strategies of stabilization. Claims made by the proponents of various rules for monetary and fiscal action need to be analyzed carefully and checked against available facts.

Despite the great interest in stabilization policy, in the voluminous discussions much has been taken for certain that is not certain and that could be tested. It is widely accepted, for example, that full employment and price stability cannot exist together. Yet this contention is usually not made specific and examined in the light of the facts. It is clear that economic change is bound to cause price indexes to change and to cause the number of unemployed to fluctuate. No one expects to achieve full employment or stable prices in the extreme sense of eliminating all fluctuations. However, for admissible definitions of price stability and full employment, the evidence that the two are inconsistent is not convincing. It is mainly the belief that, at least in the postwar years, wage increases have caused prices to rise which underlies the contention that price increases can be stopped only if unemployment rises sufficiently to check wage demands. But this view is probably wrong. Therefore, there is no need as yet to conclude that strategies for monetary and fiscal action face the dilemma that whatever is done to make prices stable will cause unemployment and whatever is done to maintain a high level of employment will cause prices to rise.

Clarification of the facts about the effects to be expected from different types of monetary and fiscal action is the primary requirement for improving stabilization policy. Changing the statement of goals or adding additional goals—making explicit the goal of price stability, for example—is likely to do much less to clarify issues and make policy sounder and more effective.

Independence of the Federal Reserve

Questions were raised during the Senate Finance Committee's study about the influence of private financial business on Federal Reserve policy, and about the relation of administration policy to Federal

Reserve policy. The answer to the first question appears to be that no evidence has ever been advanced to show that Federal Reserve policy has been made to serve private interests. It is true that during the tight money period, bank profits rose substantially. But the increased demand for bank loans would, in the last analysis, have led to higher bank profits whatever the policy of the Federal Reserve. However, the decisive fact in this matter is that the Federal Reserve had clear reasons for thinking, whether rightly or wrongly does not matter in this connection, that tight money was in the general interest.

On the matter of the administration's influence on Federal Reserve policy, the view was advanced that the Treasury in its management of the national debt tried to raise interest rates and that the Federal Reserve had helped in this. The evidence on the Treasury's policy will be presented below in the section on fiscal policy and debt management. Whatever the Treasury's policy was, there is no reason to conclude that the Federal Reserve was trying to do anything other than stop the rise in the price level. Chairman Martin said that the Federal Reserve had no reason for wanting interest rates to be high; on the other hand, it would do nothing that would permit prices to rise faster. No evidence has been advanced that contradicts this statement.

In a quite different way, however, Federal Reserve action was influenced by the financial problems of the Treasury. As officials of both agencies testified, there was consultation on monetary policy, fiscal policy, and debt management. Each agency ultimately made its own decisions but the Federal Reserve clearly was constrained, at least in choosing times at which to take action, by the debt operations of the Treasury. In the period between December 1954 and July 1958, the Federal Reserve did not support new Treasury issues by making purchases for its own account. However, Chairman Martin stated that the Federal Reserve did both advise the Treasury on money market conditions and seek to smooth the way for Treasury issues by preventing any sudden or temporary tightening of the market. Since the Federal Reserve felt obliged to do this, the timing of its monetary measures was necessarily influenced by the Treasury's plans.

As a practical matter, the Treasury's financial problems may not have had any important effect on Federal Reserve action during the last few years. Nevertheless, the principle that Federal Reserve action should not be influenced by the Treasury's financial problems is important. It is sometimes said that the Federal Reserve ought not to be independent of the Treasury since, as agencies of the Federal Government, the two should work together. It is, of course, desirable that different measures of stabilization policy be consistent with each other. But it is important that the problems of financing government not be allowed to bear on monetary policy. This is not to say that Federal Government ought never to finance expenditures by monetary expansion, but only that this ought to be done only when the interests of the economy require it—not when the exigencies of government finance make it convenient. Given the Federal Reserve's present wide powers of discretionary action, it is an important safeguard to make the Federal Reserve independent of the Treasury.

D. FISCAL POLICY AND DEBT MANAGEMENT

Fiscal policy and changes in the size of the national debt

Whereas the record of the Senate Finance Committee's study contains much disagreement about the appropriateness of the Federal Reserve's tight money policy, there is almost complete agreement, in which the Secretary of the Treasury and the Undersecretary for Monetary Affairs shared, that Federal Government cash surpluses for the fiscal years 1956 and 1957 were too small. Table 3 shows that during the fiscal years 1956 and 1957, the national debt was reduced \$3.8 billion, the portion of the debt held outside the Federal Government fell by a much larger amount, \$8.9 billion. However, it is important to note that this reduction in Treasury borrowing was offset in part by a \$2.5 billion increase in the public borrowing of certain Federal agencies—the Federal National Mortgage Association and others empowered to borrow directly on their own account. The overall result, then, was that during fiscal 1956 and 1957, total Federal debt outstanding was reduced \$6.5 billion. Commenting on part of this record, the Undersecretary of the Treasury for Monetary Affairs, Mr. Burgess, said:

TABLE 3.—Public debt of the United States: Total and amounts held outside Government investment accounts on selected dates, 1955-57

[Billions of dollars]

Date	Total public debt	Amount held outside
1955—June 30.....	274.4	228.9
Dec. 31.....	280.8	229.1
1956—June 30.....	272.8	219.8
Dec. 31.....	276.7	222.7
1957—June 30.....	270.6	218.0

Source: Treasury Bulletin.

We have had a \$1.6 billion surplus this past year with a \$2.2 billion debt reduction. That is not very much. I would like to see it bigger.⁷

Why, then, was a larger surplus not achieved? In Mr. Burgess' words, the reasons were:

* * * the cold war * * * and * * * the various pressures for expenditure of one sort or another.⁸

These statements are highly significant. It seems to be a lesson of the recent period of rising prices that unless the Treasury is under a rigid obligation to achieve a surplus of a specified size in time of inflation, other considerations will inevitably crowd out the objective of a sizeable surplus. The proposals for a "balanced budget at a high level of economic activity," which carry the implication of a surplus increasing in amount as inflation mounts, gain added point in the light of recent experience.

Borrowing by Federal agencies

As was pointed out above, the outstanding debt of certain Federal agencies that borrow directly from the public increased sufficiently during fiscal year 1956 and 1957 to offset about one-quarter of the reduction in the Treasury's own outside borrowing during the period.

⁷ Hearings, p. 1006.

⁸ Hearings, p. 1007.

An offset of this magnitude could seriously reduce the effect on the economy of Treasury fiscal policy. At present the agencies consult with the Treasury about their borrowing but the Treasury cannot control the amount of their borrowing. The effectiveness of fiscal policy would be increased if the Treasury were able to fix the total amount of this outside borrowing.

Rapid amortization of defense facilities and the new treatment of depreciation

Although tax policy was not treated extensively in the study, two provisions of tax law were discussed at some length, in relation to the inflation. It was agreed, by Treasury officials among others, that the Treasury's continuing to award the certificates that allowed rapid writeoff of so-called defense-related facilities had contributed in some measure to the incentive to build new business plants and had therefore been inflationary. This was also the effect of the 1954 change in the tax law that permitted firms a choice of methods of computing depreciation on tax returns. The position of the Treasury on these matters was that the rapid amortization allowances were no longer useful and should be stopped, but that the new provision about depreciation was sound and should be kept: the year 1955 turned out to be a bad year in which to introduce the new depreciation option but in the long run its effects would be desirable. This appears to be a sound conclusion on both issues.

Treasury debt operations and interest rates

Since the Treasury is the largest single borrower in the United States, its debt operations are bound to have marked effects on financial markets. In the markets for short-term credit, the weight of Federal borrowing is much greater than it is in long-term markets. The volume of Treasury bills outstanding in recent years has been about 10 times the volume of private short-term paper—commercial paper and bankers acceptances. In the bond market, Federal debt outstanding is a much smaller proportion of the total. But to show the effect of Treasury borrowing on changes in interest rates it is necessary to compare not totals outstanding but changes in the totals. During the calendar year 1956 and the first half of 1957, increased Treasury bill issues accounted for over half the total increase in short-term securities outstanding. The higher Treasury demand for short-term credit must have contributed importantly to the rise in short-term rates. Treasury intermediate and long-term securities outstanding, however, declined below 1954–55 levels, while the total of other obligations increased. Therefore, the change in Treasury borrowing must have moderated the upward pressure on long-term rates of interest.

It has been suggested that the Treasury may have influenced interest rates in another way, by issuing securities with higher coupons, for the purpose of forcing market rates up. This contention is not supported by the facts. Issuing securities with higher coupons would not in itself force bond yields up: a marketable security bearing a coupon corresponding to a yield above the going market rate would simply increase in price, the yield declining correspondingly. The Treasury could have increased yields only by increasing its borrowing enough to bring interest rates up. But total Treasury borrowing was reduced during 1956 and 1957, as table 3 above shows.

Another point in this connection is that in 1956 the initial prices quoted on Treasury offerings of intermediate and long-term securities averaged only one point over par, and in 1957 (through May) the average was exactly par. This suggests strongly that the Treasury was attempting to issue its securities at the lowest cost the market would permit and was not seeking to force interest rates up.

Debt management and the maturity of the debt

The objective of lengthening the maturity of the debt—by replacing maturing short-term debt with bonds and by issuing bonds with a term longer than 10 years—has continued to influence debt management. In fact, however, the average time to maturity of the outstanding obligations decreased slightly in 1956 and 1957. In a period of relatively high interest rates, the cost entailed in issuing bonds, especially long-term bonds, seemed to the Treasury prohibitive. As with the objective of reducing the size of the debt, other considerations militated against stretching out the maturity. In order to evaluate the seriousness of this fact, it is necessary first to be clear on the costs and advantages of lengthening the maturity of the debt. As to costs, there would probably be savings in marketing costs if issues were less frequent and the Treasury bill turnover were smaller. On the other hand, the interest cost of a longer dated debt would be higher. If, for example, 10 percent of the amount of Treasury bills outstanding on the average in 1956—a figure of about \$2.4 billion—had been funded into bonds of 5- to 10-year term, the resulting increase in the annual interest cost of the debt can be calculated, on certain assumptions about the effects on interest rates of this change, to have been about \$19 million. This would have been an increase in the total interest cost of the debt of about one quarter of 1 percent. Would such an increase in costs have been excessive? Of course, this calculation gives only a rough approximation of the correct figure; and the hypothetical “funding operation” to which it relates was chosen arbitrarily. The point is that some estimate of costs is necessary if a judgment is to be made on the desirability of lengthening the debt. The Treasury did not present such figures to support its contention that issuing longer dated securities in 1956 and 1957 would have been too expensive; the lack of such figures makes the contention inconclusive.

As advantages of lengthening the debt, two chief points are claimed: first, that reducing the frequency of Treasury issues would make the Federal Reserve's task easier; and, second, that to change to longer dated securities during inflation would help to check private spending. Undoubtedly, frequent large issues of Treasury securities poses awkward problems for the Federal Reserve. But were the problems during 1956 and 1957, for example, more than technical complications in the Federal Reserve's job? Did they actually inhibit monetary control? As for the second point, replacing maturing short-term securities with bonds during inflation probably would help to control the inflation. In fact, however, other pressures on the Treasury have often led to the opposite change, as happened in the recent inflation. It is interesting that the presidents of the Federal Reserve banks in their joint reply to the Finance Committee's questionnaire conclude that countercyclical debt management is probably not feasible, and that

the objective should be rather to minimize the interference of debt operations with other policy.⁹

The probable effects on Federal finance of lengthening the maturity of the national debt are not clear, nor are the effects on monetary control and the economy at large. It seems to be taken for granted that the change would be desirable but the costs and advantages need to be clarified if the case for a change is to be convincing.

E. MONETARY AND FISCAL POLICY IN THE RECESSION

Monetary policy in the recession

In the second phase of the Finance Committee's study, attention shifted from inflation to the recession that was by then under way. Although the committee's questionnaire, sent out in March 1958, related to inflation as well as to recession, the answers reflect the same shift of interest to the problem then current. However, both the answers and the testimony in the hearings themselves reflect concern over the possible return of inflation.

Federal Reserve policy after October 1957 was much less controversial than the tight money of the previous 2 years. But some expert observers criticized the Federal Reserve for not doing more to expand the money supply. A comparison of the change in the total of commercial bank deposits and currency held by the public during the first 9 months of the recession with the behavior of the same total in 4 previous downturns shows that the Federal Reserve's action was unusually strong:

Change in commercial bank deposits plus currency held by the public

First 9 months after downturn in—	Billions
June 1929.....	-\$1, 056
May 1937.....	- 694
November 1948.....	-2, 000
July 1953.....	+3, 100
July 1957.....	+6, 400

These figures do not, of course, demonstrate that the Federal Reserve took "adequate" action to counter the decline. They do show, however, that, compared to past recessions, these were unusually strong measures.

Fiscal policy in the recession

Controversy over fiscal policy in the recession centered mainly on the merits of a special tax cut, an emergency increase in expenditures, or both. The official position of the administration was that the effects of reduced tax rates or increased expenditures would come too late to aid recovery and would, instead, give a strong impetus toward renewed inflation. Critics of this position argued that the recession was more severe than the administration and others who agreed with it recognized, and that without special measures the decline would continue for some time and would reach lower levels than the recessions that began in 1948 and 1953. Disagreement was mainly over the correct diagnosis of the economy's condition, and only to a lesser extent over the magnitude and timing of the effects of changes in expenditures and taxes. At this writing, it is too soon to be certain

⁹Joint and Supplemental Comments of the Presidents of Federal Reserve Banks in Response to the Questionnaire of the Committee on Finance, pp. 50, 51.

about who was right. Present appearances are that an upturn came in the spring of 1958 and that by the early autumn recovery was well underway. If this turns out to be true, then the administration will be proved correct: special tax or expenditure changes adopted in early 1958 would have produced their main effects only after recovery was well underway. But it is too soon to know.

F. CONCLUSION

The Senate Finance Committee's study presents much relevant data on the monetary changes and fiscal experience of the past 3 years and raises a number of important questions about the period. Perhaps the most important question concerns the nature of the recent inflation. It appears that the inflation, and the recession that followed, were not different in essential respects from previous economic fluctuations. Though it is not possible to show conclusively that price increases resulted from the pressure of increased business and consumer demand, it can be shown that demand increased early in the inflation and that the pattern of price increases among different industries is related to the pattern of demand increases. It is also clear that when demand stopped rising and then fell, production and employment declined and, with a lag, prices stopped rising and then fell.

Both monetary and fiscal policy during the period were free of many of the errors charged to them. However, important questions remain unanswered about the soundness of presently accepted principles of stabilization policy. In the case of monetary policy, the problem is mainly uncertainty about the timing of the effects of Federal Reserve action. This uncertainty has important implications for the fundamental question of the effectiveness of discretionary control of the money supply.

PART II

SUMMARY OF THE TESTIMONY ON THE PRINCIPAL SUBJECTS OF THE HEARINGS

INTRODUCTION

This summary of the views expressed by each witness on the principal subjects considered in the hearings is arranged according to subjects, to facilitate comparison of the views. Under each heading, or subheading, the statements appear in the order in which the witnesses appeared before the Finance Committee.

At the end of each section there are brief comments on the main issues raised in the statements. These comments are based on the analysis presented in part I of this report, where the points are stated more fully.

The witnesses were:

Hon. George M. Humphrey, Secretary of the Treasury
Hon. W. Randolph Burgess, Under Secretary of the Treasury
Hon. William McChesney Martin, Jr., Chairman, Board of
Governors of the Federal Reserve System
Hon. Bernard M. Baruch
Marriner S. Eccles, former Chairman of the Board of Governors
of the Federal Reserve System
Sumner H. Slichter, professor of economics, Harvard University
Seymour E. Harris, chairman of the economics department,
Harvard University
Charles C. Abbott, dean of Graduate School of Business Adminis-
tration, University of Virginia

A. CAUSES OF THE INFLATION AND THE RECESSION

(1) *The inflation*

Mr. Humphrey.—Inflation is now [June 1957] “perhaps our most serious domestic economic problem” (p. 8). Current price increases are caused by the pressure of rising consumer and business demand, financed by bank loans (pp. 13, 103–107, 112–118, 181–186, 188–194, 223–224, 340, 602, 634, 635). Rising interest rates have not been an important cause of price increases (pp. 31–33, 40). However, the high level of Government spending has contributed to the inflationary pressure (p. 6).

Mr. Burgess.—Causes of the inflation are (1) the delayed effects on rents and other prices of cost increases in earlier periods (p. 736); (2) current cost increases (pp. 1050, 1051); and (3) rising demand for capital goods (pp. 736–738, 831, 848, 1040, 1043, 1074, 1085). The high level of government expenditures, especially armament expenditures (pp. 1127–1130), has also caused inflationary pressure (pp. 738,

739). Higher interest rates have restrained rather than stimulated price increases (pp. 739, 858, 1033).

Mr. Martin.—A general increase in demands for goods and services bid prices up, beginning in 1955 with the prices of industrial goods (pp. 1262–1264). An important cause of higher business and consumer demands in 1955, 1956, and 1957 was the easing of credit by the Federal Reserve in 1954 (pp. 1304, 1305). Higher interest rates have restrained inflation (pp. 1268, 1269); on the other hand, higher labor costs were an independent cause of price increases, working through a wage-price spiral (pp. 1848, 1872, 1873).

Mr. Baruch.—“The main cause of inflation today is the deficit financing of war—the enormous borrowing in World War II and Korea” (p. 1639). The wage-price spiral is the aftermath of inflation; it has kept inflation going, though it was not an original cause. The wage-price spiral will inevitably be checked by consumers’ refusal to pay higher prices (pp. 1676, 1677).

Mr. Eccles.—The four principal causes of the recent inflation were (1) the excessive growth of consumer borrowing, resulting from easier terms of credit offered in 1954 and 1955; (2) the boom in house purchases, also stimulated by easier credit; (3) an increase in capital expenditures by business, which was induced principally by the automobile and housing booms but which was stimulated also by the continuation of accelerated amortization allowances and the new treatment of business depreciation allowed by the 1954 change in the tax laws; and (4) higher labor costs, which have resulted from the strong bargaining power of labor union monopolies in a period of high demands for goods and services (pp. 1694, 1695).

Mr. Slichter.—Mr. Slichter did not make a direct statement on the causes of the inflation but his remarks on wage-push inflation were clearly intended to apply. He said:

* * * rising wages are a principal cause of rising prices.

They are not the only cause but the issue had been confused by the honest belief of many people that rising wages simply reflected a strong demand for goods.

Wages have continued to rise throughout the recession in the face of falling demand for labor and goods (p. 1843).

Mr. Harris.—Mr. Harris also did not make a direct statement on the causes of the inflation. His testimony contains the following remarks relating to the subject: An investment boom preceded the recession (p. 2015); during the boom, the lending of Federal credit agencies, life insurance companies, and other nonbank financial institutions rose considerably (pp. 1989, 2004, 2005). Nonfinancial corporations also drew on large cash reserves to finance additions to capital equipment (pp. 1990, 2005). Higher labor costs, which in some industries led to price increases in excess of the rise in costs, were a cause of the inflation (pp. 1990, 2014, 2037, 2038).

Mr. Abbott.—Current inflation is wage-push inflation. When the money supply is flexible, “* * * wage increases inevitably push up prices” (p. 2061). Other causes of the increases in the price level since the 1930’s are the Federal deficits, the increased national debt, the rise since 1945 in the rate of turnover of bank deposits, farm price supports, the increasing amount of services purchased by consumers, and the larger fraction of national output going for military purposes of foreign aid.

(2) The recession

The witnesses who appeared in 1958 also gave their views on the causes of the recession that was by then in progress.

Mr. Baruch.—The recession is the result of inflation; consumers' refusal to pay higher prices caused unemployment (p. 1637).

Mr. Eccles.—The recession developed because high prices and the redistribution of buying power caused by inflation reduced the volume of goods and services purchased. Other causes of the fall in demand were the high rate of durable goods purchases during the previous 2 years, the high level of consumer debt, and the overbuilding of business plant and equipment (p. 1696). Restrictive monetary policy brought on the recession sooner than it would otherwise have occurred but, in any case, a recession would have followed the boom (pp. 1707, 1708).

Mr. Slichter.—The recession is concentrated in durable goods manufacturing, mining, construction, and transportation (p. 1818); it came as a reaction to an unusually high level of investment spending during 1956. The tight money policy, the reduction of Federal expenditures in 1957, and the unpopularity of the 1958 cars also were causes of the recession (pp. 1822-1825).

Mr. Martin.—The recession was a reaction to the investment boom of the preceding 2 years, in which business added to its plant and equipment faster than the growth of consumer demand warranted (pp. 1848, 1849). The excessive growth of private debt also finally reduced consumers' spending (p. 1863). Monetary restraint slowed down the inflation but did not cause the recession (pp. 1892, 1918).

Mr. Harris.—The recession was caused mainly by excess capacity but it was made worse by the Federal surpluses of fiscal 1956 and 1957, and by the tight money policy (pp. 1988, 2014, 2015).

Mr. Abbott.—The recession is concentrated in the heavy goods industries (p. 2058); it was caused by declining business purchases of plant and equipment and by a reduction of business inventories (p. 2060). The upward push of wages had made prices inflexible, so that output and employment have decreased as demand has fallen (p. 2061).

Comments on the causes of the inflation and the recession

(1) All the witnesses except Mr. Humphrey and Mr. Baruch listed the push of labor costs—or both labor costs and administered prices—among the causes of inflation. Mr. Baruch described the wage-price spiral as an aftermath of inflation and Mr. Humphrey did not mention it. There is strong evidence to support the view, criticized by Mr. Slichter, that price increases were the cause rather than the result of higher wages. This evidence is the fact that the largest price increases, and the increases in the most important segments of the Consumer Price Index, were associated with increases in the quantities of goods and services purchased. Furthermore, wages continued to increase during the recession only where demand continued high or where there existed previous commitments, including escalator clauses, to increases.

What caused demands to increase so rapidly and then to fall sharply in 1957 is another question, to which, it appears, no conclusive answer can be given in the present state of knowledge.

(2) It is unlikely that government control of consumer credit or of lending by nonbank financial institutions would have exerted any additional restraint on spending. There is no evidence that the amount of private debt was a cause of the recession.

(3) The inflationary effects of government expenditures, a point discussed by several witnesses, needs to be clarified in two respects. First, government expenditures for weapons—and for many other purposes, e. g., paying the salaries of Federal judges—are like private consumption expenditures in that they absorb goods and services into uses that do not—in most cases—make possible more output in the future. However, all increases in today's expenditures add to current demand and may raise current prices—investment expenditures are potentially as inflationary as any other. Whether future prices will be lower because of today's investment is another question.

Secondly, there is a point in saying that weapons expenditures are inflationary even when financed by increased taxes but the point is often overstated. If consumption goods had been produced instead of weapons, the additional goods on the market would have tended to hold prices down. But, on the other hand, higher taxes tend to reduce the private demand for goods and services, because taxpayers are, in effect, compelled to purchase weapons and their incomes available for purchasing other things are reduced. So much must be subtracted, as it were, from the statement often made, that weapons expenditures are inflationary because incomes are earned in the production of weapons and there is no corresponding production of goods for private markets. However, a point still remains: experience shows that private spending will not fall by the amount of the increased taxes (which, by hypothesis, equals the increase in government spending), therefore, total spending will rise and prices may rise. There have been no attempts to compute the magnitudes involved, allowing for all relevant factors, but it is clear that the increase of prices, if any, must be less than is implied by the statement of the point referred to above.

B. THE FEDERAL RESERVE AND MONETARY POLICY

(1) *The gold standard*

Mr. Humphrey.—It would not be wise to return to unrestricted gold redemption of the currency (p. 480); present arrangements for monetary control are sound (pp. 480, 529). Foreign governments can purchase gold with their dollar balances and the total of such balances is large in relation to the Treasury's gold stock (pp. 480-483, 524-525); nevertheless, there is no danger that the gold stock will be inadequate to meet the demands on it.

Mr. Burgess.—Return to the gold standard should be an objective of monetary policy, but unstable international conditions make it unsafe to return to gold now (pp. 1021-1024).

Mr. Martin.—It would not be safe to return to gold redemption of the currency now, because of the danger that agents of unfriendly countries would disrupt the monetary system by demanding large amounts of gold (pp. 1461, 1474-1479). Ultimately, we ought to return to gold, but the present monetary system is sound (pp. 1485,

1488, 1494, 1495, 1550, 1555). The present gold reserve is adequate (p. 563).

Mr. Baruch.—Under present international political conditions, a sound decision cannot be made on the long run question of returning to the gold standard (p. 1684).

Comments on the gold standard

It is doubtful that if the currency had been redeemable in gold, monetary policy and the behavior of the money supply would have been very different during the past 7 years. However, the fundamental issue raised by the question of restoring gold redemption is whether the present scope of discretionary monetary control ought to be reduced. This issue deserves serious consideration.

(2) *Federal Reserve policy*

Mr. Humphrey.—Monetary control ought to be flexible, aiming at ease during recessions and at restraint during inflations (p. 176). The Federal Reserve System ought to be independent of the administration (p. 24); during the past 4 years, the Treasury and the Federal Reserve have discussed monetary problems but the Federal Reserve has been free to make its own decisions on monetary action (pp. 232, 233).

The recent tight money policy has been “* * * in the best interest of the great majority * * *” (p. 27). The Federal Reserve did not seek to raise interest rates but the restrictive monetary policy was one cause of higher rates. A more important cause was the increased demand for credit (pp. 545, 546).

Mr. Burgess.—The Federal Reserve should be independent of the administration in reaching decisions on monetary policy, though it should consult with the Treasury (p. 742). The Federal Reserve has not sought to raise interest rates (p. 1051); rising demand for credit rather than Government policy has been mainly responsible for rising rates. The Federal Reserve's policy of monetary restraint has been sound (p. 1056).

Mr. Martin.—The Federal Reserve Act and the Employment Act of 1946 prescribe the objectives that guide Federal Reserve decisions (pp. 1898, 1899). Federal Reserve policy since 1955 has aimed at stopping the rise in the price level (p. 1850); the Federal Reserve has not tried to raise interest rates (p. 1327). The Federal Reserve has regarded the control of inflation as essential for economic growth (pp. 1301, 1302).

Mr. Eccles.—The general lines of Federal Reserve policy during the inflation were sound (p. 1702). The Federal Reserve should have the power to control consumer credit and mortgage credit (p. 1738).

Mr. Slichter.—The Federal Reserve policy of restraint was correct but restraints were kept on too long (p. 1844).

Mr. Baruch.—The Federal Reserve did not try to raise interest rates (p. 1669).

Mr. Harris.—The primary objective of Federal Reserve policy now is a stable price level (p. 2002). The Federal Reserve ought not to be independent of the administration (pp. 2046, 2047). Federal Reserve action against the recession has been too weak (pp. 1991, 1992).

Mr. Abbott.—The correct objective of monetary policy is to offset economic forces, including Federal fiscal operations, that create infla-

tionary or depressive tendencies (p. 2064). The Federal Reserve should be independent of the administration. The Federal Reserve should be given power to influence the operations of Federal lending agencies (p. 2080).

Comments on Federal Reserve policy

(1) The question whether price stability or full employment should be the principal aim of monetary policy requires clarification. What is at issue is not what the aims of policy ought to be (there is agreement about what is desirable in general), but how the aims can best be achieved. There is disagreement on the probable effects of different strategies of monetary action; resolving this issue requires further study of past experience.

(2) There is a strong case for separating monetary control from government finance. During the hearings Treasury officials admitted that fiscal expediency took precedence over control of inflation in decisions on taxes and expenditures during the 2 previous fiscal years. It is difficult to avoid this when pressures for expenditure are strong and decisions on expenditure and taxation are not well coordinated. If the Treasury also exercised control of the money supply, these pressures would bear on monetary policy as well as on fiscal policy. Therefore, the interests of economic stability are better served by not allowing the Treasury to have discretionary powers of monetary control.

(3) There is no evidence that the Federal Reserve tried to raise interest rates during the inflation.

C. FINANCIAL POLICIES OF THE FEDERAL GOVERNMENT

(1) *Taxes, expenditures, and fiscal policy*

Mr. Humphrey.—The administration succeeded in reducing Government expenditures, reducing taxes, and eliminating planned deficits (pp. 9–11). Present levels of taxation are too high (pp. 66, 67). The principle of a limit on the national debt is sound and the [then] current limit ought not to be increased, except temporarily (p. 86). It is no longer desirable to allow rapid amortization of defense-related facilities; the issuance of new certificates has been curtailed (pp. 248, 249).

Mr. Burgess.—The budget surpluses achieved in fiscal 1956 and fiscal 1957 were too small; pressures for expenditures made it impossible to realize larger surpluses (p. 1007). Reducing expenditures is better than increasing taxes as a fiscal measure against inflation. The principle of a debt limit is sound (p. 1060). As a long-run measure, the 1954 change in the tax law that allows firms an option in the method of computing depreciation on tax returns is sound; the timing of its introduction proved unfortunate and it has contributed to inflation (p. 1093).

Mr. Martin.—During inflation, the Government should reduce expenditures and achieve a budget surplus (pp. 1271, 1272). The surplus in fiscal 1957 and the prospective surplus (in April 1958) for 1958 are too small (p. 1271). Deficits during recession may be helpful but their benefits are often overstated (p. 1317). A tax change that increased incentives to produce would help to achieve economic stability (p. 1856). A tax cut now would not aid recovery and its later effects would be undesirable (pp. 1855, 1867, 1868).

Mr. Baruch.—In the present recession, taxes should not be cut and any increases in expenditures should be paid for out of increased taxes (pp. 1634, 1635). The Government ought to adopt a regular schedule of debt amortization (p. 1638). Deficit financing during World War II was unsound and has caused the subsequent inflations (p. 1639). It is sound to issue Government bonds for certain purposes, provided that taxes are increased to pay for the cost of interest and amortization (p. 1642). A statutory limit on the national debt is desirable (pp. 1670, 1671). Congress should have the service of an expert staff to study proposals for expenditures (p. 1643).

Mr. Eccles.—Budget surpluses and a reduction of the national debt ought to be used during inflation to offset the growth of private debt. During depression, when private debt is contracting, there should be deficits and an expanding public debt (p. 1703). The deficits should be created by tax cuts rather than increases in expenditure (p. 1704). In the present recession, tax collections should be reduced by 6 to 7 billion dollars through the elimination of certain excises, a reduction in the rate of corporate income tax, and a reduction in the rate on the first \$2,000 of individual incomes (pp. 1698, 1699).

Mr. Slichter.—Surpluses should be planned for periods of high private spending and inflation, and deficits for periods of recession (p. 1833). Ideally, increased expenditures would be authorized in advance and put into effect when a recession occurred. Procedures for timing such authorizations correctly do not exist, however; it will be 10 years before they can be developed and put into operation (p. 1828).

It is now (April 1958) too late in the present recession to cut taxes; the increased expenditures already authorized will produce a deficit large enough, though timed too late, to do all that fiscal policy can do to overcome the recession (p. 1838).

Mr. Harris.—The budget should be in surplus during inflation and in deficit during recession (p. 2032). Present (April 1958) expenditures ought to be increased and the tax rate applying to the first \$2,000 of individual income ought to be reduced, to give a deficit of \$7 billion for the calendar year 1958 (pp. 1996–1997). The administration has made changes in programs and accounting procedures for the purpose of reducing current expenditures; it is questionable whether the resulting reductions in the budget are genuine decreases in spending (pp. 2048, 2049).

Mr. Abbott.—Except in times of extreme crisis, the aims of fiscal policy ought to be only (1) to protect the Government's credit and (2) to make as small as possible the effects on the private economy of Federal financial operations (p. 2064). Raising Federal expenditures is an inefficient remedy for unemployment, because the effects are slow and because there is no direct provision of jobs for those out of work (p. 2059). As a means of stimulating business spending now and as a long-run reform, tax law should be changed to permit business firms to deduct depreciation according to any time pattern they choose, provided that the pattern is not changed (p. 2062).

Comments on fiscal policy

(1) The controversy over the merits of special fiscal action against the recession was mainly about the seriousness and expected duration of the recession; there was relatively little

disagreement about the timing of effects to be expected from special action.

(2) Control of government expenditures is aided by maintaining the rule of a balanced budget but the rule has important defects in the face of economic fluctuations. It is not likely that the rule will be adhered to in a recession; if it were adhered to, the recession would be deepened. During inflation, tax collections rise; if tax rates were reduced or government expenditures increased, as the rule would require, prices would rise more. On the other hand, recent experience shows again that to have no fixed principle also is unsatisfactory, because it is difficult to time ad hoc changes correctly and because fiscal expediency may exert a strong influence on the relation between expenditure and revenue.

One principle that has been suggested as a replacement for the balanced budget rule is that the budget be balanced at a high-employment, noninflationary level of national income, and the tax rates and expenditure level thus established be maintained over the business cycle. As national income rose during inflation, an increasing surplus would be generated; during recession, the deficit would automatically increase as the recession deepened.

(2) *Debt management*

Mr. Humphrey.—The Treasury has tried to lengthen the maturity of the debt, to reduce the fraction of the debt held by banks, and to increase individuals' holdings of savings bonds (pp. 17-18). During the recent period of high interest rates, however, it has been necessary to sell more short-term securities in order to keep interest costs down (p. 17). Though the large volume of Treasury borrowing inevitably affects interest rates, the Treasury has not tried to establish any level of market rates, but rather to borrow as cheaply as possible, in keeping with the objective of lengthening the debt (p. 631).

Mr. Burgess.—The Treasury has tried to lengthen the debt and to sell more savings bonds (pp. 668, 669); however, the average time to maturity of the outstanding obligations has increased only very slightly (p. 671). In setting the rates to be offered on new issues, the Treasury has been able to anticipate very closely actual market rates at the time of issue (pp. 683-687). The Treasury has not tried to raise interest rates (p. 759). January 1954 was the last previous time that the Treasury sold securities directly to the Federal Reserve (p. 898); however, it is a regular practice for the Federal Reserve to aid the Treasury by insuring that the bond market is not in a period of temporary tightness at the time when a Treasury issue is sold. In planning its issues, the Treasury receives advice from the Federal Reserve and from private financial firms (p. 682).

Mr. Martin.—In a recession, the Treasury should issue mainly short-term securities and during inflation it should emphasize long terms (pp. 1232, 1233). The Federal Reserve advises the Treasury on bond market conditions and attempts to avoid tightness in the market at the time of a Treasury issue but the Federal Reserve does not peg prices and, since 1952, only in exceptional circumstances has it bought securities directly from the Treasury (pp. 1422-1424).

Mr. Baruch.—The issue of a large volume of short-term securities has made debt management difficult and expensive; during the period of low interest rates, short-term securities should have been funded into long dated debt (p. 1637).

Mr. Eccles.—The Treasury should issue long-term securities during inflation, and short-terms during recession. In recent months, the Treasury has issued intermediate and long-term securities that have competed with private borrowing and tended to keep long-term interest rates high (p. 1697).

Mr. Harris.—By selling short-term securities during 1957 and intermediate and long-term securities during the recession in 1958, the Treasury worked against the monetary measures of the Federal Reserve (p. 2004).

Mr. Abbott.—The Treasury should provide the types of securities needed by the economy. Debt management should not be made a part of stabilization policy. The Treasury should try to sell its securities to investors other than banks (p. 2064).

Comments of debt management

(1) Although little or nothing is known about the actual magnitude of the stabilizing effects to be expected from countercyclical debt management, on general grounds it seems likely that the effects would be weaker than the effects of monetary and fiscal policy.

(2) On some occasions, notably in the spring of 1953 and again in the spring of 1958, Treasury debt operations and the expectations attending them have caused sharp fluctuations in the prices of Government securities. Regardless of the techniques used by the Federal Reserve and the Treasury, large, discontinuous Treasury operations are very likely to cause the market to be unstable from time to time. There is therefore a strong case for making Treasury debt operations as regular and continuous as possible. This improvement would probably do more than would the adoption of cyclical changes in the maturities of new issues—or any other change in debt management—to make the economy at large more stable.

PART III

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CHAPTER II

ANALYSES OF HEARINGS ON INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES HELD BY THE COMMITTEE ON FINANCE PREPARED BY DR. SEYMOUR E. HARRIS, CHAIRMAN OF ECONOMICS DEPARTMENT, HARVARD UNIVERSITY

INTRODUCTION

U.S. SENATE,
Washington, D.C., July 22, 1959.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: We hand you, herewith, "An Analysis of the Hearings of the Senate Finance Committee on the Financial Conditions of the United States, 1957-58," prepared and submitted by Dr. Seymour E. Harris.

We regard this document as being a very valuable contribution both to the committee and to the Congress. We do not submit this as a documentation of our views. While we agree with much of it, there are conclusions in it with which we do not agree.

We do regard Dr. Harris as an eminent authority, and he was one of the able witnesses who appeared before our committee during the hearings.

In order that his analysis and conclusions may be made more readily available both to the committee and the Congress, and to others interested in this very important matter, we recommend that his analysis and conclusions be printed along with those heretofore submitted by Dr. James W. Ford.

Sincerely,

CLINTON P. ANDERSON,
ROBERT S. KERR,
U.S. Senators.

JULY 1959.

To: Senators Clinton P. Anderson and Robert S. Kerr. •

From: Seymour E. Harris.

Subject: An Analysis of the Hearings of the Senate Finance Committee on the Financial Condition of the United States, 1957-58¹

Available since this original report was written: Parts I to III of the Joint Economic Committee hearings on "Employment, Growth and Price Levels, 1959."

¹In conjunction with these hearings one should note the following relevant hearings: (1) "Monetary Policy and the Management of the Public Debt," by the Joint Committee on the Economic Report, parts I and II, 1952; (2) other hearings by the Senate Finance Committee: "Savings Bond Interest Rate Increase," April 1957, and "Hearings on the Debt Ceiling, 1958"; (3) Hearings before the Joint Committee on the Economic Report, aside from the "Annual Hearings on the President's Report," we should note "Monetary Policy, 1955-58," December 1956, "Fiscal Policy Implications of the Current Economic Outlook," April and May 1958, the "Relationship of Prices to Economic Stability and Growth," compendium of papers submitted by panelists appearing before the Joint Economic Committee, March 1958, and also hearings on the "Relationship of Prices to Economic Stability and Growth," May 1958; (4) Senate Committee on the Judiciary, Subcommittee on Antitrust and Monopoly, "Administered Prices, 1955"; (5) Senate Banking and Currency Committee, Senate Report No. 2500, "Federal Reserve Policy and Economic Stability, 1951-57," report prepared by Asher Achinstein; (6) Subcommittee on Government Operations, House of Representatives, "Amending the Employment Act of 1946 To Include Recommendations on Monetary and Credit Policies and Proposed Price and Wage Increases, 1958."

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AN ANALYSIS OF THE HEARINGS OF THE SENATE FINANCE COMMITTEE ON THE FINANCIAL CONDITION OF THE UNITED STATES

In the summer of 1958, Senator Anderson asked me if I would not help him with an analysis of the hearings of the Senate Finance Committee on the "Financial Condition of the United States, 1957-58."

I spent several weeks in Washington during the summer when the Government witnesses appeared, and I also appeared as a witness myself in the spring of 1958. In the fall of 1958, after analyzing the hearings of the committee inclusive of the compendium and joint supplementary comments of the presidents of the Federal Reserve banks, who were responsible for the questionnaire of the Committee on Finance, I wrote an 83-page report (mimeographed) for Senators Anderson and Kerr.

In early June 1959, Senators Anderson and Kerr asked me if I would not try to bring the report up to date. I have therefore inserted numerous additions within the earlier manuscript where recent developments have required additions or revisions. I have also included two additional parts, one (III) on the failures of the administration and the second (IV) on proposed legislation resulting from the hearings and recent developments.

I am very much indebted to Senators Anderson and Kerr for the opportunity they gave me as well as their cooperation, and to Mr. Samuel D. McIlwain, who was special counsel for the investigation and who also made many helpful suggestions for my revision.

The first witness was Secretary of the Treasury Humphrey, and he was on the stand for 14 days. This must certainly have been some kind of record for this kind of hearing. His evidence covers 658 pages, inclusive of all kinds of exhibits.

Under Secretary Burgess required 10 days (and 550 pages) in the summer of 1957 to complete his evidence (pt. 2). Chairman Martin, of the Federal Reserve Board, was the third witness, and his interrogation required 5 days in August 1957 and more than 400 pages (pt. 3). An index to parts 1, 2, and 3 accounted for part 4.

In the spring of 1958, Mr. Bernard Baruch appeared for 2 days (pt. 5), and in 7 days in April 1958 Marriner S. Eccles, former Chairman of the Board of Governors of the Federal Reserve System, Sumner H. Slichter, professor of economics at Harvard University, Chairman Martin, of the Federal Reserve Board, Seymour E. Harris, chairman of the economics department, Harvard University, and Charles C. Abbott, dean of the Graduate School of Business Administration, University of Virginia, all appeared.

In addition, there was a compendium of comments of presidents of the Federal Reserve banks, executives of corporations, officials of trade and business associations, professors and economists, in response to a questionnaire.

The presidents of the Federal Reserve banks had a joint statement as well as supplementary comment. Twenty-eight top corporation officials also responded to the questionnaire. In addition, 19 economists replied to the committee's questionnaire.

PART I

SUMMARY AND CONCLUSIONS

(Numbers relate to sections in Pt. II)

A. STABILITY

In the Senate Finance Committee hearings, the Government representatives emphasize especially the need of stability. They stress this point much more than the need of maximum output, employment, and growth. In fact, they were prepared to impose a recession in order to be assured of stability. (See S1, S2, S3). They emphasize especially the possibility of a creeping inflation becoming a galloping inflation.

It is not clear that this is a sustainable position. Aside from the Korean war, the increase in prices averaged only about 1 percent over a period of 10 years. In this same period, output rose by 40 percent—not a bad record.

It is not at all clear even that there has been a price rise of 10 percent in these 10 years aside from the Korean war. In the compendium before the Joint Economic Committee, Professor Ruggles, of Yale, argued in fact (pp. 298-299) that improvements in quality are not adequately measured by index numbers. Hence at the same price the consumer gets increased value.

Along the same lines, for example, it is known that hospital daily charges have increased greatly. This is shown in the index numbers. But what is not shown is the fact that the average patient spends about half as much time in the hospital, because of great improvements in medicine. The genuine rise in prices is less than indicated by this part of the rise.

It is an interesting observation that, of the 47 economists who appeared before the Joint Economic Committee in 1958 in the hearings on the "Relationship of Prices to Economic Stability and Growth," few economists seemed to be reasonably sure, as were the Federal Reserve officials and the Treasury, that a creeping inflation would develop into a galloping inflation.

B. THE WAGE OR COST PUSH

In the Senate finance hearings, administration officials, and especially the Federal Reserve bank presidents, stressed the relationship between the rise of wages and the inflation. None of the governmental representatives or of the Reserve Banks tended to emphasize other factors accounting for the rise of prices. (See S4.)

It is apparent from the evidence of the Government officials and the Federal Reserve chairman that the way to deal with inflation was to cut down the supply of money. But this was not the view of many of the witnesses before the Joint Economic Committee. The economists tend to emphasize the point that, when the inflation is a

demand inflation related to excessive purchasing power, then the approach is to cut down the purchasing power. But they were considerably less sure that with a rise of costs this is the proper approach. In fact, numerous witnesses emphasized the point that, since it was impossible to reduce wages or that it was impossible or unwise to reduce prices because wages could not be depressed, new techniques for dealing with inflation had to be found.

Hence, it followed, an attempt to deal with a rise of prices associated with higher wages or other costs through monetary policy would bring about a recession. Indeed, a few witnesses argued that a small recession might not be unwise, but they were opposed to a recession of the order of 1958. They contended that a little uncertainty might perhaps contain, to some extent, the rise of wages and prices. If labor and other factors of production were assured of passing on increased costs in higher prices, then the inflation would be much more serious. It is clear to many of the economists that, since wages in most industries cannot be cut, the average wage rate must rise, because there must be differentials in order to attract resources from one industry or employment to another.

What the Senate Finance Committee hearings failed to show was that the increase in costs per unit of product was just as much non-labor cost as labor cost. This was shown clearly by a study by the Bureau of Labor Statistics.

The unwisdom of a monetary policy that brings about unemployment and reduced output is emphasized by another point; namely, that in periods of recession, productivity falls and therefore not only do wage rates rise, though not as much as in periods of prosperity, but productivity falls and therefore there is a double cause of rising prices.

In a survey of business cycles over a long period of time, Mr. Thor Hultgren, of the National Bureau of Economic Research, concluded (hearings, "Relationship of Prices to Economic Stability and Growth," pp. 97-98):

In expansions, the effect of declining man-hours per unit has been more powerful than that of rising hourly earnings. Labor costs fell in most cases, although not as frequently as man-hours per unit. In more recent contractions, changes in man-hours per unit and changes in hourly earnings have worked in the same direction and labor cost has usually risen. * * *

In a most interesting study, Mrs. Ruth P. Mack, of the research staff of the National Bureau of Economic Research, has produced some evidence to show that labor is not primarily responsible for the rise of prices. Between January 1947 and the 1956 or 1957 high point, she holds (compendium, p. 130), that the cost of raw materials and labor rose by 15-16 percent and of manufactured goods by 54 percent in the 10 years ending 1957. Her explanation is primarily large rises in overhead costs—marketing, administration, research, insurance, et cetera.

None of the 47 economists, with the exception of Prof. Abba Lerner, before the Joint Committee hazarded to suggest a way out of this dilemma of checking a cost-induced inflation without bringing on a recession. Very few proposed the Federal Reserve medicine of reduced supplies of money. Indeed, there was a general willingness to use both monetary and fiscal policy and certainly a greater disposition to use fiscal policy than was suggested by the administration.

Professor Lerner alone, however, would deal with the problem through controls of prices and wages. Elsewhere ("Review of Economics and Statistics," May 1957), Professor Galbraith did indeed suggest some restraints on rising wages and prices in crucial industries.

This is obviously one of the tough problems the Senate Finance Committee should deal with. What should be the contribution of monetary policy? Of fiscal policy? Of control, should fiscal and monetary policy fail to achieve the objectives? I am sure that most would agree that a rise of prices of 1 percent per year and a gain of output of 3 or 4 percent would not justify the use of controls, or even strong monetary policy. But if, for example, prices should continue to rise at 3 or 4 percent per year, and output 1 or 2 percent, then the pressure may be on for strong monetary and fiscal policy or even some limited kinds of control.

The rise of wage rates did not bring a greater inflation, because to a substantial degree the increase in wage rates was offset by a rise of productivity. There is also some evidence that the labor groups squeezed the capitalist groups to some extent. This does not mean that capital did not very often increase prices much more than was justified by the rise of wages. Professor Kendrick, of George Washington University, argued that inflation would have been greater had it not been for the rise of productivity and the squeezing of capital, but contended that this particular squeezing of capital could not go on for long (*ibid.*, hearings, pp. 100-101). Ruggles (*compendium*, p. 301) argued in a somewhat similar vein. He found that profits as a percentage of wages and salaries had fallen from 36 percent in 1948 to 29 percent in 1956. This is subject to some reservations. Of course, one should allow here for the relative rise of capital and of numbers of workers. But the Senate Finance Committee hearings (p. 1419) seemed to show no clear trend of corporate profits before taxes as a percent of national income and a trend downwards after taxes since 1930 (Chairman Martin).

C. MONETARY RESTRICTIONS AND THE ECONOMY

It is clear from the discussion in part II (see S5-S10) that the Federal Reserve policy contributed toward the recession. Moreover, it is also clear that monetary policy is not an overall medicine; it affects different markets in different ways, and in this sense it may be as selective as selective controls.

One of the unfortunate aspects of the restriction of money is that production was cut in fields where there was excess capacity. This is clearly the case in the construction area.

In the Consumer Price Index the rise was largely in services and notably in medicine, where productivity had not increased greatly and where there were shortages of services. But a serious rise in manufacturing prices is also to be found, and this is reflected in the wholesale prices of finished goods.

For example, from 1955 to 1958 wholesale prices rose by 8 percent; but those of metals and metal products by 12 percent, machinery and automotive products by 18 percent. These are industries with much use of administered prices. But in another administered area, rubber and rubber products, the increase was but 3 percent.

But it should also be noted that there were oligopolistic markets in some of these industries, and with strong trade unions and administered prices these contributed to inflation.

D. OBSTACLES TO MONETARY POLICY

One of the objectives, according to the Federal Reserve, of the dear-money policy was to increase savings and thus keep down the pressure of demand. Unfortunately, the Federal Reserve was not aware that the most important factor in determining savings is not the rate of interest, but income. The response of savings to higher rates of interest was disappointing throughout the period of dear-money policy. (See S11.)

Another obstacle to successful policy was, of course, the loose relationship between the supply of money and the amount of spending. In 1 year when the supply of money rose by 1 percent, the total bank debits rose by 8 percent. Similar developments occurred throughout the period of anti-inflationary policy. (See S12.)

A great obstacle to the achievement of Federal Reserve objectives was the presence of the financial intermediaries, that is, life insurance companies, pension funds, etc. They had become more and more important vis-a-vis the commercial banks over which the Federal Reserve had restricted control. As commercial banks, under restrictionist pressure, tended to cut their lending, the financial intermediaries were in a position to expand even as commercial banks were restrained. They could do this in part because they could take in active cash from the public and make it more active, or they could dispose of Government securities and make loans. (See S13.)

One of the surprises of the hearings was the failure of the Federal Reserve to make any suggestions or for that matter the Treasury to cope with the problem of intermediaries that made control of the economic system so much more difficult. This is certainly a problem for consideration for the Senate Finance Committee.

There are various possible attacks on this problem. For example, since the intermediaries deal especially with consumer and housing credit, any selective control of consumer and housing credit may be an approach to the control of the activities of the intermediaries. (Compare Prof. Warren Smith in the compendium, pp. 509-511.)

Another approach is direct control of the intermediaries, for example, by requiring that they keep their assets in certain forms, or at least that they would keep certain liquid assets behind their liabilities.

In his recent book, "Prosperity Without Inflation," Prof. Arthur Burns, the former Chairman of the President's Council of Economic Advisers, had this to say about financial intermediaries (p. 82; also see S13-S15):

* * * One suggestion is to require various financial intermediaries to hold reserves against their liabilities on a basis similar to the requirements imposed on commercial banks. Another suggestion is to free commercial banks from some of the regulations that may have impeded their growth * * *. A third suggestion is to give the President or the Federal Reserve Board standby authority to regulate the terms of consumer installment credit and perhaps also the terms of conventional housing mortgages * * *.

One of the assumptions of the Federal Reserve and the Treasury apparently was that an increase in rates and reduction in the supply of money would not bring any trouble into the Government bond

market. This proved to be an unjustifiable assumption. The banks reacted to higher rates by disposing of Government securities and lending under more favorable terms to others. The Federal Reserve policy had the effect of forcing an abandonment of the Government security market and a very large decline in the prices of securities. The financial institutions were not deterred by the fall in the price of bonds to hold on to their securities. Indeed, once the market price reached a very low point, they then began to purchase. But this was too late.

Surely, it is one of the responsibilities of the Senate Finance Committee to consider the effects of monetary policy on the bond market, and particularly the extent to which a general monetary restriction tends to result in a serious depression in the prices of Government securities. Has not the movement to leave the Government bond market to the free market forces gone too far since 1951? (See especially S14.)

E. FEDERAL RESERVE AND THE RECESSION

Although the Federal Reserve increased rates substantially in the years 1956 and 1957, on occasion they were inclined not to take the responsibility for the higher rates, restrictive monetary policy, and their aftermath. They claimed at times that they were merely following the market. There is much evidence that this was not so. (See S16.)

Unfortunately, the Senate Finance Committee did not have an occasion to deal with Federal Reserve policy during the recession. I hope that, if the hearings are continued, the Federal Reserve policy during the recession will be given sufficient attention. It seems to the writer that they tended to worry about inflation excessively right in the midst of the recession. Only thus can we explain a continued stability of excess reserves over a period of more than a year, and the failure to increase the reserves of member banks after 1 year of recession. We might thus also explain the increase in the bank rate in August 1958, when the reality of the recession was apparent to almost everybody. The time to deal with inflation is when it comes, not in the midst of a recession. (See S17.)

F. FISCAL POLICY

In his opening statement (p. 10), the Secretary of the Treasury charted the immediate tasks of the administration. The essential items were: reduce the planned deficit and then balance the budget; meet the huge cost of our defense; properly handle the burden of debt and obligations; check the inflation; work toward the earliest possible reduction of the tax burden. In every instance, the administration, of course, has failed. They have now given us a \$13 billion deficit, a record for peacetime. They have not met the huge costs of defense but rather have drastically cut defense expenditures. They have failed to achieve their objectives in the handling of the debt, especially in re the holdings by banks and the maturity of the debt. They clearly have failed to check the menace of inflation, and the budget which the President had promised at \$60 billion in 1952 is now around \$80 billion.

With encouragement from Secretary Humphrey, the Government introduced a rigid debt ceiling as a means of cutting expenditures down.

Unfortunately this debt ceiling has had serious effects. In order to maintain the debt ceiling and not spend in excess of it, the Government has endangered the integrity of the budget. By all kinds of devices the debt has been kept down for accounting purposes, but only by selling assets, refusing to make payments that were parts of a contract, pulling items out of the regular budget, and the like. Even the defense effort has been seriously jeopardized by the debt ceiling. (See S19 and S20.)

In the recession period, the Government refused to use antirecession policies adequately. As a matter of fact, by the second quarter of 1958, when the GNP had fallen by \$17 billion, Federal spending had increased by only \$1 billion. Indeed, there has been a substantial recovery since. But the question still remains whether we would not have had a much greater recovery had the Government introduced a tax cut in 1958, even a small one, and also had substantially lifted its spending program. With higher incomes the deficit would undoubtedly have been cut. The Government still had not learned that in periods of recession the appropriate policy is to increase spending and reduce taxes. They seemed to have a glimmer of this idea in 1954, though it is not at all clear but that the objective at that time was to keep the promise of a tax cut and not exactly to stimulate the economy.

Indeed, we must recognize that fiscal policy directed toward stabilizing the economy and achieving greater growth is only one objective of the economic system. Indeed, the need of expenditures for security may be a more important objective than the stability of the currency. Furthermore, there are questions of equity that must be considered. (See S22.)

G. DEBT MANAGEMENT

Little evidence is available that the Eisenhower administration has improved the structure of the national debt. In fact, the commercial banks held larger amounts of securities in December 1958 than at the end of 1952. Furthermore, they have not lengthened the maturities, as we shall see. (See S23.)

Why did the Government fail to issue long-term securities in the anti-inflationary period and why did they issue long-term securities in the recession? Almost all economists agree that the job of the Federal Government, when the objective is higher money rates, is to issue long-term securities and absorb excess money; and in a period of recession the one thing the Federal Government must not do is to compete with the money market when the authorities through other measures are trying to bring about monetary ease. Yet the Federal Reserve and the Treasury between them operated in a perverse manner. They issued short-term securities in the boom and long-term ones in the recession until quite recently. This is a matter for investigation by the Senate Finance Committee. The only defense offered by the Treasury was that they did not like to interfere with the private market when the private market was anxious to expand its activity. But surely the objective of stability is more important. (See S24 and S27.)

When confronted with the increase in the rate of interest on Government securities, Secretary Burgess' defense was that this would involve the transfer of income from one group to another. But Senator Long made it quite clear that those who receive the interest are not necessarily those that pay the taxes. In fact, he showed that most mem-

bers of the population did not hold savings in any substantial amounts. (See S25.)

One of the hottest issues in the course of the hearings was that of the lengthening of the maturity of the debt. Actually, the record of the Treasury was not as good as Secretary Burgess claimed. He was able to show a decline in the floating debt, but only by excluding E and H bonds. In other words, he excluded E and H bonds and included other savings bonds. If he had been consistent and excluded all savings bonds or included all of them, he would have shown an increase in the floating debt. (See S26.)

In 1951, an agreement had been made for reducing the support of the Treasury security market. Another innovation by the Federal Reserve was the bills only policy, which tended to weaken its hands in the control of the economic situation. It is of some interest that despite the earlier criticism of the Truman administration, the Federal Reserve has supported the Government bond market at crucial moments and has also abandoned the bills only policy when the pressure was too great.

Finally, we have the problem of independence. Should the Federal Reserve be independent? In the hearings before the House Committee on Government Operations in 1958, this issue was fully thrashed out. The Federal Reserve has contended, as has the President, that the Federal Reserve should be independent. The President has gone so far as not to make recommendations in his annual report on monetary policy. This seems an absurd position when it is realized that the responsibilities of the Government for the economic health of the Nation are great. In view of this fact, it is very important that the Federal Reserve should integrate its policies with other agencies and departments of the Government, and this cannot be done so long as the Federal Reserve is independent. An independent Federal Reserve means independent agencies all over, with disastrous effects on a well integrated policy.

H. SELECTIVE CONTROLS

Much evidence is available that, had the authorities in the administration been willing to support selective credit controls, they might have been made available. But the Federal Reserve and the Treasury spurned such offers. Their position seemed to be that selective controls involved meddling in the system. But they failed to note that general measures in the monetary field were uneven and inequitable in their incidence; and the net effects, in contrast to selective controls, could be much more damaging to the economy.

I. ANOTHER VIEW OF FEDERAL RESERVE POLICY AND ECONOMIC STABILITY

Late in 1958, the Senate Banking and Currency Committee released a report on Federal Reserve policy which was very critical of Federal Reserve policy in both 1953 and 1957-58. The writer of this report, with the minutes of the Open Market Committee available, found no such concern for inflation in 1957 in that Committee as Chairman Martin reflected in his statements and policies. Again, the report was critical of the Federal Reserve for raising rates in August 1957 when, at the very least, it was clear that the boom had lost its potency and a downward movement was on its way.

PART II

HEARINGS AND COMPENDIUM: DIGEST AND COMMENTS

1. *The hearings of the Senate Finance Committee on the investigation of the financial condition of the United States.*

The investigation of the financial condition of the United States used up 29 days in the summer of 1957 and 9 days in the spring of 1958, the total pagination amounting to 2,090 pages, exclusive of a 758-page compendium based on replies to questions. In what follows, the pages will be given and those in the compendium will be prefaced by a "C."

I have tried to summarize the hearings, to bring out the major results and to suggest where we should go from here.

2. *Stability of the currency a major issue.*

I am reasonably sure that the American people are very much interested in financial policy. They realize that the stability of the price level depends upon financial policy in no small part, and they are aware of the fact that financial policy also has a considerable effect on output. All of us want as high an output as possible in a growing economy, but we want it, insofar as possible, consistent with relatively stable prices. These are, of course, relative terms. A rise of prices of 10 percent with a rise of output of 1 percent is not a very good record. But an increase of output of 10 percent and a rise of prices of about 1 percent is not a record to be ashamed of.

In the hearings of 1957-58 on the financial condition of the United States by the Senate Finance Committee, under the chairmanship of Senator Byrd, perhaps no issue attracted more attention than that of the instability of the value of the dollar. This had been a very important issue in the 1952 campaign and undoubtedly contributed to the Democratic debacle. It is not surprising, therefore, that in the hearings of 1957-58 the Democratic members of the senatorial committee stressed greatly the failure of the Eisenhower administration to provide the country with a stable currency. It seemed shocking to many members of this committee that in the period of recession price rises should average 3 or 3½ percent per year.

Without a doubt, the No. 1 problem for the Republican administration and its spokesmen was inflation. This was clear from the hearings. Indeed, the Chairman of the Federal Reserve Board, Mr. Martin, and others suggested that we now have the responsibility for growth; but what they emphasized above all was the need of containing or even stopping inflation. Mr. Martin not only sees the usual dangers of inflation, that is, injustices to those with fixed incomes, distortions in the production process as the result of inflation, but he and his supporters emphasized especially the point that a creeping inflation must inevitably become a more violent inflation; that is, a galloping inflation. Above all, the job of the Federal Reserve, in his view, seems to be to stop any inflation. Since 1957,

Mr. Martin and members of the administration have been seeking congressional support for a clear-cut mandate that stabilization of the currency should be a fundamental objective of policy. On other occasions, for example, in the 1920's and 1930's, when Congress wished to thrust upon the administration of the Federal Reserve the objectives of a stable price level, the Federal Reserve has protested on the grounds that they were not capable of stabilizing the price level. Now they seem to come out for such a responsibility to be imposed on them by Congress.

At the opening hearings, Senator Byrd made the point that everybody was concerned over the rise of prices.

The committee cannot overlook the fact that responsibility for sound currency is a prime responsibility of the Central Government.

* * * * *

Actually, confidence in the American dollar is the principal deterrent in the world today to Russian aggression. The pages of history detail the stories of nations which have been wrecked by unsound fiscal policies and debased currencies. If the value of the dollar continues to drop at the rate of 2 cents a year, as it has in the past year, it will be worth only 25 cents in 12 years, as compared to the 1940 dollar.

This committee wants to know the causes of this new inflation, and it wants to find the remedy before the consequences become disastrous (pp. 3-4).

Witnesses before the committee repeatedly echoed these sentiments. In his opening statement, Chairman Martin asserted (p. 1262):

The objective of the [Federal Reserve] System is always the same—to promote monetary and credit conditions that will foster sustained economic growth together with stability in the value of the dollar.

This goal may be thought of in human terms and should be. The first part may be considered as concerned with job opportunities for wage earners; the latter as directed to protecting those who depend upon savings or fixed incomes, or who rely upon pension rights. In fact, however, a realization of both aims is vital to all of us. They are inseparable. Price stability is essential to sustainable growth. Inflation fosters maladjustments.

According to Mr. Martin, the Federal Reserve Act and the Employment Act of 1946 supply the Federal Reserve with a mandate to seek price stability in conjunction with economic growth (p. 1518):

Mr. MARTIN. I think if you read the Federal Reserve Act, and take it in conjunction with the Employment Act of 1946, which was also the law, that those objectives are quite explicit.

Senator MALONE. You go beyond the Federal Reserve Act. The 1946 Employment Act is where you get this objective. You did not get it out of the Federal Reserve Act, did you?

Mr. MARTIN. Well, not line for line out of it. I supplemented it.

Later, Mr. Martin conceded that his mandate to pursue price stability is not as explicit as he would like (p. 1520):

Senator MALONE. Would it not be more desirable to state the objective of the System is to maintain the integrity of the U.S. dollar, its honesty and soundness?

Mr. MARTIN. I think you could have stated it more explicitly than in the present act.

Senator MALONE. You think it would be a good addition to the act?

Mr. MARTIN. I do not think it would be necessary. I think the most necessary amendment is to make clear what I believe to be implicit in the Employment Act. * * *

Of the several witnesses who dealt with this issue, only Prof. Howard Ellis seemed satisfied that present legislation provides the

Federal Reserve System with a mandate concerning price stability (p. C599):

All three of the objectives [price stability, growth, and stability in production and employment] are important for the economic policy of the United States; all three have, in my judgment, quite correctly, been so designated in the Employment Act of 1946.

Most of the other witnesses urged that the Employment Act be amended to direct the pursuit of price stability; they did not seem satisfied with its present preamble. In the words of Mr. Alfred Hayes, president of the Federal Reserve Bank of New York (p. C76):

There has been much discussion during recent years on the merits of inserting a clause in the declaration of policy in the Employment Act of 1946 making the maintenance of price stability a stated objective of Government economic policy. The closing phrase of the declaration, which refers to promoting "maximum employment, production, and purchasing power," has been interpreted as meaning maximum sustainable levels, and we believe that requires avoidance of either inflation or deflation in any marked degree. I would, therefore, favor the proposal that the declaration of policy be amended to include explicitly stability of the value of the dollar among the objectives of national economic policy.

By January 1959, the President was echoing the views of Mr. Martin. In his annual Economic Report, he also urged the need of stable prices. He appealed to the consumers to shop around carefully, to businessmen to be aware of the relation of lower prices and increased market, but he appealed especially to labor; and he, like Martin, would make reasonable price stability a goal of Federal economic policy and amend the Employment Act of 1946. Accordingly:

Leaders of labor unions have a particularly critical role to play, in view of the great power lodged in their hands. The economic actions must reflect awareness that the only road to greater material well-being for the Nation lies in the fullest realization of our productivity potential and that stability of prices is an essential condition of sustainable economic growth.

The terms of agreements reached between labor and management in wage and related matters will have a critical bearing on our success in attaining a high level of economic growth with stable prices. It is not the function of Government in our society to establish the terms of these contracts, but it must be recognized that the public has a vital interest in them. Increases in money wages and other compensation not justified by the productivity performance of the economy are inevitably inflationary. They impose severe hardships on those whose incomes are not enlarged. They jeopardize the capacity of the economy to create jobs for expanding labor force. They endanger present jobs by limiting markets at home and impairing our capacity to compete in markets abroad. In short, they are, in the end, self-defeating.

Self-discipline and restraint are essential if reasonable stability of prices is to be reached within the framework of the free competitive institutions on which we rely heavily for the improvement of our material welfare. If the desired results cannot be achieved under our arrangements for determining wages and prices, the alternatives are either inflation, which would damage our economy and work hardships on millions of Americans; or controls, which are alien to our traditional way of life and which would be an obstacle to the Nation's economic growth and improvement.

The chief way for Government to discharge its responsibility in helping to achieve economic growth with price stability is through the prudent conduct of its own financial affairs. The budget submitted to the Congress for the fiscal year 1960, which balances expenditures with receipts at a level of \$77 billion, seeks to fulfill this responsibility. If Government spending is held within the limits set in the proposed budget, the growth of our economy at the rate that may be expected would make it possible in the reasonably foreseeable future to provide, through a significant further step in tax reform and reduction, added incentives and means for vigorous economic growth and improvement.

Governmental actions in other areas can also help to maintain price stability as our economy expands. The Congress will be requested to amend the Employment Act of 1946 to make reasonable price stability an explicit goal of Federal

economic policy, coordinate with the goals of maximum production, employment and purchasing power now specified in that act. Steps will be taken within the executive branch to assure that governmental programs and activities are administered in line with the objective of reasonable price stability, and programs for the enlargement and improvement of public information on prices, wages, and related costs, and productivity will be accelerated.

But by June 1959, the President had not made much progress in getting across his recommendation for a revision of the Employment Act of 1956. Actually, over a period of 10 months there had been no net change in the Consumers Price Index.

This does not mean that important rises did not occur—largely offset by reductions in foods. Especially striking was an increase in the price of solid fuels and fuel oil of 6 percent in 8 months, of transportation of 4 percent, of medical services of 3½ percent. The first two suggest the importance of administered prices and the last the shortage of medical services, inclusive of hospitals, under the rising pressure of demand in turn related to the advance of insurance. A very large rise in the wholesale index for metal and metal products also points to the significance of the administered prices.

3. *A creeping inflation inevitably brings a galloping inflation?*

Especially fearful of the conversion of a creeping inflation to a galloping inflation, many of the authorities stressed the dangers of creeping inflation. Thus Hugh Leach, president of the Federal Reserve Bank of Richmond, puts it (p. C103):

* * * The whole concept of creeping inflation is dangerously misleading, for a chronic inflation cannot be either mild or controlled. If the public in general, and business in particular, should become convinced that a continuous loss of purchasing power were inevitable, the incentive to save would be greatly reduced, the incentive to spend sharply increased, and the end result could only be an acceleration of inflationary pressures. The process would tend to feed upon itself and eliminate any possibility that the pressures could be controlled within narrow limits.

Even among economists, Dr. G. Colm (p. C591), Prof. H. Ellis (p. C601), Prof. G. Haberler (p. C624), and Prof. T. Yntema (p. C754) there was some fear of a *long* inflation blossoming out into a *large* inflation.

It is not exactly clear why this position was taken. Actually, over a period of 10 years, aside from the effects of the Korean war, the rise of prices did not average more than about 1 percent a year. This rise of prices of 10 percent, aside from the effects of the Korean war, should be compared with an increase in gross national product at stable prices of about 40 percent. Even if the Korean war were included, the rise of output would be twice as great as that in prices. It would have been better if prices could have been stabilized, but surely the history of the last 10 years does not give strong support for the view that a creeping inflation must inevitably result in a great inflation.

It is now more than a year since the hearings of the Finance Committee were concluded, and more than half a year since my original report was written. The Federal Reserve authorities still emphasized especially the dangers of inflation—despite the remarkable stability of prices for almost a year.

The President, the Secretary of the Treasury, and the Chairman of the Federal Reserve Board continue to harp upon the great dangers of inflation. One of the first to bring back reports on the weakness of

the dollar was Mr. Martin. The implication was: Why should the dollar be weak except that wages and prices were rising too rapidly here? This threat to the dollar is also presented as an excuse for cutting expenditures for defense and welfare. How much would our dollar be worth if our defenses are cut so that we lose the cold or the hot war?

Losses of gold and dollars to foreign interests have indeed been a matter of speculation, and possibly of concern. In a period of a year we lost \$2 billion-plus of gold, a record loss; and the losses continue. Also, there have been substantial rises in short-term liabilities of American banks to foreigners.

After a period of 40-50 years in which the dollar was scarce, this sudden reversal arouses anxiety. It is easy to put the blame on the rise of wages and prices that tend to make the United States less competitive. But for many years prices have been rising much more abroad than in this country, and losses of competitive position then being corrected at least in part by devaluations. But even in the years 1955-58, when inflation was of special concern, inflation in the United States was not out of line:

Percentage rise of cost of living, 1955-58

United States.....	8
Brazil.....	64
France.....	8
Germany.....	8
Italy.....	8
United Kingdom.....	12

Inflation, which leads to a loss of competitive position, may suggest to many the need of balanced budgets, anti-high-wage policies, and higher rates of interest. Why the last? Because with higher rates of interest capital would flow in instead of out, and therefore the outward flow of gold would be reduced or stopped.

But it is clear we have not experienced a relative inflation and more recently any inflation. There may be a weakening of our competitive position; but the explanation lies primarily in the continued recovery of our competitors from the ravages of wars. Our competitive position has been abnormally strong since the war.

That we continue to lose gold is explained also in part by military expenditures abroad of \$3.3 billion in 1958, of unilateral transfers (gifts) of \$2.3 billion, and capital exports of \$4 billion, or outflows of \$9 billion plus as compared to gold, etc., losses of about \$3 billion.

An examination of world exports suggests that the United States is far from being in a weak position. From the table below, we note that her export position improved abnormally in 1957, in part because of the Suez crisis, and hence had to deteriorate in 1958. But she maintained well her export position from 1950 to 1958 with her share of world exports being 18.6 percent in 1958 as against 18.0 percent in 1950. Her ratio of exports to world exports in 1950 was larger than before the war. But as might be expected, in part under the stimulus of American aid, the relative share of world exports increased relatively and notably for Germany, Japan, and Continental Europe, in that order (American aid strengthened these economies). The United Kingdom actually experienced a relative decline in her share of world exports. But these large relative gains for our major competitors reflects largely the low position held in 1950 as compared to prewar.

In one sense, the U.S. position is weak. The IMF reveals that imports of the United States and Canada, which were 17 percent of world imports in 1937, had increased to 25 percent in 1957. Exports in the same period had increased from 16 to 18 percent.

In this connection, note the following:

From 1913 to 1954, U.S. exports of manufactures rose more than twice as much as those of all major industrial countries—a reflection of rising competitive power.

Her total exports increased from 22 percent of exports of 10 major industrial countries in 1913 to 26 percent in 1938 and 34 percent in 1954, an indication of larger gains than suggested by the IMF combined figures of the United States and Canada in relation to world trade.

But against this we note a rise in the percentage of imports for the United States among 10 leading industrial nations from 15 to 24 percent in these years, respectively.

Exports, world and various sectors and countries, billions of dollars and percentage of world, 1950, 1955, 1957, and 1958

	1950		1955		1957		1958	
	Billions of dollars	Per-centage world	Billions of dollars	Per-centage world	Billions of dollars	Per-centage world	Billions of dollars	Per-centage world
World.....	57.23	-----	84.79	-----	101.0	-----	96.0	-----
United States.....	10.28	18.0	15.55	18.3	20.86	20.6	17.86	18.6
Continental Europe.....	14.31	25.0	26.06	30.6	31.75	31.4	31.75	33.1
United Kingdom.....	6.32	11.1	8.47	10.0	9.68	9.6	9.39	9.8
Germany.....	1.98	3.4	6.13	7.2	8.6	8.5	8.81	9.2
Japan.....	.82	1.4	2.01	2.4	2.86	2.8	2.88	3.0

Source: IMF, International Financial Statistics, May 1959 (my calculations).

Undoubtedly, a factor reflecting the problems for this country is the relative decline of exports of raw materials and food, drink, and tobacco, as well as the large increase of imports. To this changing composition of trade, this country will have to adjust by producing more raw materials and food at home, economizing on their use, increasing exports of manufactured goods or (and) cutting down on loans and aid programs and travel abroad.

Percentage trade, United States, among 10 major industrial currencies, 1913, 1938, and 1954

	Exports		Imports	
	Raw ma-terials	Food, drink, and tobacco	Raw ma-terials	Food, drink, and tobacco
1913.....	40	23	11	11
1938.....	25	20	16	14
1954.....	19	12	24	28

Increased imports of raw materials are the rule among industrial countries. Thus, the 10 important industrial countries had an adverse balance on raw material accounts of \$2,834 million in 1938, and \$9,650

million in 1952, as compared to an overall deficit of \$1,272 million in 1938, and a credit of \$106 million in 1952.¹

Hence, I conclude that it would be a mistake to justify higher interest rates, monetary restraint, and balanced budgets irrespective of our security and welfare needs, on the grounds that our dollar position has deteriorated dangerously. Our annual losses of gold are still a fraction of our loans and gifts.

4. *Wage push and inflation*

In the discussion of the inflationary problem, the contribution of rising wages did not receive a great deal of attention. This may undoubtedly be explained by the fact that the politicians who testified were fearful of putting the blame on the trade unions or laborers. Indeed, there were moments when Secretary Humphrey came pretty close to saying that a significant amount of unemployment might contain the demands of the workers and therefore keep prices down. But he did not say so directly. In the current discussion of the inflation, many authorities in Washington and elsewhere have held that trade union wage policy was the fundamental factor in raising prices. Obviously, if the workers send wages way up beyond the point justified by higher productivity, then it does become more difficult for the Federal Reserve to contain the inflation. If they cut supplies of money so that the increase in wages is not validated by an adequate rise in the supply of money, then the only result can be a reduction of demand and a reduction of output. Higher wages are reflected in reduced output. Professor Angell (p. C531) has put the issue as follows:

* * * a "cost-push" is not itself an independent factor forcing prices up. We must look further for the explanation of "inflation" * * * this explanation must obviously lie in the expansion of aggregate monetary demand. If sellers try to put up their prices but monetary demand has not increased proportionately, either buyers will not pay the higher prices, and prices will fall back again; or they will pay the higher prices, but will buy smaller physical quantities. On a nationwide scale, the latter alternative means falling output and unemployment.

It is not at all clear that the wage inflation has been the fundamental factor in the recent rise of prices. In fact, a study by the Bureau of Labor Statistics, issued by Mr. Clague, shows that the nonwage elements contributed as much to the rise of real costs per unit from 1947 to 1957 as the wage element.

Another indication of the net movements is given by a study by Mr. Murray Wernick, senior economist of the Federal Reserve Board, who showed that, from a base of 1947-49, unit wage costs rose by 15.7 percent by 1957, whereas the wholesale industrial price index rose by 25.6 percent. Again, between 1947 and the spring of 1957, unit labor costs in the iron and steel industry had increased 35 percent, but the steel industry had raised priced by 96 percent, or 2 to 3 times the increase in labor cost. The cost per unit of other materials and services purchased by United States Steel, aside from some direct labor costs, increased 37 percent in a period of 10 years. Obviously, prices rose considerably more than was justified by the rise of wages or even of other costs.

In its careful study, the Council on Prices, Productivity, and Income of the United Kingdom in its first report (p. 24) emphasized

¹ Statistics in table and last few paragraphs from R. E. Baldwin, "The Commodity Composition of Trade: Selected Industrial Countries, 1900-1954," Review of Economics and Statistics, February 1958, pp. 850 to 871.

especially as a factor accounting for a rise of prices and income the view—

that the main cause has been an abnormally high level of demand for goods and services in general, maintained for an abnormally long period of time.

In this period, there have been many large programs, partly as the result of the war and partly in order to assure high levels of employment.

Monetary systems "have evolved in such a way as to make easier the expansion of the flow of transactions to match the so-called needs of trade—whether these reflected a growth in the volume of goods and services exchanged or merely a general rise in their prices. Firms and individuals emerged from the war with abnormally large holdings of money and other liquid assets. Further, for a number of years after the war the general tendency of monetary policy was to permit ready expansion of the money supply and to maintain relatively low rates of interest. Thus the state of high liquidity persisted for a long time."

In other words, though this committee does emphasize the contribution of rising wages enforced by powerful trade unions, they also make the point that the availability of a high degree of liquidity and the willingness to expend large supplies of money made possible the great inflation of prices and income.

Along somewhat similar lines, Professor Haberler has argued, in the "Review of Economics and Statistics," that the Federal Reserve has to restrict the supply of money in order to impose upon the economy a substantial amount of unemployment. This is the price that has to be paid in order to prevent a great inflation.

In the hearings many of the witnesses blamed the trade unions for the inflation. See, for example, the following in the compendium: pages 201, 221, 227, 233, 245, 250; 273, 294, 304, 311, 332, 349, 410, 445, 451, 474, and 576. Mr. Ralph J. Cordiner, president of General Electric (p. C192), had this to say:

Union officials do not appear to be concerned with protecting the economy from inflation. They disclaim responsibility for the inflationary effects of their excessive wage demands, and seek to shift the burden to other groups in the economy. They claim special protection for their members, in the form of escalator clauses to provide automatic wage increases to offset the tax of inflation which shows up the increasing cost of living, and they demand further inflationary increases in pensions, insurance, and other benefits. They seek political support by demanding increased social security and unemployment benefits to make up for the declining value of the dollar, and a topheavy tax structure which reduces their share of the inflated costs of government. Relying on these special privileges, they ignore the fact that the wage earners suffer more than any other group from the periodic recessions that come from inflation, because they bear the primary burden of unemployment.

When Congress originally granted union officials the privileges on which their monopolistic powers have been built, the Nation consented in the hope that these powers would be used with such wisdom and sense of responsibility as to contribute toward greater economic growth and stability. Experience has shown, however, that these powers have been abused in an irresponsible attempt to gain special privileges at the expense of the Nation as a whole, while the penalty for these abuses has fallen most heavily on the group which was presumed to benefit from them.

It is abundantly clear that by these abuses the union officials have forfeited whatever right they may ever have claimed to the enjoyment of such special privileges and immunities. Curbing the monopoly power of unions is a necessary first step if the economy is to be effectively protected against the cycle of inflationary spirals and business recessions, by the use of sound Government fiscal and monetary policies and the exercise of sound business judgment.

A similar view was expressed by Marriner Eccles (p. 1700):

Finally, we must recognize that future inflation cannot be prevented so long as the Government is willing to let the monopolistic powers of labor organizations go unchallenged. These organizations, which have grown immensely in size and power (about 25 percent of the entire labor force), must be made subject to the antimonopoly laws of Government to which business has always been accountable.

Without such control, there is no limit to their demands, all of which, in the final analysis, must be paid for by the entire American public through higher prices.

Prof. Arthur Burns, the former Chairman of the President's Council of Economic Advisers (p. C527), wanted to regulate the trade unions to a greater degree and offered a threat of further regulation if their monopolistic policies continued to be inflationary.

Although I believe that inclusion of reasonable stability of the price level among the objectives of the Employment Act would help to reshape the wage policies of our trade unions and both the wage and price policies of business firm it would be desirable for the Government to go further at this time. Business monopoly is prohibited by law, and the enforcement of our antitrust laws has of late been very vigorous. Trade unions, however, enjoy immunities under the law that are denied other groups or individuals. Our antitrust laws need strengthening in their application to the business world, as the President and many leaders in the Congress have repeatedly pointed out. The least that we can do with regard to trade unions is to subject their finances, as well as the election of their officials, to standards defined by law. Such legislation would of itself have no effect on what happens at the bargaining table; but it should help to remind the leaders of our trade unions that unless they practice greater restraint and foresight, the Government may need to take drastic steps to curb their power to push up costs and prices.

In his statement, George Terborgh argued that the increase in wages cannot come out of profits except in a temporary manner. A large drain of profits would result in serious effects on production (pp. C678-C679).

5. Higher prices and excess capacity

Secretary Humphrey was certain that plenty of competition existed in the iron and steel industry and that therefore the industry could not regulate prices and send them up in excess of a rise given by costs. The Secretary had this to say (p. 613):

Senator GORE. Do you really contend, Mr. Secretary, that the classical law of supply and demand operates now and does operate normally in the steel industry?

Secretary HUMPHREY. Well, it was operating very normally $4\frac{1}{2}$ years ago.

Senator GORE. Well, I think that would require a definition of what you call normal. In view of your prior knowledge of the steel industry, not current—

Secretary HUMPHREY. Well, it was operating the way I have indicated, when I was in it.

Senator GORE. With a very few who control the supply in an item which the Nation must have to sustain its industrial economy, you think that the operation of the law of supply and demand is normal?

Secretary HUMPHREY. I think so. I think that, in my experience, you can have just as difficult competition and just as effective competition with a small number of strong companies as you can with a large number of weak ones.

In reply to Senator Kerr, Secretary Humphrey contended that it was the increase in demand for all kinds of goods which was exceeding supply that explained the upward pressure on prices (pp. 102-103). Chairman Martin took a similar position (pp. 1218-1219):

In the second half of 1955 and in the course of 1956, aggregate demand appeared sufficiently strong to permit increases of wages and other costs to be recovered through price advances. With the demand-cost price spiral well underway, expectations of continued inflation became widespread. These expectations, as

well as the advanced level of prices, are major influences on continued strong demand for funds. * * *

The factors which contribute to inflation are those which lead to a rate of spending in the economy greater than the rate at which goods and services are being made available on the market at existing prices. But Senator Kerr showed quite clearly, in discussions with Secretary Humphrey (pp. 103 and 108) and with Under Secretary Burgess that they could not reveal many items that were scarce in the summer of 1957, that is, when there was an excess of demand. This, in fact, was the beginning of a long discussion of the possibility of inflation in conditions of excess capacity. The following is germane (pp. 772-773):

Mr. BURGESS. * * * That is one interesting part of this thing, that it is not a shortage of individual commodities.

Senator KERR. Are there shortages in other things than specific items?

Mr. BURGESS. I just enumerated them. We seem to think we are short of utility plants and short of tankers and office buildings, because we are spending enormous sums to build them.

Senator KERR. There is no shortage of materials out of which they are building them, Mr. Secretary.

Mr. BURGESS. I did not say they were short. There are shortages of teams of workers in the technical skills required for the finished product.

* * * * *

Mr. BURGESS. I did not say general shortage of labor. I say the skilled teams, of the skilled teams that build some of these things. I think it is more a matter of managerial crews, and so on.

But in a later discussion (p. 1388), Chairman Martin was not so clear.

In my statement, I made clear what out thinking on it was, which is that there are no specific shortages or bottlenecks, but there is a broad general pressure on all of our resources.

Chairman Martin did not explain how, without any specific shortages and a broad, general pressure of demand, there should be a general rise of prices.

For the Presidents of the Federal Reserve Banks, the crucial point was that wage rates contribute toward the inflationary process. The wage increases were induced, in their view, by excess demand and a shortage of labor (pp. C6, C7, and C17).

Some of the positions taken by the Federal Reserve authorities seem to lead nowhere. For example, Mr. Riefler, the Assistant to the Chairman of the Federal Reserve Board said (p. 1359):

The consumer is spending his money, and prices are going up. There is no question that prices are high. Prices could not go up unless they were spending.

In Mr. Martin's view (p. 67), the consumers were spending money they did not have and that was sending up prices.

6. *Monetary restraints and unemployment*

Of course, one of the major issues was the effect of monetary policy on employment. The charge made against the Federal Reserve was that by its excessive concern with inflation it had brought about, through the reduction of the supply of money, much unemployment. This greatly worried Senator Kerr. He wanted to know why the country should not have maximum employment as well as a stabilized value of the dollar.

Senator KERR. All right. Now I want to ask you this question: Which do you regard as the more important, stabilized value of the dollar or stabilized maximum employment?

Mr. MARTIN. Maximum employment every time. No question about it.

Senator KERR. Well, do you think we have that today (1958)?

Mr. MARTIN. No, I do not think we have it today. But when we talk about employment, and the mandate of the Employment Act, we intended jobs that could be sustained, not jobs that are temporary in nature.

Later, this exchange occurs (pp. 1914--1915):

Senator KERR. There are the words "maximum employment."

Mr. MARTIN. Also maximum purchasing power.

Senator KERR. How can you have maximum purchasing power without maximum employment?

Mr. MARTIN. Well, do you want to describe full employment as being that level of employment which is consistent with maximum purchasing power?

* * * * *

Mr. MARTIN. I think the dollar should never be our master. It should be our servant; but I do not believe you can get away from the fact that the business machine depends upon a dollar that has integrity and value, saving and investment, and all of the factors that go into this machinery, the lubricating—

Senator KERR. How about employment that has integrity and value?

Mr. MARTIN. That comes from this. That is a part of this.

Incidentally, Chairman Martin did not interpret the term "maximum purchasing power" in the correct manner. This term really means maximum aggregate demand and does not mean a stability in the price level.

The presidents of the Federal Reserve banks (p. C29) said:

It is extremely difficult, if not impossible, to keep aggregate demand strong enough to maintain full employment without spilling over into rising prices, especially with the close interrelationship between wages and prices under our present institutional structure.

And Chairman Martin told the committee (p. 1301):

Now in terms of the situation we have been struggling with in the last 6 years; the only possible means of attaining the objectives of the Employment Act, in my judgment, are to resist inflation.

What comes first is inflation, and then deflation. In other words, we are fighting deflation all the time.

Many, of course, have been concerned with the relationship between full employment and the price level. With high levels of employment it is likely that labor demands higher wages. But it should be noted that actually this country has not had full employment in the real sense. In the 1950's, unemployment averaged more than 4 percent, compared to roughly 2 percent, the full employment level of the British. This may possibly explain the greater rise of prices in Great Britain than in the United States, a rise in recent years of about three times as great as our rise in prices.

Along these lines, Professor Haberler has argued, in the "Review of Economics and Statistics," that if the price rise is to be kept to a creep, it is necessary to bring about unemployment.

I expect that after a short breathing spell the price creep will begin again; but since the money illusion has worn thin and since the breathing spell, if it comes at all, will be too brief to revive it sufficiently, I do not believe that the price creep can be kept for long without becoming a trot. Then if steps are taken to keep the price rise to a creep, unemployment will again increase.

Thus what I foresee is a period with a somewhat greater average volume of unemployment than we had in the early fifties—something like 5 and 6 percent. That much unemployment may be needed to keep the wage push to a level compatible with stable prices. This is the price we have to pay for permitting

labor monopolies to push up money wages in excess of the gradual rise in overall productivity of labor.

But Professor Haberler says nothing about all the other inflationary factors in the economic situation, including the strong position of semimonopolistic business units.

In his statement before the committee (p. C623), Professor Haberler wrote as follows:

The unusual phenomenon of rising unemployment and sagging production combined with rising prices, which we are experiencing at the present time (early 1958), is a very dangerous development. It means that we have the worst of two worlds.

The main reason for this disquieting innovation must be sought in the downward rigidity of, and upward pressure on, wages.

Chairman Martin, confronted by some questions from Senator Martin (p. 1302) had to admit that there must be some bloodletting in this system; in other words, monetary restraint was required in order to correct the abuses that had crept into the system.

Senator MARTIN. * * * If you were faced with the choice between price stability and temporary cessation of economic growth on the one hand, or creeping inflation and continuing economic growth on the other hand, which would you choose?

Mr. MARTIN. * * * I do not want a recession of any sort at any time. I do not want any man to be unemployed in this country if it is possible to avoid it. But I still think you have to come face to face with the reality that under conditions of excess, extravagance, waste, incompetence, and inefficiency—under those conditions somebody has to take a loss.

At one place, Chairman Martin made it quite clear that he was prepared to bring about unemployment if the pressure for increased supplies of money were sufficient. In other words, he would not tolerate increases in wages that were in excess of productivity (pp. 1309-1310):

Senator MARTIN. If the productivity equals the increased cost in wages, there is no danger, so far as inflation is concerned?

Mr. MARTIN. That is right. And if we can spread that productivity. What we want to do is to spread that productivity through the entire economy as far as we can, and not get it imbalanced and in the hands of a relatively few people.

Senator MARTIN. Are not more and more contracts including escalator clauses?

Mr. MARTIN. They are; and cost-plus contracts have become quite common, also.

Senator MARTIN. Are not fringe benefits being extended by both Government and in industry?

Mr. MARTIN. They are.

Senator MARTIN. In all of this, has the supply of money and credit been fully adequate to support these increasing demands?

Mr. MARTIN. I do not know whether it has been fully adequate to support them, but it is our intention to keep a steady flow of money, as steady a flow of money as we can have. And if that flow of money does not cover the increases that are unwarranted, there should be no pressure on us to increase the money supply just to validate some imbalance which occurs in the economy which is not warranted by productivity.

On two issues discussed in this section we can now add some material not available in 1958. First, the fact is that wages do not rise as rapidly *relatively* in recession as in prosperity even if inflation prevails. Thus, compare the rise of wages in 1948-58 and in 1958. (The rise in 1958 was much less than one-tenth of that in 1948-58.)

Percentage rise hourly wages

	1948-58	1958
Manufacturing.....	60	3
Bituminous coal.....	59	0
Building construction.....	67	4
Railroads (class 1).....	87	7

The second point is that monetary expansion undoubtedly as a result in part of Federal Reserve policy in recent years has been surprisingly restrained. Thus, from 1955 to 1958, demand deposits rose from \$110 billion to \$114.5 billion, or 3-4 percent in 3 years. It is not surprising, then, that as compared to an annual average increase of GNP of 4 percent in the years 1948-58, from 1955 to 1958 there was no increase at all.

In this connection I also present a table constructed by Profs. J. G. Gurley and E. S. Shaw. This table reveals that in real money (money corrected by the price level) the per capita amounts had fallen from \$484 to \$453. This decline should be compared with the steady rises (with one exception) throughout our history. Ordinarily per capita supplies of money rise more than per capita income, in part because with rising income people tend to hold much more in cash relative to income.

The nominal and real money supply, 1799-1958

(In billions of dollars; dollars)

Year	Nominal money supply	Demand deposits	Currency outside banks	Real money supply	Real money supply per capita
June					
	Billions	Billions	Billions	Billions	
1799.....	0.03			\$0.03	\$5.8
1819.....	0.08			.09	9.6
1839.....	.24	\$0.09	\$0.15	.29	17.4
1849.....	.27	.00	.18	.45	19.9
1859.....	.58	.20	.32	.95	31.0
1869.....	1.66	1.08	.58	1.78	45.6
1879.....	2.09	1.46	.63	3.55	72.1
1889.....	3.05	2.16	.89	5.31	86.0
1899.....	5.61	4.43	1.18	10.75	143.7
1909.....	9.83	8.14	1.69	14.54	160.7
1919.....	22.61	19.02	3.59	16.31	155.2
1929.....	26.80	23.16	3.64	23.12	230.9
1939.....	37.66	31.65	6.01	49.85	373.2
1949.....	111.19	85.92	25.27	72.20	484.0
1958.....	144.65	116.83	27.79	78.83	452.9

For sources, see "American Economic History, 1960," edited by S. E. Harris.

7. The Federal Reserve responsibility for the recession

In 1957-58, the country experienced a rather serious recession. There have been all kinds of estimates of the cost of this recession. I would estimate the cost at least at \$50 billion. This is the difference between what output might have been in the absence of a recession. This is the cost that was paid in no small part for trying to stop inflation, though without great success.

Indeed, the recession may be associated with an excess of investment. Undoubtedly investment had increased at a very rapid rate ever since the end of the war, particularly in 1955 and 1956. This rate could probably not be sustained. But it is well to remember

that excess capacity is related to the demand. In turn, demand is related to the monetary policy; and if monetary policy cuts down the total supply of money, then demand suffers and to that extent excess capacity becomes greater than otherwise.

Expert on the Federal Reserve, Mr. Marriner Eccles, a former Chairman of the Board, observed as follows (pp. 1694-1695 and also pp. 1700, 1702, 1707, and 1711):

The action of the Federal Reserve curbed the growth in the supply of money causing the demand to exceed the available supply. Hence, the cost of money was bid up. This tightness had the effect of increasing the velocity, or use, of money about 15 percent—a record. This tended to compensate temporarily for the curbing of its growth. The Federal Reserve was confronted with an unhappy choice—to permit the supply of bank credit to increase to satisfy demands would continue the wage-price spiral. To do otherwise would curb the growth of production and employment, and risk bringing about an economic recession.

We are now witnessing the result of the courageous action which they have taken.

* * * * *

The CHAIRMAN. In your judgment, did the policies of the Federal Reserve System contribute to that recession?

Mr. ECCLES. I think so. I think they prevented the growth of the money supply.

* * * * *

Mr. ECCLES. I think the Federal Reserve System acted wisely. Had I been Chairman of the Federal Reserve Board I would have undertaken, I think—would have supported the same type of policy that they pursued.

The CHAIRMAN. You do not think the high interest rates that existed prior to October was the main cause of this present recession?

Mr. ECCLES. Yes; I do. I think the high interest rates that were brought about tended to bring about the recession. But I think you had the alternative of whether you bring about a recession or whether you support and feed an inflation.

* * * * *

Mr. ECCLES. Well, I do not think it was deliberately produced. I think that the Federal Reserve knew they were taking a risk, but I think they were hopeful that by restricting the growth of the money supply for the purpose of curbing the inflationary development that was taking place, that the economy could be leveled out.

Senator KERR. That means that the degree of activity reduced—

Mr. ECCLES. That is right. But I am not sure that they expected or thought that it would lead to the recession that it has led to. I think they took the risk all right. They took the risk but I do not believe—

Senator KERR. They deliberately took the risk?

Mr. ECCLES. Oh, yes, they took the risk because I am sure they felt that it was their obligation to do it. It was their responsibility.

It is quite clear from these excerpts that the Federal Reserve had taken the risk of bringing on the recession in order to contend with the dangers of inflation. It may be recalled that in 1953, when almost no economist saw any dangers of inflation, the Treasury in cooperation with the Federal Reserve introduced a dear-money policy which helped bring on a recession.

Many economists also shared this view that the tight credit policy helped bring the recession or tended to aggravate it. For example, Professors Slichter, Harris, and Colm presented this viewpoint in the following.

Prof. Sumner Slichter (p. 1823):

* * * Tight credit policy tended to aggravate the tendency of the economy to contract because it retarded growth in new areas which might offset to some extent the drop of investment in business plant and equipment.

Harris (p. 2014):

I was just going to say, of course, that this present recession is partly a cyclical phenomenon and I don't put the whole blame on the Federal Reserve.

I think that we might have had some reaction even if they had done nothing, but actually they helped to accelerate the process and so to that extent, I hold them responsible.

Dr. Gerhard Colm (p. C579):

The orthodox view is that if cost inflation exists it does not require any other countermeasures than the old-fashioned demand inflation. As pointed out in response to question 1 [of the Finance Committee questionnaire], cost inflation requires an injection of money in order to become effective. Representatives of the orthodox view, therefore, conclude that to avoid cost inflation the creation of the credit needed to finance transactions at the higher cost level should be prevented. There is some logic to this argument. If in the light of cost and price rises credit expansion is denied by the monetary authorities, then business activity will contract and if the policy is pursued drastically enough prices will eventually come down. We got a relatively mild dose of that medicine in 1957. It contributed to the recession but not enough to bring prices down.

In his 1958 statement, Chairman Martin was inclined to explain the recession by the investment boom of 1955 and 1956. He would only accept responsibility in that he had not succeeded in stopping the inflation, and the recession generally follows an inflation.

Martin (pp. 1848-1849):

Now the current recession is a reaction to both the investment boom and the inflation which accompanied it. The growth of business capital spending beginning in early 1955 was at a rate that was unsustainable. An economy with a longrun upward growth trend of about 3 or 4 percent per year cannot sustain for long an increase in business investment of about 10 percent per year in real terms, such as we experienced in 1955-56. The investment spending, even if prolonged by inflationary trends, had at some point to slow down.

* * * * *

In the 1955-57 investment boom, inflation aggravated the tendency toward overexpansion as well as the subsequent decline. Inflation, as I have said, was the result of an excess of total demands at existing prices over what the economy was producing, and apparently able to produce under the existing organization and use of resources. But once prices started up and expectations of additional price and cost increases were engendered, spending was stimulated further. With prospective costs rising, business had every incentive to enlarge its productive capacity at today's rather than tomorrow's prices. And when investment plans are made on this basis, a certain amount of uneconomic productive capacity is likely to be created; that is to say, capacity which does not reflect a basic pattern of demands undistorted by expectations of rising prices.

The best way to fight a recession is to fight the preceding inflation, and we were not successful (p. 1858).

I am sorry—but I don't believe that tight money brought on this recession, and I do not really think, again we are getting into terms—I don't think it was tight money, I think it was loose money that was the precursor of the present situation that we are in (p. 1892).

In an exchange with Senator Kerr, Chairman Martin was not very effective in putting across the position that Federal Reserve policy had not interfered with production and had not reduced output below where it would have been. The only blame he would take was that they had not been restrictive enough. He did not explain that a greater degree of restriction might have cut employment and output even more (pp. 1920-21):

Senator KERR. You thought that [higher interest rates] would be one of the brakes on the situation, didn't you?

Mr. MARTIN. One of the governors on the economy, right.

Senator KERR. Well, one of the governors; that was one of the things that would slow it down, is it not?

Mr. MARTIN. That is right.

Senator KERR. And that slowing down resulted in the unemployment, did it not?

Mr. MARTIN. I do not think so.

Senator KERR. Well, didn't it result in building fewer houses?

Mr. MARTIN. It resulted in building fewer houses.

Senator KERR. Didn't it result in producing less goods?

Mr. MARTIN. Not quite—you see, one of the problems we have today is overcapacity.

Senator KERR. No; one of the problems we have got today is overproduction.

Mr. MARTIN. Overproduction; all right.

Senator KERR. But you see the capacity that was built, Mr. Martin, was built on the assumption that men had a right to think we would have an economy geared to full employment.

Men did not know this Federal Reserve Board was going to impose these restraints, turn that screw tighter and tighter.

* * * * *

Mr. MARTIN. This is a free country and we have only one apology to make, and that I made—that is, along with other Government agencies, we should have been tighter. We should have been more restraining than we were.

Now, on that score, I accept a portion of the blame for the current recession. But on no other score.

In earlier pages (1896–1897) Martin admitted that the objective of bank credit expansion was to slow down the tempo of the economy; but he argued that this had not been achieved.

Senator KERR. Well, it is a fact, now, Mr. Martin, and we are going to stay with this until we either prove it or fail, that the restraints on bank credit expansion were calculated to slow down the tempo of the economy.

Mr. MARTIN. That is correct.

Senator KERR. All right.

Mr. MARTIN. That is correct. No question about that.

Senator KERR. And it succeeded?

Mr. MARTIN. No, I do not think it succeeded—

Senator KERR. That is what it was done for and that is what happened.

* * * * *

Mr. MARTIN. But not as a result of tight money. The tempo of the economy slowed down because of the inflationary excesses.

One of the interesting aspects of this exchange between Chairman Martin and Senator Kerr is that the former stresses excessive expansion, and relates it in no small part to an investment boom. Undoubtedly the expansion of investment was a factor tending to bring inflation. But three aspects of this problem should be noted as I supplement this discussion in June 1959, the first being that unlike the President and the Secretary of the Treasury, Martin was not emphasizing the unbalanced budget in his explanation of the recession. Perhaps he was aware, as the rest of the administration did not seem to be, that the Federal deficits did not check well with the inflationary trends.

From the table below, it is difficult indeed to infer that Federal finance was the cause of inflation.

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Net cash receipts, Federal Government, and changes in consumer prices

Calendar year	Excess of receipts (+) or payments (-)	Change in consumer prices
	Billions	Percent
1955.....	-\$0.7	-0.3
1956.....	+5.5	+1.5
1957.....	+1.2	+3.3
1958.....	-7.1	-2.7

Source: Economic Report of the President, 1959 (my calculations).

The second point is Mr. Martin's excessive concern with the inflationary dangers. He regrets that stronger and earlier action had not been taken. Yet the consumers' price level was 114.4 in 1953, 114.8 in 1954, and 114.5 in 1955. In 1954, GNP in stable prices (1958 dollars) had fallen by \$8 billion, or 2 percent or a decline from trend of about \$25 billion; in 1955, the rise was \$32 billion, or 8 percent; for the 2 years, \$24 billion, or about \$8 billion below the average for the 8 years, 1948-56, and even more below 1946-52 average. In view of this history, it is not easy to support the Federal Reserve position that they had not been sufficiently vigorous in stopping the inflation.

Finally, Mr. Martin should be reminded that one reason the investment rate could not be sustained was the discouragement of consumption induced in part by monetary restraints and recession. Investment depends upon spending for consumption; the ultimate objective of investment is increased production and sale of consumption goods.

The "Federal Reserve Bulletin," in April 1959, had this to say:

Improvement in general economic conditions by the summer of 1958 created an environment favorable to renewed expansion of installment credit. Better incomes and expectations strengthened the willingness and ability of consumers to use credit as well as their demand for goods purchased on credit. Competition among lenders and better collection experience encouraged the expansion of credit operations. On the other hand, relatively large pockets of unemployment and rising costs of funds to lenders were unfavorable factors.

Extension of installment credit turned up early in the second quarter of 1958 about the time of the upturn in general business activity. They regained pre-recession levels by December and rose to new highs in the early months of this year.

8. *Rise of money rates and construction*

Anticipating that many of his opponents would criticize the high money rate policy as a factor contributing toward declines in construction, Secretary Humphrey dealt with this in his opening statement (pp. 27-29). In general, his position was that many new programs had been introduced by the administration after 1952, and these had contributed to a liberalization of financing provisions as well as a rise in the total number of homes built. Not only had guarantees greatly risen, but the FNMA special-assistance programs "have been innovated since 1952 to provide mortgage support for relocation, redevelopment, and rehabilitation housing under sections 220 and 221 of the National Housing Act, for housing for the elderly, and for Capehart military housing." He also pointed to the purchases of mortgages by FNMA and secondary mortgage markets which had become very large. The general position was that the factor in

depressing demand for housing was not primarily the rate of interest but rather the increased costs of building, inclusive of taxes. Note the following (pp. 33 and 265):

This shows that the \$10,000 house in the spring of 1946 cost \$19,000 in the spring of 1957; and of the amount of increase in monthly payments, \$55.07, \$46.46 was due to other costs and \$8.71 was for interest.

* * * * *

Which has been the major factor in discouraging construction? The \$9,000 increase in building cost (\$46.36 per month), or the 1-percent increase in the cost of interest (\$8.71 per month)?

While interest is an element in the cost of mortgaged homes, the increase in interest rates has not been the major factor in delaying home construction. Mortgage interest rates were higher in 1955 than in any prior recent year; yet new nonfarm housing starts were the second highest in history; at more than 1,300,000.

* * * * *

Senator FREAK. Now, Mr. Secretary, if we use that yardstick, how do you claim your current monetary and fiscal policies are resulting in success in the field of housing?

Secretary HUMPHREY. I think that during this period housing was in very large volume, the largest volume that it has ever been.

Now, I think that our policies and during that same period the cost of housing was rising, the latter part of the period, the cost was rising very rapidly. I think our policies are tending to stabilize and will tend to stabilize the cost so the price of the house will not go up so much, and in that way it will again stimulate the development of additional housing.

Housing was getting to a place where it was beginning to price itself out of the market.

In general, the point was made frequently during the hearings that what was keeping housing down was the low rate on VA guaranteed housing. The relative absorption of this market was less than other markets, because the rate of interest had been kept down. Of course, this does not deal with the general problem of why rates in general rose. In competition with other markets, obviously a market that keeps its rate down may fail to attract the necessary supplies of cash.

9. Government spending, credit, and the recession

Throughout the hearings, Secretary Humphrey did not discuss the problem of the Government contribution through reduced spending to the recession. For example, in the calendar year 1955, the Federal Government's deficit on a cash basis was \$729 million; but in 1956, this was converted into a surplus of \$5,525 million and in 1957, one of \$1,194 million. The Government had become an absorber of potential spending funds instead of a net disburser and hence contributed toward inadequate buying. In this connection a large cut in new defense contracts in the second half of 1957 should not go unnoticed.

Its dear money policy cut the increase of active money to 3 percent in 1956 and to 1 percent in 1957. This is indeed a low percentage increase for an economy that is supposed to grow several percent a year and an economy in which an increased proportion of the total supply of cash is hoarded as incomes rise.

The following table indicates the effects of the Federal programs. It will be noticed that the contribution of consumer credit and mortgage debt tended to decline from 1955 on. Once the economy gets accustomed to substantial increases in this kind of credit, a reduction in the contribution tends to have a depressing effect. This, in turn, is of course related to the rate of interest.

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Millions of dollars change, 1955, 1956, and 1957

	1955	1956	1957
Consumer credit.....	+6.4	+3.4	+2.7
Mortgage debt.....	+16.2	+14.7	+11.6

Senator Long (p. 1402) showed that an increase in interest rates from 4 to 5 percent raised the total interest cost on a \$10,000 20-year mortgage by \$1,294.91 and increased the monthly payment by 8.9 percent. That raised the total interest charge on a \$10,000 30-year mortgage by \$2,149.78 and increased the monthly payment by 12.4 percent (p. 1402).

In an exchange between Senator Anderson and Secretary Humphrey, the following occurred (pp. 548 and 556). Senator Anderson obtained some telling admissions by Secretary Humphrey.

Senator ANDERSON. The National City Bank has a publication which I read, which comes to me from another source out in my country, the First National City Bank monthly letter for June, and I notice on page 63 "tightness in the supply of money and credit and the rise in interest rates hit the homebuilding industry harder than most other lines."

Secretary HUMPHREY. I think that is true.

Senator ANDERSON. You would agree, then?

Secretary HUMPHREY. I think that is so. It is operative there more rapidly, because homebuilding does not take as much preliminary work; it does not take as long in planning, and does not take as long in development as building a plant or a factory. In other words, the commitment in plant expansion has to be done over a longer period than it does in home expansion.

* * * * *

I think, as I said before, Senator, I think that it does take effect, and it has taken effect more in building, small building, and residential building than it has in large capital construction because of the fact that the former is done over a shorter period, planned over a shorter period, and the financing is provided for over a shorter period. So that we have had quite a demonstration, this experience that housing has been more affected than capital expenditure; the figures demonstrate that.

In this particular passage, the Secretary failed to note that the interest rate has a greater effect in housing than in industrial investment, because housing mortgages are for longer periods of time, and therefore the costs are higher and interest rates are greater. Obviously, if the Government increases the rate of interest through its monetary policy and if the mortgage market is more inflexible, this results in the diversion of money from the mortgage market to other areas of lending.

In a sense, the high money rate policy has resulted in cash being diverted from the mortgage and housing market into industry. This, of course, contributed to the investment boom. Senator Anderson (p. 548) made this clear in a colloquy with Secretary Humphrey.

Senator ANDERSON. On new plant and equipment, the rise (in expenditure) was about \$8.6 billion, or more than a third in those 4 years.

Secretary HUMPHREY. Yes.

Senator ANDERSON. And from the first quarter of 1956 to the first quarter of 1957, the rise was at the rate of about 13 percent. But residential construction is down 7 percent in the 4-year period and 18 percent from the peak. Would that indicate that the money has been pouring into plants and equipment and away from housing?

Secretary HUMPHREY. I think that is right. I think that is exactly what has happened.

At one point, Under Secretary Burgess admitted that the tight money policy had seriously affected the mortgage market. In fact, he pointed out that the billion dollar FNMA operation in 1956-57 was inspired by these conditions (p. 1061).

* * * We were hit by a situation where we had to buy a lot more mortgages than we would have preferred, and I think it was right to do so because as I think I have stated before, when you do have a credit restraint in an inflation, it hits some people more than others, and it hits some people who are not in a position to bear the flow as readily, and you have a social responsibility to try to ease that blow a little here and there.

In turn, of course, the decline in new housing starts would affect the market for durable goods, and smaller amounts of refrigerators, television sets, washing machines, et cetera would be required.

10. *Dear money effects on different markets*

One of the disturbing aspects of the dear money policy and one to which the Government authorities and the Federal Reserve authorities had little to say was the fact that different markets were hit in different ways. There is much to be said for the general idea that the large business corporation was not hurt very much by higher money rates and in fact improved its competitive position as its smaller competitors were confronted with difficulties. Other victims of the dear money policy were, of course, State and especially local governments that were trying to raise large sums of money especially for schools. Senator Kerr submitted evidence to this effect during the interrogation of Secretary Humphrey (pp. 463-464).

In a statement of the National Education Association (pp. C400-C401) the following was said:

All public school expenditures are ultimately paid from tax revenues, largely those of States and local governments. Annual current expenditures are met by current tax revenues of school districts or by appropriations from the State and (to a small extent) from the Federal Government. The payment of capital expenditures from tax revenues is largely deferred by school districts, by the issuance of bonds which are a first obligation on the local tax revenues. These bonds are then retired over a period of years from local tax revenues.

The workability of this system of capital financing is currently threatened by high interest rates and congestion in the tax-exempt bond market. This comes after a decade of increased construction and borrowing activity with no period of diminishing activity in sight.

School bond yields, even those with attractive tax-exempt interest features, have been forced to move closer to the yields of non-tax-exempt securities to attract investors. In 1946, high-grade tax-exempt bonds, including school district bonds, were 0.89 percentage points below corporate bonds of the highest grade. By 1957 these tax-exempt yields were only 0.29 percentage points below the corporate bonds.

It is hoped that your committee will give attention to the precarious state of capital financing of public school plants. Questions are raised here of how public education can compete in the money market with private borrowers in times when, partly by Government action, the supply of money is limited. Educational needs frequently cannot be deferred until the school districts can afford to borrow. Hence, many school districts borrow at high rates—the payment of the principal and interest of which may jeopardize the future of the educational program should economic conditions reverse.

At earlier hearings, for example before the Joint Economic Committee, on monetary policy, 1955-56 (pp. 23 et seq.), the Congress had been warned about the increased costs of borrowing. For ex-

ample, Mr. Arthur Levitt, comptroller of the State of New York, said as follows:

The cost of borrowing to finance school construction has been rising alarmingly. In 1951-52 capital outlay for the schools was \$170 million, and the average rate of interest on the money borrowed by the school districts was 2.85 percent.

In June 1950 the average interest rate on school borrowings was 2.700. Evidence of the tight money policy playing more and more pressure upon the money market is found in the interest rate which prevailed in school borrowings the past month.

In November 1950 the average rate was 4.078 over the life of the bond issue. It cost districts and taxpayers \$2.8 million more for the \$13.8 million borrowed in November than it would have cost them in June. * * *

The \$5.5 million bond issue of Union Free School District No. 5 in the town of Hempstead was sold on November 15 at an interest rate of 4.3 percent.

Four years ago this same district sold its bonds at 2.7 percent. If the 1952 rate had continued, the difference in interest payments over the life of the bond issue would be \$1,383,767—enough to build a school for 900 pupils.

Secretary Burgess was not very sympathetic with the problems of State and local governments (pp. 1040-1041). Indeed, as he argues, the demand was great, and the tax-exempt feature was becoming of less importance because of the need of appealing to those to whom the tax-exempt feature meant less than to the very high income groups. But, nevertheless, the high-money-rate policy of the Government and the Federal Reserve certainly was a contributing factor.

A great deal of unhappiness among State and municipal people exists about the interest rates they are paying, and I sympathize with them. But the fact is, they have borrowed more money in these 3 years than ever before in their history, and there just is not that much money of that sort available.

Their demands have overflowed the bounds of the tax-exempt market, so they have to sell their bonds to people for whom the tax exemption is not of great value, so their rates have gone up faster than interest rates in other places.

But they cannot blame the Federal Government for that. They are just trying to borrow more money than there is available.

* * * * *
And some of these buildings that are being built, schoolhouses and courthouses, and so forth are—* * * are somewhat more expensive than they need to be, to put it mildly.

11. Money rates, savings, and investment

One objective of higher interest rates was increased savings. This point was made time and again. In fact, at one point Chairman Martin forgot his earlier discussion of excess capacity and insisted that an increase in savings was necessary even if the effect was to reduce the total amount of consumption. Senator Long cornered the chairman at this point (p. 1357):

MR. MARTIN. I think the important thing at the moment is to increase savings that has to come out of the consumers.

Senator LONG. Since you mentioned that subject of increased savings, do you believe that it would be desirable to increase consumer savings even in order to finance plant expansion, even though this means a considerable reduction in consumer spending resulting in a considerable reduction in production of consumer goods at a time when we have a large amount of industrial expansion, that is, industrial facilities, to spare?

MR. MARTIN. I do not think we have a large amount to spare. I think you have got to recognize the size of this economy.

The chairman did not seem to realize that the volume of savings depends much more upon income than it does upon the rate of interest. The most important effect of the rise in the rate of interest is to reduce investment, and a reduction of investment tends to bring about

unemployment. Actually, despite the substantial rise in the rate of interest, personal savings in the third quarter of 1957 were \$20.4 billion and in the third quarter of 1958, \$22.5 billion, or a rise of \$2.1 billion at the same time that the disposal personal income rose from \$308.7 to \$314 billion.

Surely this small rise in personal savings is an inadequate offset to the very large increase of unemployment and the deficiency of gross national product, which is to be associated in no small part with the higher interest rates and Federal Reserve policy.

Where the Federal Reserve was unwilling to validate an increase in wages and an increase of output, there were other alternatives for the corporation. Senator Gore made this clear in showing from numerous statements of the various corporations that an alternative to external financing which was being depressed by monetary policy was to pass on the cost of expansion to the consumer (p. 603):

The chairman of the board of United States Steel advised the stockholders at the annual meeting on May 7, 1956, that a projection of the financial needs of the company showed that they would need an additional \$140 million. He then proposed to the stockholders that the method to use to get expansion capital "is by raising prices from time to time—as circumstances require and permit."

Similarly, the minutes of the Standard Oil Co. of New Jersey for the meeting of the board of directors on December 13, 1956, showed that "for the first time in many years" the company was faced with the probability that they would have to use something more than internal financing to "cover replacements, modernization, and expansion."

However, as it inevitably turned out, this company was able to increase its prices to the extent that it was unnecessary for the company to resort to external financing.

This type of price inflation primarily to finance expansion, is actually encouraged, not discouraged, by current Government policies. High interest rates and diminished possibility of competition, both created by current policies, encourage and invite big business concerns to finance their capital expansion and improvement in large part from inflated prices and consequent swollen profits.

The Democratic Senators in particular were impressed by the fact that, despite the high money rate interest by the summer of 1957, there was little evidence of a depressive effect upon private business investment. This was, of course, part of the whole problem. The incidence of high interest rates and unavailability of money affected various groups in different ways. Many had suggested that some control of investment, some control of consumer credit and credit in other areas might be desirable in order to get the better distribution. But the Federal Reserve opposed accepting responsibility for the control of consumer credit, or any other new area of credit control.

At the time, that is, in the summer of 1957, Senator Long and Senator Kerr were quite right in pressing Secretary Humphrey and Secretary Burgess in re the failure of the high rate of interest to reduce investment. They pointed to the high level of interest currently. (See, for example, pp. 340-341, 758, and 813.)

Mr. Burgess (p. 759) even conceded that the increased interest rates may have accelerated business borrowing:

I think there is some anticipation borrowing here. I think if the people who borrow these funds once got the feeling that they could borrow cheaper next year or the year following and build cheaper or not pay more that this thing would be over, this thing would level off, you would have a balancing off.

In a discussion with one of the Senators, Secretary Burgess insisted that the important thing was (pp. 1166 and 1089) the availability of credit rather than its costs.

I make a distinction between money rates and credit availability. I do not admit that the present less ease in credit availability has not affected investment. I think it has postponed some investment and put other investment forward in the future, so I think it has had an effect.

* * * The thing that affects it is not the rate, but the availability of the money. It is working with the supply of money that largely has the effect.

* * * It is a question of whether they can get the money on the kind of terms they want, apart from the rate. The rate is not the big thing here. People often overlook that.

But this is really evading the question. A higher rate of interest which results in a reduced supply of money does, of course, affect the availability of money. What the Secretary was saying here is that as an increase in the rate of interest reduces the supply of money, then the banks begin to ration their credit on the basis of relations with borrowers, quality of loans, and the like.

Since writing the above, we have had an analysis of member bank loans to business. From 1955 to 1957 (October), loans to all borrowers rose by 47.5 percent. But note the expansion by size of assets. Clearly, despite the great advantages held by big business through self-financing they are also in a favored position vis-a-vis the banks.

Size of borrower (total assets \$1,000)

Assets	Percentage rise of term loans from member banks, 1955-57
All	47.5
Less than \$50,000	15.9
\$50,000 to \$250,000	44.3
\$250,000 to \$1,000,000	48.2
* * * * *	
\$5,000,000 to \$25,000,000	37.3
* * * * *	
\$100,000,000 and over	50.6

Source: "Federal Reserve Bulletin," April 1959.

This article also reveals easier financing obligations for the larger borrowers. Installment repayment, with interest, of borrowers with assets of less than \$50,000 was 9.96 percent; then costs decline with size of firm until for those with \$5 million of assets or over the charge is 5.51 percent. The small borrower also much more frequently has to provide security. The percentage of loans (in dollars) secured from small to large borrowers was as follows in October 1955: 94 (less than \$50,000), 95, 90, 74, 51, 35, 22.5 (\$100 million and over).

12. The relation of money and spending

Indeed, a reduction in the supply of money does not necessarily result in a cut in spending. On this point, the Federal Reserve was inclined to be too optimistic. Their failure to stop the expansion and the inflation is explained in part by the fact that they were not as effective as they otherwise would have been because of the great liquidity of the economic system. Business units, for example, had large supplies of liquid funds. As the monetary authorities reduced the supply of money, these funds could be used more effectively, that

is, much more often. All the various financial intermediaries, for example, the savings banks, the insurance companies, pension funds, and the like, also had large resources which could be put into use. These resources, of course, made it possible for a given supply of money to be much more active and, therefore, to bring about an increase in spending. Ultimately, of course, this liquidity would be greatly reduced, but not before the total amount of spending had greatly risen.

Actually the intermediaries (savings banks, savings and loan associations, etc.) increase the amount of credit by offering higher rates of interest. The result is a transfer from demand deposits which require relatively large reserves to liabilities requiring smaller reserves.

From 1952 until 1957 the rise in the supply of money was 7 percent, a very small rise indeed; but the rise of banking debits was 40 percent. In other words, the activity of money was increasing greatly as a result of the liquidity of corporations and also of the ability of the financial intermediaries to operate independently of the Federal Reserve. This was a point about which the Federal Reserve had very little, if anything, to say. In fact, throughout the Federal Reserve was reluctant to acknowledge its impotence in many of these matters. It did not refer to the great liquidity of the economic system, nor its lack of control over the financial intermediaries, nor its increased difficulties in view of current wage and price policy. The Bank of England authorities, on the other hand, were very quick to admit that the possibility of control was much less than it used to be. Perhaps it is fortunate for the economy that the powers of the Federal Reserve have been restrained by these various institutional developments.

Just to give an indication of the quantitative aspects of this problem, note that over a period of at least 4 years the total amount of money had increased by about 7 percent, banking debits by about 40 percent, insurance company assets by almost one-fourth, Federal credit agency assets by about three-fourths, consumer credit by close to one-half, and mortgage debts by one-half. These certainly indicate a rather loose relationship between the total supply of money and the total amount of credit made available in the economy. (These figures were presented before the Joint Congressional Committee on the Economic Report on February 1, 1957, in a paper on the effectiveness and relationship of fiscal and monetary policy.)

In fact, expansion can take place with very little increase in the supply of money. Banks tend to accumulate short-term securities in recession and dump them in prosperity. They can then substitute loans and investments in non-Federal Government securities. Thus, during the restrictive period from the end of 1954 to the middle of 1957, commercial banks increased their stake in loans and non-Federal securities by \$22.5 million, though demand deposits and currency actually declined. Prof. Warren Smith, one of the leading experts in this area, pointed out that in this period the banks obtained \$14.5 billion by selling Treasury securities and \$7 billion from an expansion of time deposits, which require less reserves than demand deposits.

There was a certain amount of inconsistency in the evidence presented by the governmental representatives. Their intent was to cut down the supply of money, even if it might bring about a recession. When they were accused of having reduced the supply of money,

their reaction was: but is there really a shortage of money when velocity obviously can go up? I quote a statement from Under Secretary Burgess (pp. 1103 and 1174).

I would remind you of our discussion yesterday with respect to the rate of turnover of money, that in considering the availability of money you have to consider not just the amount of money, but the rate at which it is utilized, that is, the velocity.

And if you do that, there is plenty of money, because the rate of velocity has gone up 10 percent in the past year.

* * * * *
 Senator CARLSON. I think that is one thing that has got to be made abundantly clear, because there is an impression out in the country that they like to call it a tight money policy; and when they use those words, the inference is that we do not have sufficient money, and that the Federal Reserve ought to, through discount rates and other methods, increase the supply of it.

But I think your testimony proves conclusively there is sufficient money through volume and amount.

Mr. BURGESS. I am sure of that Senator, that there is plenty of money for every sound and legitimate operation in this country.

13. *Financial intermediaries and increased spending*

Senator Anderson confronted Under Secretary Burgess with the general position that there had been a very large increase in the assets of financial intermediaries, a factor contributing to the rise of credit. Mr. Burgess' reply was inadequate. He explained that this kind of expansion of assets was the counterpart of an increase in savings (p. 1143).

Senator ANDERSON. * * *

While you were having this restraint between 1952 and 1956, the assets of these commercial banks only increased 13 percent; but the savings and loan associations' assets increased 90 percent.

Mr. BURGESS. Of course, that is all to the good, because they are dealing with savings money, that is, they are taking the money from the saver and putting it to work. Now, there is nothing inflationary about that.

That is, the dollar they put to work is paralleled by the dollar they take away from the man who saves it. That is what we want. That is the way America is going to grow. By one man saving a dollar and lending it to another man to work with, one man postpones his use of that money. He waits.

* * * * *
 Senator ANDERSON. These credit agencies were increasing the total supply of credit, were they not?

Mr. BURGESS. I would not say they were increasing the credit. They were increasing the amount of savings. * * *

It is credit in a certain sense, but if the credit is derived from savings, it has an entirely different effect than if you created it out of the air.

Unfortunately, it is not necessarily true that the net purchases of assets by these financial intermediaries, inclusive of Government credit agencies, all reflect current savings. They may, in fact, reflect for example, accumulations of cash which are then put to work because the markets are good. Ultimately, of course, there may be some relationship between the total supply of money and the activities of the intermediaries. But the relationship is a very loose one. Inactive money becomes active. Also, the process includes transfers from demand deposits with high-reserve requirements to time deposits with low-reserve requirements.

There is much reason to believe, as several witnesses before the Finance Committee suggested, that the increase of velocity has undermined Federal Reserve policy in recent years. Where, for example, one transfers to an intermediary cash that was being hoarded

and the intermediary puts that cash to work, this is inflationary. (See pp. C169, C294, C298, C645.)

On some occasions, the Federal Reserve seemed to argue that they could control in a very precise way not only the supply of money but the velocity of money. On the other hand, their failures to stop the expansion of velocity and the accompanying inflation suggest their inability to control velocity. The following is of some interest on this score (Chairman Martin, p. 1307):

We have let the balance of the 2 percent on our 3-percent growth take place out of the velocity of money, the turnover of money, and we have felt that that was about right, though I think sometimes we felt that perhaps we have erred a bit on the side of letting the velocity accumulate faster—it is very difficult to measure—than the situation warranted.

14. Higher rates and the market for Government issues

One of the effects of the higher interest rates is a depression in the price of existing bonds. Such increases especially affect the price of Federal securities. But this apparently did not worry the Federal Reserve authorities, and Chairman Martin quotes an article from the Federal Reserve Bulletin (pp. 1237-1238).

At the lower prices and higher yields, Government and other short-term securities will be more attractive. Nonbank investors may be induced to buy more of them, using temporarily idle deposit balance. * * *

With prices lower and yield higher on short-term paper, banks are less likely to reduce their holdings of secondary reserve assets, notably short-term Government issues. Some banks may continue to do so, but others will stop selling or many [sic] buy. In the aggregate, the secondary reserve position of banks will tend to stabilize. This development is brought about in several ways. Many banks and other potential lenders are reluctant to sell securities at a loss. As the potential loss becomes greater, this reluctance deepens. * * *

* * * * *
 Thus in a period of tightening credit, long-term lenders and investors, while at first attracted by the higher yields available on assets of less than top grade, gradually become more restrictive and selective. They become less willing to sell prime securities to acquire higher yielding but more risky assets, partly because they can sell the prime securities only at a loss, which they hesitate to accept. * * *

The fact is that the high rates of interest have been a signal to the financial intermediaries, and especially the commercial banks, to desert the Government bond market and to turn to their customers, who borrowed at high interest rates.

In the years before 1951 the Federal Reserve and others were critical of the Treasury for insisting upon the support of the Government bond market. According to the accord of 1951 the support of the Government bond market was to end and monetary policy was to be determined on the basis of the general needs of the economy. Undoubtedly, the Government bond market had attracted too much attention in the determination of policy up to that point.

The Federal Reserve policies of 1956-58, however, had a somewhat different result. Instead of supporting the Government bond market, the authorities in fact encouraged a desertion of the bond market by financial institutions. Despite the above quotation, it is clear that this has been the net result. For example, from 1954 to 1957 financial institutions, under pressure of induced higher rates and unavailability of credit, disposed of \$19 billion of public securities. Purchases of \$15 billion by Federal agencies, State, and local governments, individuals, etc., required a substantial drop in prices, that is,

a large increase in rates that increased the annual cost of financing the debt by a billion dollars in 3 years, or about 15 percent.

On the issue of whether the banks were losing money on the falling prices of Government securities, Senator Kerr made it quite clear that this was not so (pp. 918-919).

Senator KERR. Let us talk about that loss they [the commercial banks] sustained.

I know some bankers who, in December of 1956, sold substantial quantities of the long-term holdings they had at a loss of about 10 or 11 points. They told me that in so doing they could charge that up against operating income and reduce their tax liability by 52 percent of that loss.

Mr. BURGESS. I would say that is right.

Senator KERR. And that then they immediately went into the market and bought other long terms of comparable maturity. * * *

* * * * *
Now if he went out and bought another long term at the same price—

Mr. BURGESS. Yes.

Senator KERR. He could carry it until maturity and only pay a capital gain on the increment.

Mr. BURGESS. That is right.

Indeed, as the price of Government securities declined, the banks tended to take advantage of the low prices and purchased in larger amounts. From September 1957 to September 1958, holdings of commercial banks of the U.S. Government securities increased from \$56.2 to \$66.1 billion.

With the yield on U.S. Government bonds falling from 3.73 in October 1957 to 3.12 in April 1958 and then rising to 3.76 by October 1958, the banks were at a loss concerning the appropriate policy. Actually, they tended to purchase at the wrong time. They purchased, for example, heavily from January to May. In January, the yield was 3.24 and by May, 3.14. These, on the whole, were high prices. By October, when the yield had risen to 3.76, they were beginning to sell. Financial intermediaries did not show the same interest in Government securities in 1957-58, as the commercial banks.

15. *Proposals to control intermediaries*

One of the striking features of the hearings was that not a single suggestion was made about the control of the intermediaries. Indeed, there were hints that through the control of the supply of money the intermediaries were controlled. But in admitting that velocity may move in a way different than the total supply of money, the Federal Reserve authorities, in fact, were admitting that they had only limited control over the intermediaries. It is difficult to explain this silence. It may be that the Federal Reserve was not anxious to introduce reforms that might upset the financial intermediaries with whom they were generally on good relations.

16. *Federal Reserve not responsible for higher rates?*

Another interesting aspect of the Federal Reserve viewpoints relates to the frequent announcement that they were not really responsible for higher rates of interest; They were merely following the market. Demand had gone up and therefore the rate of interest had risen. This, of course, was the result of the great pressure put upon the Federal Reserve, and they found it convenient to deny any interference with the free market forces. If the central bank merely follows the market, one may ask the question why a central bank is needed. On the whole, the Federal Reserve policy was a courageous

one; but in denying any net effects on the rate of interest the Federal Reserve was, in a sense, taking the same position as the Treasury when it insisted that by issuing long-term securities at 3½ percent in 1953 they were having no effect on the market. Typical of the Federal Reserve position here is the following reply of Chairman Martin to Senator Williams (p. 1316):

* * * There may be circumstances where it would be desirable for the rediscount market [rate?], if we thought there was heavy pressure building up, to lead the market just a little bit.

But generally speaking, we recognize that the market forces are the ones that are controlling—that we can influence the market. We never want to take the position that we do not have any influence at all—that market forces just produce all these changes. Otherwise, there would not be any reason for our existence.

We influence them. We lean against the wind when we can determine which way the wind is blowing. But we never try to usurp the function of making the wind. Whenever we think we can make the wind, we think we are in trouble.

In insisting that the Federal Reserve followed the market, Chairman Martin was virtually abandoning responsibilities of a central banking system for leadership. Actually, of course, through its bank rate and especially through its ability to indulge in open-market operations, the Federal Reserve can, of course, to a considerable extent determine the amount of money available and therefore the rate of interest. There have been numerous experiences when the Federal Reserve clearly did try to influence the rate of interest and the total supply of money, and sometimes with success. We can go back to the late 1920's episode, the great open-market operations in the early 1930's, and the making available of billions of dollars of credit to finance the Government during World War II. But here is Chairman Martin's position (pp. 1424-1425):

This is a technical problem, in my judgment, and it seems to me that the problem is that the banks are closer to the loan demand than we are—we follow it very closely, but after all, banks are the first line on the matter of judging loan demand, and they decided to go up in their prime rate to 4½ percent.

Now, with a 4½ percent prime rate and a discount rate of 3 percent—and we have had a bill rate in excess of 3 percent for nearly 9 months—it means that the policing of the discount window by the individual reserve banks has a good bit more strain with a 1½ percent spread than it had with a quarter of 1 percent spread.

I believe you can police the window effectively, but our judgment in the Board and throughout a good portion of the System was that this was a technical situation; we would have just as much difficulty explaining not going up in the rate as we would explaining going up in the rate; and we recognized it as a technical operation and therefore increased the rate.

Now, if the expected demand for loans this fall does not materialize, then the commercial banks were in error in raising their prime rate. If there should be a decline in loans of a substantial amount this fall, and business should taper off, we might want to consider reducing the discount rate.

In a later period, in the fall of 1957, it is quite clear that the Federal Reserve actually led the money market in the decline of rates. Many have, of course, criticized the Federal Reserve for increasing its rates in August 1957, when it was already clear to many that the recession was well on its way. (See, for example, pp. C271, C330, C410, C384, C335, C537, C620, C630, C661.) Chairman Martin's defense of the August increase (p. 1849) was not very impressive.

* * * Federal Reserve discount rates were raised one-half percentage point in August in order to relate them more closely to market rates which had been rising for some time and in this way to maintain their effectiveness in restraining bank credit and monetary expansion. That action also served as an indication to the business and investment community that the Federal Reserve rejected the idea that creeping inflation was inevitable.

17. Federal Reserve policy in the recession

While we are discussing the Federal Reserve policy, we should say a word about the recession policy. The Byrd committee had not really had an opportunity to deal with this problem, and I hoped it would in the next session. After a year of recession, member bank reserves had declined, and excess reserves had increased by the negligible sum of \$100 million. In fact, in June 1958, after a year of recession, the volume of demand deposits and currency was exactly at the level of a year earlier. Though we are supposed to have learned much about monetary policy since the early thirties, this program should be contrasted with the vigorous open-market policy of the Federal Reserve in treating the recession of the early thirties. Even by September 1958, the total amount of demand deposits and currency was only \$136 billion, as compared to \$139.7 billion in 1956, \$138.6 billion in 1957, and \$133.3 billion in September 1957. From August 1957 to October 1958, excess reserves varied generally between a half billion dollars and \$600 million, though in May 1958 the figure was \$700 million. This does not suggest any aggressive measures to deal with the recession. Throughout this period, the Federal Reserve was still worried about the oncoming inflation. Indeed, the total indebtedness of banks at the Federal Reserve had fallen from about \$1 billion to \$400 million. But, in my opinion, the Federal Reserve puts altogether too much emphasis on the volume of indebtedness as a factor in determining policies of commercial banks.

Since writing the above, material has become available through April 1959. This period from October 1958 to April 1959 has been one of expanding business activity. From the third quarter of 1958 to the first quarter of 1959, seasonally adjusted GNP has risen by \$23 billion (with prices virtually stable) or 5 percent in one-half a year, a very satisfactory rate of growth. But during this period of 6 months (November to April, inclusive) unemployment averaged about 1.5 million above the 3 millions that may be considered a reasonable achievement.

Federal Reserve policy, with the Board still concerned over inflationary dangers, was cautious. In October 1958 and March 1959, the Reserve banks raised their rediscount rates. In this period of 6 months, member bank reserves increased only by less than \$200 million, or about 1 percent; demand deposits and currency by \$3 billion, or 2 percent, loans and investments by \$5 billion, or 2½ percent, and Government securities held declined by \$2.5 billion, or about 4 percent. Consumer prices were virtually unchanged. Later we shall evaluate more fully the Government's policies in 1958-59.

18. Fiscal policy: Objectives and achievements

In the course of the Byrd hearings, considerable space was given to the issues of fiscal policy. It is well to remember that before the 1952 election President Eisenhower had promised us a \$60 billion budget. The budget estimated in the summer of 1958 for the fiscal year 1959 was \$79 billion, and current estimates for the 1960 budget are a few billion dollars below that figure. At any rate, the promise of a \$60 billion budget seem to be largely forgotten now.

In his opening statements, Secretary Humphrey made it clear that he was going to present a political document which would show that

the Republican administration had improved greatly on Democratic policy. He said (p. 10):

Our immediate task is to chart a fiscal and economic policy that can—

First, reduce the planned deficits and then balance the budget, which means, among other things, reducing Federal expenditures with a safe minimum;

Second, meet the huge cost of our defense;

Third, properly handle the burden of our inheritance of debt and obligations;

Fourth, check the menace of inflation;

Fifth, work toward the earliest possible reduction of the tax burden;

Sixth, make constructive plans to encourage the initiative of our citizens.

It is clear that these objectives have not been achieved. Not since the budget of 1946, which included large war expenditures, has there been a deficit like \$12 billion, the deficit planned for fiscal year 1959. In the 8 years of the Republican regime, it looks now like 6 years of deficit and 2 years of surpluses.

In 1952, the national debt was \$259 billion, as against \$269 billion in 1946. But by fiscal year 1959, the national debt had risen to \$283 billion and legislation has now been enacted authorizing a temporary limit of \$295 billion. Clearly the promise of a reduced debt had not been achieved, and that despite the fact there had been a large reduction in defense expenditures, which may prove disastrous to the country. Major national security, which cost \$50 billion in fiscal 1953, had fallen to \$41 billion in fiscal 1955 and is estimated at \$46 billion in fiscal years 1959 and 1960. At prices of 1959, the security program has been cut from \$60 to \$46 billion, or roughly by one quarter.

Later we shall see whether the national debt has been handled adequately as the Secretary promised. His fourth objective was to check the menace of inflation. Indeed, in the first few years of the administration the stability of prices was well maintained. But the same cannot be said for the years 1956-58. To have had an inflation in the midst of a recession is an achievement.

The fifth goal, work toward the possible reduction of the tax burden, is clearly out of the picture. The tax burden has continued to increase. The Secretary of the Treasury and the Chairman of the Federal Reserve were quite clear on the disastrous effects of deficit spending. Said Secretary Humphrey (p. 65):

I think that there is nothing that will push you along the road to inflation much faster than large government deficit financing.

Mr. Martin (p. 1317) had this to say:

I think that—I never favor deficit financing, although I recognize that it can sometimes have an impetus on our economy.

But again, it is like debt, that I commented on yesterday: It is not a situation to be desired. Under certain circumstances it may be useful, but—and I do not want to make a blanket statement on it, but I never favor deficit financing. I think it is wrong in principle; and I think it is not really the benefit, even when it is used, that those who claim it has the benefits think it has.

For Mr. Burgess the important point was that the creation of credit by banks for private enterprise produced goods which satisfied human needs; but a creation of money for the Government was wasteful, and the debt unproductive (pp. 1129-1130):

* * * that is a point we always try to make, that when the Government spends money, it does not produce goods which the people can buy.

On the other hand, if we have an increase in commercial loans of banks, the mechanical effect at the borrowing window may be just as inflationary as with the Government, but the people who borrow use the money normally to produce goods or services which meet human needs, so it tends to balance off the additional creation of money.

* * * * *

May I put it another way: that we ought to draw a distinction between productive debt and nonproductive debt. One comfort that I take out of the present inflation, which is a capital goods inflation, is that it is producing this great expenditure of capital for machinery to produce goods which will meet the demands of the people, so it contains within itself, I think, some of the seeds of its correction.

The CHAIRMAN (Senator Byrd). Government debt certainly is not productive debt; is it?

Mr. BURGESS. Government debt is not productive; therefore, it is the worst kind of debt.

Obviously, the distinguished members of the Government were not exactly correct here. Expansion of investments through the creation of money can also bring a great deal of inflation. In fact, the extension of credit to business in the years before the recession contributed toward the inflation. Nor does it follow that a government borrowing, for example, to build schools or roads is providing unproductive credit, whereas the individuals who obtain money to gamble or to buy television sets are productive borrowers.

19. *The debt ceiling*

So strong was the administration against debt and growing public debt that Secretary Humphrey (p. 258) had this to say about the debt ceiling:

* * * I think that the restraint the present debt ceiling gives to the Executive, to the Congress, to everyone concerned is a very wholesome thing to have, and I think that it is like breaking through a sound barrier; there is an explosion when you go through it; and there ought to be one.

On the whole, the debt ceiling was an unfortunate episode in American economic history. The support in Congress for a rigid ceiling would have been much less without the encouragement of the Treasury.

In an excellent article, to be published in the National Tax Association Bulletin, Prof. Walter Heller, of the University of Minnesota, makes clear the dangers of the debt ceiling. He shows that the ceiling has been a major factor in prompting—

(1) manipulations to remove certain spending items from the budget entirely (e.g., in 1953, \$1.3 billion of price support loans), (2) proposals in 1955 for highway financing outside of the conventional budget and outside the debt limit, and (3) substitution in 1957 of costly agency borrowing for cheaper Treasury borrowing.

In periods of prosperity when the debt should have been reduced the debt ceiling had very little effect. But in recessions like 1953 and 1957-58, the ceiling was a serious obstacle to proper financing by the Government. In 1953, the Commodity Credit Corporation sold \$1.2 billion of certificates of interest to commercial banks, against a nationwide pool of support loans on grains. This episode was related to the debt ceiling, but I believe also to a general tendency on the part of the administration to conceal its real credit situation.

How serious the situation may become is brought out in an article in the Wall Street Journal of September 7, 1957, as quoted by Professor Heller:

Fiscal chiefs struggled to stay under the debt limit. They seized on new tactics. The defense officials postponed every postponable spending item beyond

the critical next few months. They confer with major contractors on delaying payments. Thus urgent operating, maintenance outlays will wait until after January. The Budget Bureau holds back funds to keep other agencies from expanding employment as much as Congress allows, at least for now. Other weapons are on reserve. Farm officials consider selling private bank certificates representing shares in a pool of price support loans; the cash would ease the current squeeze. The Federal National Mortgage Association can sell more securities privately, pay off some of debt owed to Treasury. Money men talk of last-ditch moves of escape if the debt ceiling gets desperate. Defense officials say they could stop paying all bills until January tax receipts roll in.

Professor Heller well says:

The debt limit, then, has served as an ethical shield behind which assaults have been made on the fidelity of our Federal budget. I put it this way because some of the manipulative practices described above were attractive in serving quite a different purpose, namely, to make the budget look smaller than it really was—sort of an incredible shrinking budget—but they might not have been dared without protective casuistry of the debt ceiling.

Perhaps the most serious aspect of the debt ceiling was the fact that the administration cut back its program for its long-term national security in the second half of 1957. According to *Business Week* (Nov. 2, 1957):

Here are some major Defense Department actions in recent months that are related to the campaign to save the debt ceiling: (1) the service has stretched out production schedules for at least 19 big plane and missile projects. (2) Overtime for defense contracts was restricted. (3) Installment buying of weapons was banned. (4) A \$38 billion spending ceiling for fiscal 1958 was clamped on, stimulating a new round of program reshuffling. From this action came the 5 percent reduction in progress payments; an order to contractors to cut payroll costs 5 percent; the Air Force's limitations on monthly payments to contractors, creating new stretchouts; a 200,000-man cut in the Armed Forces.

In view of what has been said above, the June 1959 request of the administration for a rise in the debt ceiling was reasonable and was quickly approved by the Congress. Government spending should be determined on merits, not through artificial pressures exerted by debt ceilings. Certainly our experience with the debt ceilings in the 1950's does not suggest the wisdom of new ceilings.

20. Integrity of the budget

Since the Eisenhower administration has come in, what has been most disconcerting is the attempt to give a misleading picture of the budgetary situation. There seems to be more interest in balancing the budget account rather than balancing the budget. Where the effects on the present budget are not serious, there is a greater inclination to spend. For example, the enthusiasm of the administration, which might not have been expected on the old-age and survivors insurance program, can be traced to the fact that the budgetary effects of this particular program would be felt later rather than currently.

I wrote recently ("Review of Economics and Statistics," November 1956, pp. 359-361):

BALANCE BUDGET ACCOUNTS OR BUDGET

Actually the budget has not improved so much as the administration claims. Early in the Eisenhower administration, the practice was introduced of trying to balance the budget account rather than the budget. For example, large sums due to the civil service reserve funds were not diverted to these reserves; CCC paper and housing mortgages were disposed of to private financial interests. In 4 fiscal years (1954-57), the Eisenhower administration disposed of \$1,780 million

of certain capital assets; in the 4 preceding years the Truman administration had disposed of but \$364 million of corresponding assets. These sales yield cash for the budget, and the income rises relatively to outlays. But though the budget comes nearer to a balance, the net effect is no genuine improvement: one capital asset is sold and the income used to pay off debt or keep debt from rising. The above figures are only part of the story.

Even in 1956 the practice continues. I quote instances below.

"PURCHASES OF SOME MORTGAGES ARE KEPT OUT OF THE BUDGET

"In addition, purchases of mortgages by the Federal National Mortgage Association under its secondary market program are expected to increase in 1957 to \$290 million. Except for temporary Treasury loans, the funds required will be obtained from sale of debentures and stocks to private investors, and the purchases are shown as trust expenditures, rather than budget expenditures. By the end of the fiscal year 1957, private purchases of stock will have made an excellent start toward the goal of replacing a Government activity with a private company."

Again, instead of building post offices, the Government now proposes to rent from private builders. The current budgetary outlays are thereby greatly reduced; but whether this is wise or even economical in the longer run is not raised.

"While these recommendations involve substantial appropriations of Federal funds, most of the Federal building improvement program will be financed with private funds under the lease-purchase authority of the General Services Administration and the Post Office Department. Already 53 projects involving private financing of construction costing \$105 million have been approved, and additional projects involving about \$250 million are under consideration."

An excellent statement of the mythical nature of many of these reductions is given in the following:

"But the recent estimate of \$2.8 billion for this year is perhaps deceptive in that it does not represent a real decline in aid operations, from the previous year, but only a shift in their financing from the Government (Commodity Credit Corporation) to the banking system in the amount of \$1.2 billion. The further reduction in expenditures indicated for fiscal 1955 may prove illusory also. A leveling off of agricultural exports together with acreage limitations on wheat and cotton planting are expected to reduce price support operations only slightly, and the main reduction in dollar expenditures thus hinges on a fairly large turnover of funds previously invested in loans and commodities; if this should not materialize, larger disbursements or increased private financing will be required. In this connection it is to be noted also that the shift from Government to private financing represents a postponement rather than a reduction in the ultimate cost of price support operations for the Government.

* * * * *

"The decline in expenditures * * * for public works and housing between 1953 and 1955 reflects partly a drop of \$300 million or 30 percent in reclamation and rivers-and-harbors projects, together with the transfer to private financing of over \$700 million in housing mortgages and obligations previously financed by the Federal National Mortgage Association and the Public Housing Administration. Here, as in the case of agriculture, while the shift from Government to private financing is reducing expenditures as they are conventionally accounted, it evidently represents a different kind of reduction than that of the defense program which involves a smaller consumption of real services and materials. In the category of 'all other' programs * * * the reduction from 1953 to 1954 is again largely nominal: the Government deferred its annual contribution of \$300 million to the civil service retirement fund pending further study; and much of the reduction in the post office deficit by over \$200 million was achieved by raising postal rates rather than by reducing (gross) expenditures. The further reduction in expenditures held out for 1955 also hinges largely on further action by the Congress in increasing postal rates."

An indication of trends in acquisition of assets is suggested by a table not reproduced here. The tendency to acquire less in the way of assets or even to dispose of assets (net) and to depend on guarantees and insurance rather than loans or investments, the latter being reflected in budgetary expenditures and guarantees and insurance only to a very small degree so reflected—this is evident in the table.

This table shows the recent trend of cutting down of the acquisition of assets inclusive of loans, public works, and other physical assets. In 1957 the acquisition of civil assets is \$1,426 million less than in 1955. The decline in loans is

almost \$2 billion in 1956 and more than \$1,300 million in 1957 (vis-a-vis 1955). The details concerning reductions in loans are indicated for the Federal National Mortgage Authority, CCC, and RFC. Not only are assets not acquired, but they are disposed of net. The resultant improvement in the budget—the approach to balancing—conceals the relative decline of assets. The Government credit expenditures decline substantially—by about 5 percent, fiscal 1955 to fiscal 1957—even as guarantees and insurance rise by one-third. Again, the budget looks much better when guarantees rise and loans decline.

Related to this issue is the tendency of the administration to go in much more heavily for guarantees and insurance than for loans and investments. Why this shift in policy? Undoubtedly, one explanation is that guarantees and insurance do not appear as a budgetary expenditure, whereas loans and investments do. From fiscal year 1953 to fiscal year 1959 (estimated), the rise of loans and investments was 23 percent; of guarantees and insurance, 132 percent, the latter rising from 28 to 66 billion.

21. *Spending policies*

We do not want to give the impression that it follows from this analysis that the Government has been spending too much money. It may well be that the Government has not been spending enough money. We are critical, however, that the Government made a promise which it far from kept. From 1952 to 1957, consumer spending increased by nearly 30 percent. During that same period, the national income increased by nearly 25 percent, but the supply of Government services declined by about 6 percent. This raises the kind of question that Professor Galbraith has raised in his "Affluent Society," namely, whether we have a proper proportion of expenditures on the services that Government alone can provide, particularly in the social welfare field, as against many of the luxurious and rather dubious expenditures of the private economy. Is there something not to be said for a change in this pattern of spending?

The contrast in policies is suggested by the following:

The rise of GNP

	<i>Billions</i>
1948-52.....	\$88
1952-56.....	65

The rise of cash receipts, Federal Government

	<i>Billions</i>
1948-52.....	\$26.0
1952-56.....	7.5

Percentage increase in cash payments to increase in GNP

1948-52.....	30
1952-56.....	11

Statement before the Joint Economic Committee, January 1957.

These figures do suggest that the Truman administration tended to share with the public the increase of GNP by absorbing a large percentage, actually 30 percent of the increase in GNP as against 11 percent under the Eisenhower administration, and using a much larger part of the GNP for the benefit of the people. Indeed, part of this rise is explained by the Korean war. Prof. Henry Wallich, now in the Treasury (p. C701) stated the issues well.

In general, I believe that our standard of living has reached a point where the consumer can get more value in many cases for a dollar spent by the Government,

than for a dollar spent for himself. I based this upon my relative appreciation of education, research, health, and cultural projects, as against tail fins, TV's, and soft drinks.

This brings up the issue of the general use of fiscal policy. There is a widespread view among economists that the Government has depended excessively on monetary policy and has made inadequate use of fiscal policy. Thus, Chairman Martin (p. 1856) had this to say:

I would accept the risk of the current deficit that we are running, but I would not want at this time to undertake to accept the risk of a greater deficit than that by cutting taxes until the situation is considerably clearer than I think it is at the present time.

22. Administration's recovery policy

The administration, of course, held that there should not be an increase of spending or a reduction of taxes in order to contend with the recession. As I write these lines, there has been a substantial recovery, though we are far from having attained the high level of the peak of 1957. In fact, unemployment is at a high level compared to the postwar average.

My criticism of policy is not that recovery is not on its way without the aggressive measures recommended by most economists, that is, cuts in taxes and increased spending to meet the problems of the recession, but rather the failure to act has slowed recovery and, therefore, increased losses of output much above what they had to be. Recovery would have been much quicker, and we would have saved billions of dollars each month had we attained the 1957 level of output and 4 percent of unemployment, say, by the third quarter of 1958. Instead of, as seems likely now, in 1959 or 1960. We are still awaiting a full recovery. I need not add here that the level of output in 1960 has to be substantially above that in 1957 if we are to attain anything like full employment, because we have to raise output to make up for the increase of productivity and the increased numbers entering the labor market net. That we have had any recovery at all is to be explained largely by extraneous factors. Among these are the increase in wage rates, which increased the total amount of spending, the rise of transfer payments, which are related especially to the welfare program of the New Deal, and also the increase in military and severance pay in 1958. Another factor has been the automatic reduction of taxes as income has fallen. This is another result of tax policies introduced under earlier administrations.

Actually, the Government contribution was small. As against a decline of GNP from the third quarter of 1957 to the second quarter of 1958 of \$17 billion, the Federal Government contributed \$1 billion of purchases of goods and services, and State and local governments, \$3 billion. Indeed, in the third quarter the Government contribution was larger.

In general, the Government did not use fiscal policy. Indeed, in 1953-54, the recession that was largely brought on by unwise policy was to some extent reversed by a large cut in taxes. This was the appropriate policy at that time. But it should be remembered that the Government also drastically cut expenditures and therefore the reduction of taxes was made necessary. From the broad viewpoint of our defense and security, it is not quite clear that the reduction of expenditures, which helped bring on the need for a tax cut, was a wise policy.

It is of some interest that the U.S. Chamber of Commerce (p. C504) did not take the administration's position on these issues.

As a fourth step, the national chamber has recommended a tax cut and tax reforms to provide greater incentive, both to buy and invest. Even though this will involve a shortrun, temporary deficit, we think the growth which will be stimulated by such tax cuts and tax reforms will, in a short time, cause revenues to increase and again bring the budget into balance.

I argued before the Senate Finance Committee for both a rise of expenditures and a reduction of taxes (pp. 1993 and 1996):

The case for expenditures rests on higher multiplier than tax cuts and the distorted pattern of spending by the American people. By the larger multiplier, I mean only that a dollar of public expenditures yields a larger total rise of income than a dollar of tax remission, in part hoarded in the first instance.

In re spending patterns, I note this point, that since 1940, the country has tended to move in the direction of increased relative private expenditures and reduced public welfare outlays relatively, e.g., on education, health, urban redevelopment, unemployment.

* * * * *
 The CED proposes a \$7 billion tax cut and rescheduling of outlays. I would not rely exclusively on a tax cut but would choose first rescheduling and expansion of spending programs. I take this position because on the whole tax cuts favor the "haves" against the "have nots" and because there is some wastage in tax cuts. In part the increased income left to the private economy as a result of a cut is not spent.

The contrast of views is also given by the position of Mr. Erickson, the president of the Boston Federal Reserve Bank (p. C69). He was opposed to tax cuts or increased spending. Mr. Marriner Eccles (p. 1700) had a somewhat different view:

The course of the recession to date would suggest that if substantial deficit financing were undertaken, either through temporary tax cuts or increased expenditures, inflationary pressures might soon reassert themselves. Restoration of full employment by means of fiscal policy could lead to the resumption of pressures toward higher wages, and they might again rise more rapidly than output per man-hour.

* * * * *
 I do not believe that because there is a later danger, which I recognize, of inflation, that we should do nothing about deflation. I think we have got to deal with the problem we have now, recognizing that there is a later danger of inflation and doing something about it, being prepared to deal with the inflationary situation when you get recovery.

* * * * *
 With the lapse of 6-9 months since writing this, the business situation has greatly improved. Here are the trends from the low of the recession to the first quarter of 1959.

GNP and components, 1st quarter 1958 to the 1st quarter 1959

[Annual rates in billions of dollars]

	GNP	Consumer expenditures	Gross private domestic investment	Net expenditures goods and services	Federal Government purchases goods and services	State and local government goods and services
1st quarter, 1958.....	427.1	386.2	50.9	1.7	49.7	38.6
1st quarter, 1959.....	467.0	400.5	70.2	- .3	54.3	42.3

Source: Economic Indicators, May 1959.

Federal contributions were substantially larger than in the early period of recovery. The major gains came after the midyear 1958. The striking improvement was in investment: an absolute increase of almost \$20 billion and almost 40 percent as compared to one of \$14 billion or 5 percent for consumption. Inventories accounted for two-thirds of the gains in investment. A tapering off of inventory decumulation more than any contribution of Government accounted for the recovery, once the automatic tax relief, substantial rise of transfer payments, and wage increases broke down the deflationary forces.

23. Debt management: An improvement?

During the Truman administration, the financial community was very critical of the management of the national debt. The view widely held was that the interest rate had been kept too low through the creation of money, that the debt was too much in short-term issues, and that it was held too largely by banks and therefore tended to be inflationary.

It is not at all clear that the new administration had improved matters in the last 6 or 7 years. For example, in July 1958, the commercial banks held \$1.3 billion more of Government securities than at the end of 1952. We shall also see that the average maturity of the debt has not been increased as the new authorities hoped that it would be. Moreover, in order to sell Government securities the Federal Reserve on numerous occasions had to interfere in the market just as the Federal Reserve had in preceding years. It was not easy to allow market forces to determine the price of Government securities.

24. Debt management: Integration and relation to private markets

One of the troublesome problems was on integration of policies between the Federal Reserve and the Treasury. For example, in the summer of 1957 the Federal Reserve was responsible for a dear money policy. It is widely held that on such occasion the issue of Government securities by the Treasury should be long term so that the excess funds are absorbed by these Treasury issues and therefore rates tend to harden. But here is what Under Secretary Burgess had to say (pp. 686-687):

With an unprecedented heavy demand for funds in the private area we were convinced quite early in our studies that there was no substantial demand for long-term Government securities. The package offering that we decided upon included two certificates and a note, to be issued on August 1: a 3½-percent certificate maturing in 4 months (Dec. 1, 1957), a 4-percent certificate maturing in 12 months (Aug. 1, 1958), and a 4-percent note maturing in 4 years (Aug. 1, 1961), but redeemable at the option of the holder in 2 years (Aug. 1, 1959). The choice of all three issues was given to the holders of the August maturities but the October holders were allowed to choose only between the two longer issues. It did not make much sense to give an October 1 holder an option of converting into December 1, you see, only 2 months, so we let them spread it out.

This package was designed to provide a very short security for corporations and other short-term investors who want their money before the end of the year, an attractive 4-percent 1-year security for other short-term investors, and a longer 4-percent issue which would appeal to two somewhat different groups of buyers: (1) those who were not sure that they wanted to invest funds for as long as 4 years in case interest rates continued to rise and, therefore, liked the idea of being able to redeem at the end of 2 years, and (2) those who felt that the present heavy demand for money is perhaps close to its peak and were anxious to get part of their portfolio invested for a longer period than 2 years at a 4-percent rate on the theory that a 4-percent rate might not be available again for a long time.

The chairman made it clear to Under Secretary Burgess that the Treasury had been fortunate in that large issues were held by the Federal Reserve and therefore the attrition, that is, the failure to sell new issues for maturing ones rather than for cash, was less than it otherwise would have been (pp. 722-723).

The CHAIRMAN. Would you venture a guess as to what would have happened if this amount of bonds were offered to the public?

Mr. BURGESS. I could not imagine anything more stupid than making an offer of \$24 billion worth of bonds to the public at one crack.

The CHAIRMAN. You would have to offer them if they matured and you had to refund them.

Mr. BURGESS. If the public held \$24 billion.

The CHAIRMAN. Yes.

Mr. BURGESS. And then you offered all of them-----

The CHAIRMAN. What I am getting at is, if the public had held the \$14 billion that the Federal Reserve [and trust funds] held in this instance, what would you have done? You had to refund them. It is not a matter of voluntary action on your part. They came due August 1, August 15, October 1.

Mr. BURGESS. That is right.

* * * * *

The CHAIRMAN. You cannot assume that, in refunding all of these bonds, the Federal Reserve will own 60 percent each time, as it did in this case.

Mr. BURGESS. They do not in most of the issues, of course.

The Treasury had a peculiar view of the problem of issuing Government securities. They were terribly concerned about the state of the private financing market. Perhaps this is consistent with the general ideology that the Government does not interfere with the private economy. But unfortunately the Government has serious responsibilities in this time and age, and therefore the job of the Treasury should be to take cognizance of the important interests of the Treasury. But apparently Mr. Burgess believed that the Treasury must always yield to the demands of the private market. In other words, if there was a great demand for funds on the part of the private market, even if it were highly inflationary or expansive, the Treasury should yield to that pressure and not issue long-term securities. The needs of the Treasury were to take second place to those of the private market. This position was held even though it was generally believed in such periods the correct policy is to absorb excess funds and discourage private demands through higher rates. Mr. Burgess said (p. 728):

Well, sir, the difficulty of selling long-term Government bonds is simply that the lenders of money, whose position Mr. Mayo has very thoroughly charted, are under enormously heavy pressure for funds. The life insurance companies are having offered to them corporate securities, mortgages, at very attractive rates; the savings banks are having mortgages offered to them more than they can absorb; savings and loan associations have their resources thoroughly absorbed by the mortgages they make.

There just is not any volume of long-term funds seeking investments, and the borrower is seeking the lender, and under those circumstances if the Government were to try to sell long-term bonds, you would have to offer a competitive rate that would be very high.

You could not justify offering Governments at a rate so competitive that these people would take it instead of the things they are absorbing.

So that they simply do not want long-term Government bonds. They regard Government bonds as a secondary reserve at the moment. The demands of their customers are so great that they are trying to meet them as their first responsibility.

Since writing the above, we have had an interesting statement from Dr. Henry Wallich, the then Assistant to the Secretary of the

Treasury. (The Second Duke American Assembly, on "U.S. Monetary Policy," March 1959, pp. 44-46.) Wallich's position is more sophisticated and more tenable than Burgess'. He at least allows that the Treasury has some responsibility for the proper functioning of the economy. But I am not convinced by his argument in support of the large issues of long-term securities in recession, namely, that this is the only occasion on which long-term issues are possible. Thus he assumes that future threats of inflation are dealt with by slowing up the recovery, the current problem. Nor is it made clear why the Treasury does not have a genuine responsibility to issue long-term in booms as an anticyclical technique.

* * * Should the Treasury abstain from long-term financing in recessions? Or should it on the contrary seize these opportunities? If the Treasury had perfect control under all conditions with regard to the securities it wants to issue, the doctrine of anticyclical debt management would have considerable merit. This doctrine says that public debt management should be used as an instrument of economic stabilization, much as monetary policy and fiscal policy are used. To implement a stabilization policy, the debt managers would sell long-term securities in a boom to reduce the liquidity of the economy, while the monetary authorities tightened credit and while fiscal policy aimed at a budget surplus. All these policies would be pulling in one direction. In a recession, contrarily, monetary policy would ease credit, fiscal policy would run a deficit, and debt management would aid liquidity by short-term financing. By distributing the load over three instruments of policy, the pressure against any one of them would be reduced and success attained more speedily.

This pretty picture of three coordinated policy instruments is misleading. In a boom, the managers of the public debt may encounter serious difficulties, under present conditions and with present techniques, in the long-term refunding that they are supposed to do. Contrary to the countercyclical doctrine, the Treasury is compelled in a boom to engage in substantial short-term refunding of its maturing obligations. In a recession, the Treasury has no difficulty in financing either long or short. According to the doctrine it should finance short to increase liquidity of the economy. But if it does so, the result is that in fact it never does any long-term financing. There then is never a good time for the Treasury to do long-term financing: in a boom it cannot, in a recession it must not.

The anticyclical doctrine of debt management evidently fluds its limits in these realities of the Treasury's position. If long-term financing remains inadequate in a boom, it must be pushed at some other time. Perhaps it could be undertaken during some intermediate period, i.e., during a recovery, as was done in 1955. In any case, unless the Treasury finances long at some time, a large part of the debt eventually will become very short. Then a new danger appears—the danger of inflation through excess liquidity and monetization of the debt by the banks. When this danger appears, the need to forestall it becomes overriding. No permanent advantage would be gained by trying to accelerate the recovery from recession, if the result is subsequent inflation followed very likely by renewed collapse.

It is on grounds like these that a policy of lengthening the debt in recession, such as was pursued during the 1958 dip, must be justified. One need not go so far as some, however, who argue that the Treasury should conduct its debt operations with total disregard of the needs of anticyclical policy. Those who believe this argue that by financing long in recessions and short in booms the Treasury will simply be doing what comes naturally. Moreover, they say, the Treasury will also finance in the cheapest possible way, because permanent financing would then be undertaken when interest rates are lowest. Countercyclical debt management, to the extent that it is possible, would be expensive. If the policy of financing cheaply and easily should have adverse effects upon the business cycle, aggravating both boom and recession, the proponents of this theory suggest that corrective action should be left to the Federal Reserve.

This, it seems to me, puts too heavy a burden upon monetary policy. It also sets a dangerous precedent in suggesting that the Treasury be virtually absolved from the broad considerations of economic stability. The proper solution, it would seem, lies in the middle: The Treasury must make sure, first of all, that the debt does not get into unmanageable short-term form. But to the extent compatible with this goal, the Treasury, like every other agency of the Government, must be conscious of the impact of its policies upon the business cycle.

25. Defense of debt interest policy

In the course of this discussion of proper debt financing, the question of the $3\frac{3}{4}$ long-term issue of early 1953 was raised. It will be recalled that this issue was not a very successful one. No long-term bond had been issued for many years and the $3\frac{3}{4}$ percent rate was much above the going rate at that time. In fact, the issue was such a surprise that a considerable collapse in the Government bond market followed. That particular approach to the problem resulted from the desire of the incoming administration to lengthen maturities and to take securities out of the banks. Here is Secretary Burgess' rather weak defense of this issue (pp. 684-685).

Now, let me take up the $3\frac{3}{4}$'s that have been discussed at considerable length on the floor of the Senate and the House over a period. * * *

This was not only the first long-term marketable bond that the Treasury had offered since 1945, but it was also the first to be put out without Federal Reserve market support for a much longer period. * * *

* * * * *

Our offering of the $3\frac{3}{4}$'s presented as difficult a pricing problem as the Treasury has ever had to face. We had to set the interest rate on the new issue in a market in which prices were moving gradually lower—a market which was still in the process of adjusting to freer market conditions.

Our longest outstanding bond, the victory $2\frac{1}{2}$'s of December 1967-72, had fallen from almost three-quarters of a point above par—2.45 percent yield—to $95\frac{1}{2}$ —2.80 percent yield—between the Federal Reserve-Treasury accord in March 1951 and the end of 1952.

* * * * *

There were no long-term Treasury issues outstanding which would serve as a real guide to the interest rate such an issue should carry. The victory $2\frac{1}{2}$'s were $10\frac{1}{2}$ years shorter than the new issue, and the market curve of rates, if you plot out a curve, rose as maturities lengthened. * * *

Therefore we took the market curve on outstanding Treasury issues and extended it parallel to the curve on high-grade corporate issues, retaining, of course, a proper spread between the two types of obligations.

That curve produced a rate of 3.08 percent as of June 15, 1978, which was the call date on the new bonds, and 3.12 as of June 15, 1983, the maturity date of the new bonds.

The $3\frac{3}{4}$ coupon would appear to offer a rate, therefore, approximately 15 base points—fifteen one-hundredths of 1 percent—above the market curve, but the spread would be much less than that if you take into consideration the fact that we were issuing the bond in competition with outstanding issues available in the market at a discount, another technical point, which had a capital gains advantage for tax purposes.

In an exchange with Senator Anderson, Secretary Burgess reluctantly admitted that they had influenced the long-term rate. But on many other occasions, both Secretary Humphrey and Secretary Burgess had insisted that they had merely followed the rate (p. 1164):

So it was an operation which had its effect in the market. But it was the fact of our selling a bond at the market rate rather than the fact that we priced it above the market, which we did not do. * * *

Now, were [sic] we right in selling a bond? Should we have sold short stuff and waited for rates to go down in the autumn before we sold a bond?

Well, you can pass your own judgment on that. Our belief was we were under very strong compulsion to get started in dealing with this debt.

SENATOR ANDERSON. I am trying to find a chart, and I seem to have lost it, but it pointed out that the rate on Government bonds rose in a pretty dramatic fashion you are undoubtedly familiar with this fact, in the last part of 1952.

MR. BURGESS. That is right.

SENATOR ANDERSON. And early 1953. And then declined pretty drastically thereafter.

MR. BURGESS. Yes.

Senator ANDERSON. Did not the Treasury have something to do with that by its own operations?

Mr. BURGESS. We had something to do with it, Senator, by the fact that we put out a long-term bond. That undoubtedly had an effect on the market.

In defense of his position in support of higher rates of interest on Government securities, Mr. Burgess had presented the following position:

Money used to pay the interest is collected from many people in taxes, and the money is paid out again partly to the same people and partly to others. I think it is fair to say that about as many people will benefit directly or indirectly from these interest payments as are hurt by them.

In reply, Senator Long had this to say (p. 1109):

It seems to me that we should attempt to determine who is hurt and who is helped. According to the 1957 consumer finances survey by the Federal Reserve Board, 25 percent of all consumers in the United States had no savings; 55 percent had less than \$500 in savings; and 77 percent had less than \$2,000 in savings.

Would you contend that rising interest rates would flow to those 77 percent of families, even in relation to the size of their income, in the same way that rising interest rates would benefit families who have large savings?

The Under Secretary was especially anxious to show that the Treasury, in issuing new issues, always came very close to guessing the market situation. He compared the new issue coupons with the 1-year market rate from 1951 to 1957 and also the interest cost on *new* corporate long-term bond and comparable market yields (pp. 716-717). This is, however, not a very fair comparison, because it is always more difficult to gage the market for long term than for short term issues.

In deciding on new issues, the Treasury takes the financial leaders of the Nation into its confidence. Obviously, some help from professionals is necessary if the Treasury is to have a successful issue.

Mr. Burgess describes the process as follows:

It should be noted, however, that some discussion with those who are not particularly involved in the process might be advisable.

Indeed, the Treasury does have a few economists in its own organization. But would it not be wise also to include a number of outstanding economists without any ax to grind in these matters who might be able to give the Treasury objective advice? At any rate, here is what the Treasury had to say (p. 682):

Each Treasury financing represents an important event in the money markets of the country. It is, therefore, essential that the Treasury take every precaution to get information from every useful source in making decisions about these operations.

In the course of exploring the facts relating to a new Government issue, the Treasury consults a great many people. We get valuable help from the Federal Reserve Board and the 12 Federal Reserve banks, with their offices throughout the country which are in contact with a large number of people and with the money and capital markets. I might add that the Federal Reserve Bank of New York is particularly helpful. They have a group of very able officers, and their help to us in deciding about Treasury issues has been invaluable, and I say that not just because I was an officer of that bank for 18 years, Mr. Chairman.

We maintain contact with the people who handle investments of commercial banks, savings banks and insurance companies, pension funds—State, municipal, corporate, and other private funds—security dealers, and trust companies which have money to invest.

Of course, this leaves the Treasury open to severe criticism. Senator Kerr took advantage of this situation and showed the possibility of insiders making large gains as a result of these consultations with the Treasury (p. 945).

Senator KERR. You do not think those meetings are one-way meetings, do you, Doctor?

Mr. BURGESS. No. I think we keep them informed of the broad national situation as far as we are concerned.

Senator KERR. Do you think they get as much impression from you as you do from them?

Mr. BURGESS. I think they do on certain broad outlines of Government policy. Senator KERR. They have as much a stake in this as you do.

My successor can be critical of me, because, using this measuring stick, we have not made the improvement that I would like to have made.

In these times of great demand for money, we have not been able to extend our debt and to put out as much long-term paper as we had hoped we might do, and as I think it is very desirable to do whenever the opportunity will permit its being done.

Professor Kenen has pointed out to me that a statement on the part of prospective purchasers that they will buy or be interested at one rate or one maturity does not necessarily mean that if another rate or maturity is offered they will not purchase. The fact may be that the former rate and maturity may be their preference but does not really reflect their reactions to another rate or maturity.

In this connection, it is of some interest to note that the failure of the Treasury to issue long-term securities in a period of great prosperity and inflationary tendencies is associated in part with this fear of disturbing the private financial interests. The Secretary of the Treasury may argue that sometimes a market will take long-term securities and sometimes it will not. But the important point is that the long-term securities can be issued at a price. The Secretary of the Treasury, in a reply to one of the Senators, remarked as follows (pp. 163-164):

Now, you can do it sometimes. Sometimes the market will take the long-term securities, and sometimes the market will not.

We have had markets during a substantial part of the time—because of the large demand for money and the high rate of prosperity—where the long-term obligations could not be put out, and where it was not desirable to put them out.

We have made progress, Senator Kerr, but not as much as I hoped we would be able to make. * * *

26. *Maturity of debt*

Under Secretary Burgess was also very proud of his record (pp. 670-676). He was, for example, proud of his record in maintaining the average maturity of the debt. Actually, all that he really claims is that the loss in average length during his regime was considerably less than in earlier years.

There are a number of ways of measuring the changes in the debt structure over the years. Some of them refer only to the marketable debt, such as figures on the average length of the debt. Others—more comprehensive—take into account not only the maturity distribution of the marketable debt, but also the demand character of other portions of the debt.

All of these "yardsticks" show that we have moved forward in improving the structure of the debt during the past 4½ years, especially in comparison with the record of the earlier postwar period.

Average maturity of the marketable debt: One measure of the structure of the debt is the average length of time that the marketable debt has to run to maturity. The amount outstanding of each security making up the marketable debt is multiplied by the number of months it still has to run.

These amounts are then added up and divided by the amount of marketable debt outstanding to give a figure on average length of maturity.

Although the average length of the marketable debt does not reflect changes in other types of debt like savings notes and savings bonds, it is still useful as a yardstick since it encompasses nearly 60 percent of the total debt outstanding, including the most volatile areas of the debt.

The average length of the marketable debt to maturity—calculated to first call date on callable bonds—amounted to 7 years and 2 months in December 1939.

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This record indicates a loss in average length of 3 months during a period of the past 4½ years, as against a loss of 29 months during the 6 preceding postwar years. The loss since December 1952 is even less when only publicly held securities are considered, since Federal Reserve-held securities, many of longer maturity originally, are being refunded into short-term issues under the present policy. * * *

Secretary Burgess was also optimistic about the great improvement in the floating debt. I am not sure that his optimism was justified (pp. 163-164):

The floating debt: A more accurate measure of changes in the structure of the public debt from the point of view of the job of the debt manager is a comparison between the floating debt on the one hand and intermediate and longer issues on the other, basing the figures on publicly held debt.

This means excluding securities held by the Federal Reserve banks and Government investment accounts, but including in the floating debt the most volatile part of the nonmarketable debt payable on demand.

* * * * *

This type of debt, the floating debt, was reduced by more than \$10 billion between December 1952 and December 1956, and the figure at the end of last year was more than \$25 billion below the all time peak in 1953, which reflected largely the inheritance of scheduled maturities from earlier years and financing growing out of the 1953 deficit.

Mr. Burgess was reminded, however (p. 1158), that Secretary Humphrey had not been as optimistic as he had been, when he replied:

Now, I would also say, I am making a double answer to this, your suggestion about Mr. Humphrey—in the first place, he was directing his remarks specifically to replying to Senator Kerr's remarks about that one measure, that he was using.

Second, I think he was too modest. I think we have done a little better than he wanted to claim.

But Burgess' statistics were rather questionable. He found a decline in the floating debt of \$4.3 billion. But the table below (p. 941) shows that this is not really correct. Actually there had been an increase in the floating debt, though his table shows a decline.

[Billions of dollars]

	Dec. 31, 1952	Oct. 1, 1957
Marketable issues maturing or callable within 1 year.....	57.8	76.5
Less issues held by trust accounts and Federal Reserve banks.....	14.9	21.9
Equals marketable issues in hands of public.....	42.9	54.6
Plus:		
Savings notes.....	5.8	
F, G, J, and K savings bonds.....	22.6	12.7
Miscellaneous demand debt.....	3.4	3.0
Total floating debt.....	74.6	70.3

Senator Anderson was quick to see the dubious statistics presented by Mr. Burgess, and Mr. Burgess had to give ground (pp. 1159-1160).

Senator ANDERSON. The only reason you put F, G, J, and K bonds in was that they are sensitive to market conditions?

Mr. BURGESS. Well, the only reason I put them in is that we have been plastered with them, we have been hit with them because they have the right to come to us for redemption and are very sensitive. It is two things together, and they have proved themselves to be floating debt. The proof of the pudding is in the eating.

Senator ANDERSON. Then you included the E and H savings bonds with the longer term debt?

Mr. BURGESS. Because they have acted that way. They have behaved that way. They have been very stable.

Senator ANDERSON. Is one of the reasons the fact that there has been an increase in them in an amount of about \$6 billion?

Mr. BURGESS. That is right. But if you take—

Senator ANDERSON. If the amount of bonds declines, they become floating and if they build up they become long term?

Mr. BURGESS. Well, no. The behavior—actually they have not declined. The total outstanding have not declined of the E's and H's if you include the accumulation of interest.

Senator ANDERSON. Are they not just as redeemable as the G, J, and K bonds?

Mr. BURGESS. Logally, yes; actually—

* * * * *

Senator ANDERSON. Now, actually the E and H savings bonds have not kept pace with redemption? It is only the accumulated interest that makes them look larger; is it not?

Mr. BURGESS. That is right.

Senator ANDERSON. Then they do not behave any differently than the others; do they?

Mr. BURGESS. Yes, they do. We have had actually to pay out in the past \$3 billion on the F's and G's.

If we include the total of E and H bonds in the floating debt, the 1952 total rises to \$109.9 billion, and the 1957 total rises to \$111.8 billion. Hence, there is a real increase in the floating debt. If we exclude both sorts of savings bonds from the floating debt, the increase is \$5.6 billion. That the Federal Reserve, for example, had changed its policy and included Treasury bills only in its portfolio had a considerable effect on Mr. Burgess' results. Professor Kenen pointed out to me that at the end of 1952 *marketable* securities maturing within 1 year accounted for only 60 percent of the Federal Reserve portfolio of Government securities. At the end of September 1957, they accounted for 90 percent. Had the composition of the Federal Reserve Board portfolio in 1957 been the same as in 1952, the combined short-term holdings of the reserve and trust accounts would have totaled approximately \$16 billion rather than \$21.9 billion in October 1957. Hence the total floating debt would have increased.

In this connection, it would be of some interest to indicate what has happened to the structure of the Government debt from the end of 1956 to June 1958.

Government securities structure, 1956-58

[Billions of dollars]

	All	Bonds	Bills	Certificates
December 1956.....	276.7	82.1	25.2	19.0
April 1957.....	274.1	83.9	25.3	19.0
September 1957.....	274.5	80.8	26.7	35.0
June 1958.....	276.8	90.8	22.4	31.1

This table is revealing because it shows the perversity of the Federal Treasury policy. Compare, for example, December 1956 and September 1957. This was a period in which the authorities were worried about inflation. Did they issue long-term securities? No, there was an actual decline in bonds outstanding. But the certificates outstanding rose from \$19 to \$35 billion. These, of course, are short-term issues.

27. Issues of long terms in recession

By September 1957, the recession had set in. Hence it is of some interest to compare the issues of securities from September 1957 to June 1958. This was a period when you might expect the Treasury would not issue bonds but would issue short-term securities. Actually, there is a great increase of long-term bonds of \$10 billion in these 9 months, and the issue of both bills and certificates dropped for a total decline of about \$8 billion. Mr. Marriner Eccles, an authority with long experience in these matters, made it quite clear that the failure of the long-term rate of interest to decline by the spring of 1958 was to be associated in no small part with the large issues of Treasury long-term bonds (p. 1697).

The rate on bills has gone down from an average of 3.59 in October [1957] to 1.14 at the end of March [1958]; at the present time it is down below that, whereas the average rate on long-term Government bonds has only gone down from 3.73 in October to 3.21 at the end of March.

* * * * *

Concurrently, the Treasury's financing has been through the issuance of intermediate and long-term securities which have largely competed with the private bond and mortgage markets, thereby tending to hold up long-term rates.

* * * * *

It would appear that no matter what the economic situation is, the Treasury feels that it should lengthen maturities of the public debt. It is my view that during periods of inflationary pressure, Government financing, whether refunding or new issues, should be lengthened and sold in the investment market so far as possible.

Conversely, during a recession, an effort should be made to increase the holdings of Government securities by the commercial banks by issuing short-term securities and thereby increasing the money supply.

In the compendium (p. 675), Professor Samuelson, one of the leading economists in the country, had this to say:

Public debt management is closely connected with monetary policy. Now that the Fed tends to operate in short-term bills only, it is the Treasury's decision with respect to stretching out the debt that have many effects on the pattern of bond yields that open-market purchases of bonds by the Fed used to have. If one wishes to make long-term credit easier to get and cheaper, one forgoes stretching out the debt. Conversely, in times when fixed investment is overbrisk, and the market will not buy new long-term Government bonds except at a very high yield, then, unpopular as this may seem to the Secretary of the Treasury, that is the time to issue new long bonds.

The Federal Reserve does not have the duty to keep Government bond yields low through thick or thin. But it does have the duty to make sure that the combined impact of the Treasury debt-management policy and its own policies are conducive to aggregate stability.

It is clear from the remarks of Secretaries Humphrey and Burgess that the policy of issuing securities with a view of stabilizing the economy is not very popular. One reason for this is that in periods of prosperity the competing borrowers are very much annoyed by the issue of long-term securities at higher rates by the Treasury. Again, the Treasury and the Federal Reserve seem to be excessively concerned about the coming inflation and therefore do not want short-term issues sold at the banks in periods of recession. This is made adequately clear by the Presidents of the Federal Reserve Banks (p. C51).

The experience of recent years, however, has raised questions concerning the feasibility and, to some extent, the desirability of such a debt-management policy. In the first place, the heavy demands for capital in a period of high activity tend to make the financial markets unreceptive to long-term Treasury securities and to require the Treasury to bid up interest rates progressively if it is to be successful

in diverting funds from other uses. The Treasury is likely to be severely criticized by potential borrowers (such as builders and municipalities) who find it most difficult to compete, and by others who object to the increased service charges on the public debt.

Furthermore, the increased liquidity of the banking system that results from large sales of short-term Treasury securities to the banks in a period of recession (such as 1953-54) delays and limits the effectiveness of restrictive monetary policies when inflationary tendencies again become a problem * * *.

The above takes the story back to June 1958. Since that month, recovery has been on the way. But whereas issues of bonds had risen by \$9 billion in the first 6 months of 1958, a recession period, the bonds outstanding in the next 10 months actually declined by \$6 billion. In other words, the Treasury obstructed recovery by issuing large quantities of bonds in the midst of recession, and once recovery was well on its way reduced its bonds outstanding. The Treasury pursued anything but a proper anticyclical policy. It put its own interests far above those of the economy.

U.S. Government security by type of security

[Billions of dollars]

	Total gross debt	Total public issues, marketable	Bills	Certificates of indebtedness	Notes	Bonds
June 1958.....	276.4	166.7	22.4	32.9	20.4	90.9
April 1959.....	285.5	180.7	34.2	34.4	27.2	84.9

Source: Federal Reserve Bulletin, May 1959.

What is more, despite its strong criticisms of the rising floating debt in the Roosevelt and Truman administrations, it had failed not only to reduce floating debt but actually increased it absolutely and relatively.

The record has been particularly bad for the period beyond that covered above. In the 10 months ending April 1959, Treasury bills outstanding rose by \$12 billion, or from 13½ percent of public marketable issues to 19 percent. Certificates of indebtedness outstanding also rose, though not in proportion to public marketable issues. Treasury notes and intermediate maturities also expanded absolutely and relatively. Clearly, the average maturity had experienced another slide downward.

28. Support of Government bond market

It has been a policy of the present administration to interfere in the money market as little as possible. The accord of 1951, which was introduced in the preceding administration, but in part is the result of pressure from the Federal Reserve, assumed that the money market would not be operated on behalf of the Treasury. It is interesting, however, that on several occasions since the new administration came in the Federal Reserve System has supported the Government bond market. In 1953 and 1954, the Federal Reserve reduced reserve requirements, partly to relieve seasonal stringency in the money market but also to encourage bank purchases of new Government securities. In November 1955, the System deviated from its bills only policy in its purchase of \$167 million of new Treasury certificates. This action was taken because of the pressure of the

Treasury in a conversion operation (p. 875). In 1958 also the Federal Reserve abandoned temporarily the bills-only policy.

A word about the bills-only doctrine. This is a policy which many economists find difficult to understand. In this particular manner, that is, by depending on the purchase and sale of bills rather than of long-dated securities, the Federal Reserve ties its own hand in its attempts to control money and the rate of interest. Obviously, the effects are greater if the central bank operates directly on the long-term securities. One major reason for this policy of bills only seems to be that, if the Federal Reserve deals with long-term securities, this introduces an element of uncertainty into the market, and the market must be protected against all elements of uncertainty. In my opinion, however, the objective of stability is much more important than protecting the market and the speculators against any uncertainties in the purchase and sales of Treasury issues.

29. Independence of the Federal Reserve Board

In the course of the hearings, many times the issue of independence of the Federal Reserve came up. It seemed that both the Federal Reserve and the Treasury were satisfied with the present arrangement even though there had been some serious disagreements.

Secretary Humphrey, for example (pp. 232-233), was clear that he was satisfied.

Well, as to the way we work, it is just the simple ordinary way in which two groups of people with independent responsibilities would normally attempt to cooperate.

We have a system which has worked all the time we have been here in which Mr. Martin comes over to the Treasury and we have a visit every Monday at lunch; and then on Wednesday, as a rule, Mr. Burgess and two or three of our people go over and visit with the Federal Reserve Board and their staff.

So that we have a constant contact between the two organizations all up and down the line, so that each knows what the other is talking about and what the other is planning.

Now, then, in our movements we discuss, each of us with the other, what we plan to do and how we plan to do it. We hear what the other has to say about it. Sometimes we can take into account criticisms; sometimes we get very worthwhile criticisms that lead us to alter our opinion somewhat.

Other times, we find that we stick to the opinions that we originally had and proceed.

But we operate together, each with his own final responsibility, but each knowing what the other is doing and each hearing the position of the other before final determinations are made.

Chairman Martin (pp. 1258-1259) contended that Congress had had many opportunities to deprive the Federal Reserve of its independence but on numerous occasions, in reconsidering the Federal Reserve System, Congress had implicitly approved of the idea that the Federal Reserve should be independent.

This question of independence has been thoroughly debated throughout the long history of central banking. On numerous occasions when amendments to the Federal act were under consideration the question has been reexamined by Congress, and it has repeatedly reaffirmed its original judgment that the Reserve System should be independent—not independent of Government, but independent within the structure of the Government. That does not mean that the Reserve banking mechanism can or should pursue a course that is contrary to the objectives of national economic policies. It does mean that within its technical field, in deciding upon and carrying out monetary and credit policy, it should be free to exercise its best collective judgment independently.

* * * * *

The members of the Board of Governors and the officers of the Federal Reserve banks are in a true sense public officials; the processes of policy determination are surrounded with carefully devised safeguards against domination by any special interest group.

Broadly, the Reserve System may be likened to a trusteeship created by Congress to administer the Nation's credit and monetary affairs—a trusteeship dedicated to helping safeguard the integrity of the currency * * *.

Despite serious disagreements with the Treasury, for example in the spring of 1956, Chairman Martin was satisfied (pp. 1361-1363).

Well, we feel ourselves bound by the Employment Act and by the Federal Reserve Act. And in the field of money and credit we consider ourselves to be, regardless of what the decisions of the administration may be—we consult with them, but we feel that we have the authority, if we think that in our field, money and credit policies, that we should act differently than they, we feel perfectly at liberty to do so.

Senator LONG. In other words, you feel that you have freedom in promoting what you believe to be the full employment policy of the law?

Mr. MARTIN. That is right.

* * * * *

Senator LONG. Could you give us some indication of recent decisions and recent actions that the Board has taken which you feel were not the policy that was recommended or was, perhaps, contrary to the attitude that you believed that the administration would have taken if it had been charged with the same responsibility that you have?

Mr. MARTIN. Well, I think the most glaring instance of that was in April of 1956. Pursuing our method of cooperation, I began discussions with Secretary Humphrey. In February of that year Governor Balderson and I had a meeting with Secretary Humphrey and there was a disagreement as to the nature that the economy was developing * * *.

* * * * *

We finally reached a point where there was no meeting of the minds that could be had, and there was nothing for the Federal Reserve to do except to go and act. And we acted.

During the hearings of the Finance Committee, numerous complaints were made of the independence of the System. Senator Malone proposed that the powers of the System be returned to the Congress (pp. 426-427). Professor Harris suggested that the System ought not to be independent of the executive (pp. 2046-2047). Senator Anderson repeatedly proposed the creation of a national economic council that would deal with the monetary as well as the economic aspects (p. 1146). Professor Angell made a similar proposal (p. C542).

The coordination of credit, monetary, and economic policies was not what it should have been. Anyone who views the expansion of the numerous Government credit agencies and operations during those periods of recession and prosperity would wonder whether there had been any discussion among these various agencies—for example, the FNMA, the FHA, the CCC—with the Treasury and the Federal Reserve (see pp. 569, 1144, C64, C224, C597). The independent myth had developed to such a point that the President himself failed to make recommendations in his annual report to the Congress on what monetary policy should be. Indeed, he did hold some informal conferences with various leaders in the monetary field.

Perhaps at one time there was a place for the independence of the Federal Reserve, when the Federal Government did not have much to say about economic developments. But the situation is entirely different now. The Federal Government spends a large part of the total income of the Nation and takes a considerable responsibility under the 1946 act for maximum employment, output, and purchasing

power. In view of these responsibilities, the Government certainly cannot allow the Federal Reserve to operate in any way it pleases.

By insisting upon its independence, the Federal Reserve has not only failed to make its maximum contribution but has encouraged other agencies and departments to move in many directions at the same time. Obviously, the independent Federal Reserve also means an independent Treasury, an independent Housing Agency, and so forth.

This independence and the failure to achieve integration among the various agencies has resulted in a number of disastrous errors. For example, in 1953, Secretary Burgess, overimpressed by academic discussions, pushed through high money which demoralized the bond market and helped bring on a recession. The Federal Reserve mildly acquiesced.

In 1956-57, the Federal Reserve introduced an anti-inflationary policy which other agencies frowned upon but did not stop.

In the midst of the peak of the anti-inflationary period, the Treasury sold billions of short-term issues. Had the independent Treasury been willing to cooperate with the independent Federal Reserve, it would have sold long-term issues and thus raised the long-term rates—in accordance with the high money rate policy of the Federal Reserve. But perhaps the Treasury was annoyed with the dear-money policy which hit first and foremost the market for Government securities.

In 1958 the Federal Reserve introduced a moderate cheap-money policy. What did the independent Treasury do? It issued billions of long and intermediate term issues. When the Federal Reserve tried to cheapen money, the Treasury made it more expensive and vice versa.

One wonders if Messrs. Martin, Humphrey, Anderson, Cole, Burns, Saulnier, and other heads of the financial departments and agencies were and are on speaking terms.

The test of the pudding is in the eating. The independent Federal Reserve and the independent Treasury and the hands-off White House succeed in giving the Nation not only a recession but a recession accompanied by substantial inflation. This is unique.

30. *Selective controls*

On a number of occasions the Washington authorities were asked about the desirability of selective controls, for example, on consumer credit. The answer was invariably no. Chairman Martin made this clear on a number of occasions. The Federal Reserve did not want consumer credit control. This is surprising in view of the fact that there had been such control. Moreover, the British showed in the last few years that by control of installment buying they could, to a considerable degree, reduce inflation. They used this kind of control despite the fact that the Government was also in a position to tell the commercial banks directly to cut down on loans, and the commercial banks would respond. Such moral suasion is not used to any great degree in this country. Had consumer credit, for example, been contained to some extent in 1956 and 1957, the backlog would have contributed to getting the country out of the recession in 1958.

An exchange between Senator Anderson and Secretary Humphrey reveals the attitude of the administration. It will be noted that Secretary Humphrey's objection to selective credit controls is largely on ideological grounds. He does not like Washington telling the people how to spend their money. Apparently he would rather have inflation (p. 558).

Senator ANDERSON. Then his [Mr. Elliott Bell, editor of Business Week] concluding sentence in that first paragraph is:

This overall restraint should be supplemented by selective credit controls directed toward particular areas of the economy which appear to be advancing at too rapid a pace.

Have we tried any selective controls?

Secretary HUMPHREY. No, and I am opposed to that. I just do not believe that—I said a minute ago, I just do not believe there is any group of men who are so smart that they can tell everybody in America what to do and be wiser than the great bulk of our people who are actuated by an incentive free choice system.

I believe with all my heart in an incentive free choice system. I believe it is what has made this country. * * *

* * * * *

So I just do not think you can run this economy entirely from Washington. I think Washington has a place. I think it can do some things, and try hard to do them properly, but I do not think you can do the whole job here, and I would much rather trust the American people to limit within some reason their borrowings and decide how much is proper expansion and how much is not, than I would have to have somebody here in Washington sit and put some arbitrary controls on what you can do.

As might be expected most of the businessmen replying to the committee's questions took a similar position. Typical was the U.S. Chamber of Commerce statement (p. C482):

We endorse the general position of the Federal Reserve Board in holding that general, indirect monetary controls are the appropriate means of restraining inflationary and deflationary movements in the money market. Direct controls, except for regulation of stock market credit and providing minimum standards for prudent commercial bank operations, are not consistent with a free market system. Selective controls over terms of particular kinds of credit—for example, consumer installment credit—are administratively not feasible and are inimical to freedom of consumer choice and efficient resource allocation. * * *

But the great majority of economists, however, seem to favor such controls. Of eight economists making explicit mention of them in their answers to the committee questionnaire, seven gave selective controls full or qualified endorsement (see pp. C542, C619, C630, C642, C662, C700, and C704). Only one categorically opposed them (p. C599). Prof. Sumner Slichter also favored them in his oral presentation (p. 1834), as did Marriner Eccles (pp. 1738, 1739, and 1790).

As has been often true in recent years, the Federal Reserve Bank of New York revealed a much more sensible position than the Federal Reserve Board on this issue. They were, as a matter of fact, much more sensible in their attack on the bill's only policy as well, but had lost this battle. The Federal Reserve banks seem to be receptive to the idea of selective consumer credit control (p. C73).

But it is at least conceivable that the capital goods boom since 1955 would not have been of the same magnitude, that inflationary pressures would have been less strong, and that there would now be less need for readjustment, if it had been possible to take direct measures to restrain the expansion of consumer credit and mortgage credit, and thereby restrain the housing and consumer durable goods boom of that year. Despite the voluminous and exhaustive study of consumer

credit controls that was completed only a year ago, and the vociferous objections from interested parties to such controls, perhaps the issue should not be considered closed if we are really serious about minimizing economic instability. I can assure you, however, that there exists in the Federal Reserve System no bureaucratic urge to administer such controls—quite the contrary. Perhaps if consideration should again be given the question of giving the System standby authority to apply such controls in the future, it might be worth while to study the experience of other countries, where enforcement, as distinguished from policy formulation, is in many cases administered by an agency other than the central bank. I do not question the usefulness of consumer credit in facilitating the purchase of items of substantial cost, nor am I disposed to pass judgment on the question of whether the absolute level of consumer indebtedness at any given time is too high. My concern, rather, is with the effects of rapid acceleration or deceleration of the growth of consumer credit on the stability of production and employment.

31. *Another view on Federal Reserve policy and economic stability*

In October 1958, the Senate Committee on Banking and Currency released a report entitled "Federal Reserve Policy and Economic Stability, 1951-57," a report prepared by Prof. Asher Achinstein (S. Rept. 2500).

The report starts with a statement from the Douglas subcommittee report of 1950 on monetary, credit, and fiscal policies. I quote:

(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.

(2) The essential characteristic of a monetary policy that will promote general economic stability is timely flexibility. To combat deflation and promote recovery, the monetary authorities must liberally provide the banking system with enhanced lending power, thereby tending to lower interest rates and increase the availability of credit. To retard and stop inflation they must restrict the lending power of banks, thereby tending to raise interest rates and to limit the availability of credit for private and government spending. These actions must be taken promptly if they are to be most effective (p. VII).

In re the policies in the first 6 months of 1953, the author of this report points out—

that the monetary authorities based their credit policy on the assumption of continuation of business expansion and the intensification of inflationary pressures. There were others who pointed out early in the spring of 1953 that the Federal Reserve Board's preoccupation with inflation resulted in its minimizing unfavorable developments indicative of an impending downward readjustment in business activity.

In its policy of contending with inflation, the Federal Reserve also had the support of the Treasury, which launched its long-term issue with a view to raising interest rates and getting securities out of the commercial banks (p. IX).

Then the authors are quite critical of the Federal Reserve for not contending with the great inflation in 1955 at an early point. They point out that between the third quarter of 1954 and the first quarter of 1955 the gross national product advanced at an annual rate of over \$22 billion, and the largest part of the increase was reflected in rising outlays for consumer durable goods, purchases of new homes, and the shift from liquidation to accumulation in business inventories. Installment credit was rising at a very rapid rate, and the mortgage debt on one to four family houses increased by \$6.5 billion during the first 6 months of 1955; but the reaction of the Federal Reserve was very slow. In explaining the tardiness and lack of vigor in the

restrictive policies, the Chairman of the Federal Reserve Board emphasized—

the human factor of hesitancy to exercise curbs that might check the pace of business expansion.

Apparently, another explanation of the slow reaction of the Federal Reserve was the fear, quite justifiable, that a dear-money policy might result in large disposals of Government securities by banks. Actually, the Federal Reserve apparently accepted the theory that small increases in rates would make it unlikely that the financial institutions would dispose of securities because of the losses involved. But their theories proved to be wrong, for from April 1955, to August 1956, when discount rates rose from 1½ to 3 percent in six moves, the banks disposed of more than \$12 billion of Government securities (pp. X and XI).

Having failed to adopt strong measures in 1955, they were confronted with the alternative of a liberal policy which would have accelerated the price rise or a restrictive policy which had the danger—of initiating a downward spiral of business activity in certain of the key sectors which had ushered in the boom and had been showing considerable weakness for some time (p. XII).

The authors of this report support the Federal Reserve in not relaxing the restraints in 1956 and the first half of 1957, but they are very critical of Federal Reserve policy in the summer and fall of 1957. A rise of the discount rate from 3 to 3½ percent in August 1957 came despite increasing signs that the boom might end soon. And from August until November, when the discount rate was finally lowered, the Federal Reserve apparently had in mind only the threat of inflation and not the possibility of a declining economy.

The authors of the report are especially perplexed by the records of the Open Market Committee, which have since been revealed. During all these 18 meetings held throughout the year—

there appeared to be an absence of that confidence in the business outlook and in the continuation of inflationary pressures, which were manifested in public statements by top spokesmen for the System. The contrast between the record of the deliberations of the Open Market Committee and the public statements and actions of the Federal Reserve require explanation (p. XIII).

The authors, then, hold the Federal Reserve in no small part responsible for the large decline in the postwar period.

In its reply to the Senate Banking and Currency Committee report, members of the staff of the Federal Reserve emphasized the point that the recession had actually not been as serious as the authors of this report had assumed. The Federal Reserve also emphasized at this point something that they were not very often inclined to say during the hearings of the Finance Committee, namely:

* * * are Federal Reserve actions the sole factor for stability on the side of public responsibility or is economic stability also affected by taxing and spending policies, by agricultural policies, and by other public policies such as those that govern the terms and conditions in the insurance and guarantee of home mortgages?

In defense of its 1956-57 policy, the Federal Reserve staff emphasizes that the Nation was in the grip of an active wage-price spiral and a universal tendency to hedge against inflation—

by incorporating in longer term contracts, escalator clauses for higher wages and other costs and a consequent speeding up of the wage-price spiral.

Business also was anticipating future rises in costs and therefore expanding excessively. The staff also now points out, as it has not before, the complications caused by Treasury debt management problems and the—

relation of Treasury refinancing and financing operations to the timing of monetary actions.

The staff pointed out that the dangers of inflation were just as great now as they were early in the summer of 1957 (pp. 84-85).

PART III

FAILURES OF THE ADMINISTRATION

In the investigation of the financial condition of the United States, the Senate Finance Committee was interested in revenue, public expenditures, management of the debt, credit facilities, and also in the effects of these variables upon the economy. In fact the hearings proved to be an overall examination and appraisal of the economic policies of the Eisenhower administration. Hence it may be worth while to run over some of the major issues and to examine the failures of the administration in these areas.

1. Federal expenditures

In the famous meeting with Senator Taft at Morningside Heights in 1952, Candidate Eisenhower had made it clear that Federal expenditures would be down to \$60 billion. In fiscal year 1953, ending June 30, expenditures had risen to \$74.3 billion, but it must be noted that this was in the midst of the Korean war. By 1955, the administration had reduced expenditures to \$64.6 billion, a notable achievement, though of course demobilization following the Korean war and large cuts in expenditures on defense, which may in the long run prove very costly, were the major factors in this decline. But by 1959 (fiscal year) expenditures had risen to \$81 billion; and planned expenditures for fiscal year 1960 were \$77 billion. What is more, in 1950, just before the Korean war total Federal expenditures were only \$40 billion. Now they have doubled by 1959-60. It is clear that the administration has not achieved one of its major objectives, namely, a substantial cut in Federal expenditures. Rather the reverse: expenditures have steadily risen, except for a decline in 1953-55 and this, as I said, is associated in part with the demobilization following the end of the Korean war.

It can be said to the credit of the administration that the percentage of Federal purchases of goods and services in relation to the gross national product declined from 1952 to 1958. But this decline is explained in no small part by the rise in the percentage of purchases of goods and services by State and local governments from 6.7 percent in 1952 to 9 percent in 1958 (calendar years).

These trends suggest that the Federal Government has increasingly tried to put the burden of public expenditures on State and local government, even though the tax structure of State and local government is not exactly capable of standing this increased burden. Though State and local government account for about one-third of all taxes collected, they provide only 11 percent of the individual and corporation income taxes. Note that the Federal Government collects about 89 percent of the individual and corporation taxes, though the Federal Government accounts for only about two-thirds of all taxes; State and local government account for all the general sales and gross receipts taxes and 65 percent of the motor fuel taxes. In other

words, the direct taxes which measure ability to pay are largely in the control of the Federal Government, and other taxes in the control of State and local government. The tax burden has been rising disproportionately for State and local governments in the last 10 to 15 years.

2. *The integrity of the budget*

Increasingly, the evidence shows that the administration has tended to be more interested in balancing its accounts than in balancing the budget. By that I mean that the administration pursues financial methods that reveal a budget smaller in *appearance* than in fact. For example, the administration has favored policies of selling assets as a means of obtaining cash (receipts) and therefore showing an improved budget. A striking case is the civil service retirement fund, an issue fully discussed between Senator Frear and Secretary Humphrey in the hearings (see pps. 273-277). On the pretext that a study was being made of the civil service retirement fund, the 1955 budget provided \$30 million to be applied to the civil service retirement fund instead of the \$427 million of the preceding year. In the year following, again the fund was deprived of funds to be transferred from the Federal Government. Later on the Secretary admitted that the deficit would be made up over a number of years. The fact is that the budget position was improved by about a billion dollars over several years as a result of this particular kind of manipulation. At least temporarily the Government was using trust funds to keep appropriations down.

Along the same lines the administration has shown great enthusiasm for guarantees as against loans. In many respects guarantees can be supported as substitutes for loans. But there is no doubt about the fact that part of this enthusiasm is engendered by the fact that guarantees are not listed as Government spending. From fiscal year 1953 to fiscal year 1959, the rise of loans and investment was 23 percent, of guarantees and insurance 132 percent, the latter rising from \$28 to \$66 billion. For fiscal 1960, direct loans and investments, that is, new commitments, amount to \$5.7 billion and guarantees and insurance \$21.8 billion. In fact, from 1958 to 1960, the last an estimate, the increase of direct loans and investments was to be only about \$400 million (budgetary item), but for guarantees, not included as expenditures, a phenomenal rise of \$9½ billion (the Budget, fiscal year 1960, p. 958). No one has been able to get an estimate from the Treasury as to what these commitments mean in terms of possible future losses.

Obviously, a disposal of assets also improves the budget. For example, the Federal Government may sell its mortgages to private banking interests. In the 4 fiscal years 1954 to 1957 the Eisenhower administration disposed of \$1,708 millions of *certain* capital assets. In the 4 preceding years, the Truman administration had disposed of about \$364 millions of corresponding assets. Here is an *apparent* improvement in the budget (rise of receipts), but is there really an improvement since the gains are in fact achieved through living on capital?

In 1959 an interesting episode occurred. In order to show a balanced budget for 1960, the President was prepared to transfer obligations for an expansion of international lending from the 1960 budget, where the expenditure would really occur, to the 1959 budget.

Another example of this kind of dubious accounting is given by an episode in the 1959 Congressional Record. Senator Gore had raised the question as to the propriety of the proposed action of the Federal National Mortgage Association to trade 4 percent mortgages held in its portfolio, maturing at an average of 6 to 10 years or 12 years at the most, for Government bonds bearing an interest rate of 2½ percent with a maturity date of 1980. On June 8, Senator Clark, on behalf of 12 Democratic Senators, offered Senate Resolution 130:

Resolved, That it is the sense of the Senate that the policy to exchange mortgages held by the Federal National Mortgage Association for Government bonds, as proposed by the President in the budget for the fiscal year 1960, is not in the national interest and should not be carried out because of (1) loss of income from the mortgage loans, (2) loss of tax revenues, and (3) adverse effects upon the home mortgage market.

The administration seemed to be interested in this procedure in part because in this way they could dispose of about a billion dollars worth of mortgages and thus show a corresponding improvement in the condition of the budget. Private interests were also very much interested because this would mean that they could get rid of long-term Government bonds that were a drag on the market and could obtain in exchange profitable mortgages yielding 4 percent. The 2½ percent bonds, of course, were selling at a large discount. (See Congressional Record, June 8, 1959, pp. 9174-9176). Private holders would also have certain tax advantages from this exchange.

Finally, I shall just mention two other items. First, the Government obtained large additional resources for the post office budgets and thus kept deficits down, not through economies but through higher prices.

Second, the penchant for renting rather than building physical facilities also reflected the desire for window dressing and probably in the long run, diseconomies.

3. Structure of expenditures

When one compares the budget of 1954 and 1960, one is struck by the very large proportion of increase of expenditures on agriculture from 3.7 to 7.8 percent of total Federal expenditures. Yet despite these large rises, the problem of surpluses is more serious than ever before. Clearly, agricultural policy does not point to any large gains. Of the welfare programs, a large category, only housing shows a large increase, namely from 1.2 to 2.9 percent. Here the administration has continued, though at a pace in some areas (e.g., public housing) less accelerated than had been planned by the Truman administration, the policies of the previous administration. Note also that the major burden of housing increasingly was reflected in a nonbudgetary category, namely guarantees.

Perhaps the most striking aspect of the budget is the decline from 69 to 59.5 percent for major national security programs. Actually, if allowances are made for the change in the price level, the security program has been cut by about one fourth under the Eisenhower administration.

This large increase of expenditures has then been consistent with very large cuts in defense outlays and with the provision of no new major program in the social welfare program. Indeed, many of the earlier programs were continued and in some cases expanded.

One surprising early policy of the Eisenhower administration was the liberalization of old age insurance. The explanation of this movement is without a doubt that these increases do not show up in the budget since they are in fact financed through a trust fund.

Finally, it should be noted that expenditures are also understated for another reason, namely, that road expenditures are in a trust fund, or at least the interstate program, which will cost at least \$56 billion in 13 years, and is included not as an ordinary budgetary expenditure, but is diverted from a regular budget and to be financed, presumably by a gasoline tax, though the attainment of this objective is not sufficiently clear today.

4. *Deficits and debt*

It has been one of the most pronounced objectives of the administration to stop deficit financing and reduce the Federal debt. Yet in the first 6 years of its administration, there were deficits in 4 years and surpluses in 2. In the fiscal year 1959 the deficit was \$13 billion, a record for peacetime period. Even in World War I, the deficit had not exceeded this figure in any 1 year except in 1919, the expenditures in which year reflected both the cost of the war and the aftermath. The debt itself rose from \$259 billion in fiscal 1953 to \$266 billion in 1954 and \$285 billion by fiscal 1959. Only in 2 years was the debt actually reduced and that only by \$4 billion in the fiscal years 1956 and 1957.

Actually, the deficit and the debt are really much larger than they seem to be on the basis of these figures. Had the Eisenhower administration pursued the same accounting principle as the Truman administration and also pursued the same policies vis-a-vis capital assets, the debt would have been much larger. But it may well be said that through excessive sale of assets, through diverting funds from the civil service retirement, through large uses of guarantees and similar practices, the debt has increased several billion dollars, as a minimum, above the figures that are given by the Budget Bureau.

5. *Debt management*

One of the best indices of debt management is the price paid for money by the Federal Government. At the end of the Truman administration, the average cost of the national debt was 2.48 percent. By fiscal year 1960, the average is estimated by the administration at 2.84, an increase in the rate of about 15 percent. But this is not nearly so significant as the yield on long-term bonds at 2.68 at the end of the Truman administration and 4.09 in early May 1959, or an increase of more than one-half.

Another objective of the administration was to reduce the floating debt. This was made clear in the very beginning of the administration when Mr. Burgess issued his famous Humphrey-Dumpty's (3¼ percent) which, of course, were a complete flop. As we have shown, the floating debt has tended to increase, and especially in the last year or so. It is larger absolutely, and relatively to the total debt. Here is a clear failure.

Again, and related to the issue of floating debt, the administration was anxious to get Government securities out of the banks on the theory that when they are held by the banks they are inflationary and contribute toward an expansion of money. Actually, from the end of 1952 to the end of 1958, the debt had increased by about \$16 billion.

Where did these additional issues go? The Federal Reserve increased its holdings by \$1.7 billion and commercial banks by \$3.8 billion. These increases are larger than the proportionate rise in total debt *publicly* held. But by putting pressure on financial institutions to dispose of debt as they increased money rates through restricted monetary policies, the Federal Reserve in fact forced other financial institutions to dispose of their Federal securities. This was true especially of mutual savings banks and insurance companies, which reduced their holdings from \$25.6 billion in 1952 to \$19.4 billion by the end of 1958. Fortunately State and local governments, which increased their holdings from \$11 to \$17 billion and other investors from \$11.1 to \$17.3 billion filled the void, but only through the incentive of higher rates. Hence again the administration had failed to take the securities out of the commercial banks, and in fact actually increased the inflationary holdings.

6. The President's proposals of June 1959 for lifting the ceiling on the Federal debt and raising the interest rate ceiling

The current discussion gives us an opportunity to appraise the President's request for lifting the ceiling on the debt, and raise the rate on long-term Federal securities.

I see no serious objection to raising the ceiling on the debt. As the earlier arguments suggest, the debt ceiling had the effect of inducing dubious accounting practices to keep the debt below the ceiling and, more important, stimulating unwise policies such as slowing up the defense program, failure to pay contractors. Economies in Government should be achieved directly, not through such devices.

The President's proposal for lifting the interest rate ceiling is another matter. Difficulties in selling long-term issues in competition with other seekers of funds are the occasion for this demand. But the high rate on long-term Federal issues stems to a considerable degree from the high money rate of the Federal Reserve, and also from the failure of the Federal Reserve to give reasonable support to the Government bond market. At the same time that the Federal Reserve denied adequate support of the bond market, the wide publicity given to inflationary dangers by the President, Secretary of the Treasury, and the Board resulted in diversions of funds from the bond to the equity markets. Should the Federal Government reduce loopholes in taxation, had they issued more long-term securities in the boom periods of 1955-56, should they not be excessively fearful of short-term issues, and should the reserve assume proper responsibilities for the Government bond market and abandon excessively restrictive monetary policies, then the raising of the interest rate ceiling would not be necessary.

In detail, here is the case against the raising of rates.

First, I think it would be a mistake to give this permission now. Senator Douglas, in his excellent statement in the Senate on June 8, pointed out that long-term money is not needed for more than a year. This is a relevant consideration.

Second, it is well to note the continued absolute and relative rise of short-term issues of the Treasury. These are not nearly so dangerous as is supposed in orthodox circles. In fact, the current issues of short-term securities would have been considered fantastic in the 1920's. But there is a real demand and need for these short-term

issues which provide the economy with liquidity. Even in the year ending April 1959, short-term issues rose by \$11 billion and yet the price level was stable.

In this connection, it should be noted that in many ways our economy is less liquid than it used to be. For example, in the last 8 years per capita money in real terms (money adjusted by the wholesale price level) has actually declined.

Third, a policy of giving the Treasury freedom in this area would also be a signal for the Federal Reserve to increase their rates without having to worry about Federal finance. But the Federal Reserve has been too anxious to raise rates and excessively concerned over inflation. They increased rates in 1957 when signs of a depression were clear and again in October 1958 at the beginning of a recovery. This is not smart central banking.

Fourth, the President, the Treasury, and especially Mr. Martin talk too much about inflation, and with their great influence in the financial world they hastened the dumping of bonds and the purchase of common stocks.

Fifth, the present difficulty of selling long-term bonds is the result in no small part of the stock market boom; but note that at the end of 1958 for the first time in a generation stocks were yielding less than bonds and values were up above those justified by profit prospects; and hesitation in the rise of the stock market could easily improve the bond situation. (Funds obtained by the sale of stocks would be used to buy bonds.)

Sixth, the Treasury has inflicted upon itself excessive competition from bonds guaranteed by the Treasury. Why buy Treasury bonds at 4 percent when Treasury guaranteed housing bonds can be had at 5 or more percent?

Seventh, in the boom period 1955-57, the Treasury failed to issue long-term securities, though this is considered sound anticyclical policy. Yet in the first 6 months of 1958 in the beginning of a recovery, when the Treasury is supposed to issue short-term issues and not compete with the market, they issued \$9 billion of long-term securities. In other words, the Treasury could have issued more long-term issues in 1955-57 if it had not been *excessively* concerned over the effects on the private market.

In this connection, a statement by Henry Wallich, then the Assistant to the Secretary of the Treasury, before the Duke American Assembly early this year, is of some interest:

In a boom, the managers of the public debt may encounter serious difficulties, under present conditions and with present techniques, in the long-term refunding that they are supposed to do. Contrary to the countercyclical doctrine, the Treasury is compelled in a boom to engage in substantial short-term refunding of its maturing obligations. In recession, the Treasury has no difficulty in financing either long or short. According to the doctrine it should finance short to increase the liquidity of the economy. But if it does so, the result is that in fact it never does any long-term financing. There then is never a good time for the Treasury to do long-term financing—in a boom it cannot, in a recession it must not.

Eighth, the need for higher rates would be considerably reduced if the Federal Reserve supported the Government bond market adequately. That does not mean excessive support like in the late forties. But it does mean that the Federal Reserve has a responsibility to help provide an adequate market for Government securities. After all, the Federal Government is 20 percent of the economy, and

with its responsibility for defense and welfare is a most important part of the economy. Ever since 1953, the Federal Reserve has been neglecting its responsibilities here, and this also holds for financial institutions generally. Senator Douglas, in his statement, put well the responsibility of the Federal Reserve for the Government bond market. At any rate, in restricting monetary supplies, to which the first response is heavy dumping of Federal issues by financial institutions, the Federal Reserve in fact take inadequate account of the effect of its policies on Federal securities.

In this connection, we find it difficult to accept the Federal Reserve policy of bills only. This policy is based in part on the theory that the private dealers in the market should not be embarrassed by uncertainties imposed on the market through Federal Reserve purchases and sales of long-term Government securities. But is not an orderly market more important? And what success has the Federal Government had? Note the gyrations in long-term rates: 3.73 percent in October 1957; 3.12 percent, April 1958; 4.09 percent, May 1959.

In this connection I cannot help pointing out that, whereas the Democrats reduced the long-term rate of interest from 5 to less than 3 percent on first-class corporate bonds, the Republicans have been instrumental in 7 years in increasing it to close to 4½ percent.

Ninth, it is also important to point out that the cost of financing the Federal debt by fiscal 1960 will be up \$2 billion, or one-third over 1952. Yet the debt has risen by less than 10 percent. This result from an administration wed to economy is disconcerting.

Finally, it is important that if the rate does go up, it should be up especially for savings bonds. These are held largely by low-income groups, and they have not shared fairly in the gains from higher rates.

7. Inflation

This country has experienced fairly steady inflation ever since the beginning of the 20th century. There have been few years when prices have actually declined, except for the substantial decline in the great depression. In 1900-13 there was a steady rise of prices. Then came the war. In the 1920's, prices were relatively stable, that is, commodity prices. In the early 1930's there was a substantial decline and a small increase in the latter part of the 1930's. Then the war through 1948 brought a rise of prices. In 1948 the consumer price level was 102.8, in 1950 it was still 102.8 (1947-49=100). The Korean war brought further increases in prices so that by 1952 the cost of living had risen to 113.5. But in the next 3 years, prices had only risen by 1 percent, that is, to 114.5 in 1955.

The record of the current administration in these first few years was very good. They had justified their promises to stabilize the price level. But unfortunately, in the next 3 years they experienced a rise of prices of 8 percent, a large rise in peacetimes. As a matter of fact, throughout our history from 1900 on we have had no such increases in prices except as an aftermath of World War I and World War II, rises that should be associated with the wars. There is only one exception to this—the substantial rise from the very low level of 1933 to 1936.

One of the striking aspects of this rise of prices in 1956-58 was that it was accompanied by a substantial recession as well. In the discussions before the Senate committee there was an interesting inter-

change between Senator Kerr and Secretary Humphrey on the concomitance of rising prices and relatively small number of shortages. (See hearings, pp. 184-194.) Senator Kerr was one of the first to show this unusual concomitance of rising prices and capacity in a period of much excess.

Another aspect of this problem, which should be stressed, is that despite the repeated statements from the Federal Reserve that creeping inflation inevitably brings galloping inflation, we have had a long experience with modest inflation in peacetimes and large inflations in wartimes, and yet we have not, except in wartimes, had the galloping inflation that worries the authorities in Washington so much.

An excessive emphasis on inflation has, of course, resulted in reduced emphasis on growth, and also on the Government doing what is required to serve the people.

In the discussions before the Senate Finance Committee, very little was said by the various authorities that was consistent with what the other authorities said. For example, Chairman Martin was inclined to discuss the inflation in terms of the classical pattern of excess of demand related to an excess in the supply of money. He, therefore, was inclined to operate through increasing rates of interest, which in turn would restrict the amount of borrowing, and money. Under Secretary Burgess emphasized especially the investment boom of 1955 and 1956.

The administration, and notably Secretary Humphrey and the President, tended to put the greatest emphasis on fiscal policy and especially the large Government deficits. But in 1959 the President, and to some extent other members of the administration, tended to stress much more the cost-push and especially the rise of wages.

In his testimony before the Kefauver committee, Gardiner Means pointed out that the large increase of 8 percent in wholesale prices in 1953 to 1958 was largely determined by the price policies of the larger corporations. He emphasized especially the contribution of steel, automobiles, machinery, paper, and other market-dominated prices.

Obviously, we shall not have an adequate attack on the inflation problem until the administration produces an acceptable theory of the causes of inflation. If the explanation is excess of supplies of money, then of course monetary restriction is required. This is on the assumption that the restriction does not seriously affect the total output.

If the explanation is Federal deficits, as the President and Secretary Humphrey have stressed, then of course it may be necessary to have a more cautious spending policy, and increased taxes for the Federal Government.

If the explanation is rising wage rates beyond levels justified by increased productivity, and administered prices, with prices rising in excess of costs, then of course the attack might very well be in trying to control the rise of wages and of administered prices. Attempts to put too much emphasis on monetary policy in dealing with wage pushes and rises of administered prices may very well bring about a serious decline of output. What is disconcerting about administered prices is that they rise even in periods of excess capacity.

8. *The stock market boom*

The average weekly price of common stocks was 195 in 1952, 341 in 1958, and 427 in May, 1959. It is of some interest that in 1952 corporate profits before taxes were \$36.7 billion as they were in 1958. Undoubtedly some increases in the stock market prices were justified but now they have risen to a price which results in a yield below that available in bonds. Furthermore, the Federal Reserve and other Washington authorities by stressing the inflationary dangers gave a strong impetus to the desertion of the bond market and the large purchases of common stocks. Insofar as this rise has been overdone, with trouble later on, the administration and the Federal Reserve may to some extent be held responsible. It should be said, however, in defense of the Federal Reserve that any restrictive monetary policies probably have the reverse effect.

9. *Inflation and the international position of the United States*

From 1950 to 1957 foreigners acquired short-term claims on \$10.3 billion, but they only converted \$2.6 billion into gold. But in 1958 total accumulation of foreigners was \$2.3 billion of our gold and \$1.3 billion additional of short-term dollar assets. In other words, whereas in the preceding 7 years they had taken only about one quarter of their dollar assets in gold, in 1958 they took more than two-thirds.

This suggests that the large outflow of gold and the accumulation of dollars by foreigners in 1958 reflect some doubts about the dollar. Insofar as the inflation of 1956-58 reduced the competitive position of the United States, then to that extent the administration should be held responsible for the current scare about the dollar. I think they might also be held responsible in the sense that we do not have a well-integrated international economic policy. Undoubtedly, one factor accounting for the large outflow of gold has been the continued amount of foreign aid, inclusive of loans and grants. Our total contribution to foreigners through the private finance market and Government loans, military spending, and unilateral transfers are of the order of \$10 billion a year. Obviously, a loss of \$3 billion should be put against these contributions of dollars of about three times as much.

I am not arguing for a reduction in the amount of foreign aid, but merely suggesting that this general problem should be tied to the problem of our monetary policy at home, our rate of interest, and other international policies. Undoubtedly, in part the gains of foreigners of gold and dollars reflect the fact that their competitive position has improved as it well might in view of their weakened competitive position at the end of the war. They are now more or less establishing a normal relationship to the United States.

Many are concerned by virtue of the fact not only that our competitive position has declined, but also that against our \$20 billion of gold, foreigners had net short-term dollar claims of about \$14 billion.

Should the excess of gold and the accumulation of dollars here proceed at anything like the rate of 1958, which was a record year in all our history, then the administration might well have to consider its policies in re private capital movements, foreign aid, foreign grants, travel, imports, and also take strong measures to increase exports through rise in productivity and increased outlays on research and the like.

In re the strength of the dollar, there was a long discussion between Chairman Byrd and Secretary Humphrey and then between Senator Malone and Secretary Humphrey (hearings, pp. 71-72 and 444 et seq.). At first the Secretary did not seem to be aware that in case of a large drain gold could be stopped from moving abroad. In the long discussion with the Secretary, Senator Malone expressed great concern about the large claims on our gold held by foreigners.

10. Failures of monetary and fiscal policy

A more effective monetary and fiscal policy might have reduced the rise of prices, and also have moderated fluctuations in output and kept output at a higher level.

In general, the administration depended too heavily on monetary policy. The Federal Reserve policy was based on the general theory that supply of money determines prices. But this is an outmoded theory. Chairman Martin at times went further and contended that though a rise in the velocity of money might offset any restriction in supply, that they also took into account the effects of their policy on velocity, and their general policies, therefore, provided the amount of banking debits that was appropriate for the situation. But as is well known, over a recent period of a few years when the supply of money increased by 6 percent, total debits increased by 40 percent and this, of course, suggested ineffective monetary policy.

Obviously, the Federal Reserve at times was trying to bring about dear money, and also at times cheap money. But when the country was confronted with restrictive monetary policy and dear money, the Federal Reserve was often inclined to deny its influence and suggest that it was merely following the market.

One effect of the dear money was, of course, an uneven incidence on different classes of borrowers. It is quite clear that the large corporation, paying out perhaps only 40 percent of its profits, is in a strong position to substitute its own capital for the loans not made available by banks. This, of course, puts them in a favorable position. There has also been revealed in the text of this report that on the whole the larger corporations tend to increase their loans from banks much more percentage-wise than the smaller corporations.

Another category of borrowers which suffers from the higher rate is, of course, the State and local government. In view of the large demands being made on State and local government and with their debt increasing by \$3 billion or more per year, the increased cost of money is a serious matter, especially in view of their straitened fiscal position.

A rising money rate is especially costly to these governments, because the advantage of tax-exempt securities is not nearly as great as it used to be. With the large additional issues outstanding, State and local governments find that they have to issue their securities at much higher rates in order to market them. The reason for this is that with much larger supplies outstanding, the appeal has to be made to lower income groups for whom the advantage of tax exemption is much less than for the high income groups these securities used to appeal to almost exclusively before. Therefore tax exemption is worth less, and the governments have to issue their securities at lower prices, that is, higher yields.

11. *Integration of monetary and fiscal policy*

Perhaps one of the greatest failures of the administration is in the failure to integrate monetary and fiscal policy. Of course, there have been differences of views between the Treasury and the Federal Reserve, as, for example, in 1956, for in the spring of that year the Treasury objected strenuously to the dear-money policy. On top of that there are all kinds of credit agencies that issue securities, and though they have to operate through the Treasury, they have a considerable amount of independence. The absence of integration is suggested effectively by the fact that throughout the Eisenhower administration, the advances of the Federal credit agencies continued to increase even as the Federal Reserve was trying to restrict credit in 1953 and also in the 1956 and 1957 period.

It is especially in fiscal policy and debt management that serious mistakes were made. Secretary Humphrey never had much faith in fiscal policy, and, at any rate, his major objective was to obtain cash from the market with a minimum cost to the Treasury. It could, therefore, well be expected that in the period of the boom he would not issue long-term securities, first, because he did not want to interfere with the needs of private enterprise and, second, because if he issued securities at that time the interest rate would be higher. Nor would he, as one might expect, issue short-term securities at the beginning of a recovery. This was the period when he would issue long-term securities. Throughout the hearings, the Secretary and his assistants never did give a clear indication of what the additional cost would be of issuing Government long-term securities in periods of prosperity and short-term in periods of recession. Nor did he tell us what the additional costs to the economy would be because of the failure to issue long-term securities in prosperity and short-term in recession as a sound anticyclical theory required.

But perhaps even more reprehensible is the failure to use fiscal policy in any serious manner. Indeed, in 1954 in the midst of a recession, the administration introduced a large tax cut, and this had a beneficial effect on the economy. But it should also be recalled that this recession would not have occurred or would have been much less serious had not the Government reduced its expenditures by about \$10 billion. Moreover, it is clear from the vantage point of history that the administration did not introduce a tax cut in order to improve the economic situation. Rather, the tax cut was a fulfillment of a promise made in the campaign of 1952.

In contrast to the 1954 tax cut, the administration fought vigorously against any tax cut in the recession of 1957-58. Indeed, we have had a recovery since then and a good recovery. But the country would have been saved tens of billions of dollars had the Government recommended a tax cut as well as substantial rise in expenditures. On the whole, from the third quarter of 1957 to the second quarter of 1958, the period of major decline, the contributions of Federal spending to the decline of investment and export balance was a minimum. That the recession ended so soon can be explained in part by the automatic reduction of tax receipts in response to declining income, the product of a tax structure for which the preceding administration could take credit. Again the large rise of transfer payments associated mainly with the social security program of the 1930's was also a factor in achieving a relatively quick recovery.

12. *Financial intermediaries*

One of the mysteries of the thousands of pages of evidence produced by the Treasury and Federal Reserve in the last year or so is that no suggestions have really come up on how to deal with financial intermediaries. A view held in the Federal Reserve apparently is that by controlling the total supply of money, the Federal Reserve controls the financial intermediaries. But this is a very loose and indirect control. For example, the total assets of the financial intermediaries from 1952 to 1957 increased by 59 percent as against a rise of financial assets of commercial banks by 17 percent. Indeed, the Federal Reserve has plenty of difficulty in controlling the assets of the commercial banks because they have found it possible to dump Government securities in periods of great demand for money, and to substitute other assets and particularly bank loans. They can do this even though the total money supply rises little as is evident in the history from 1954 to 1957. But the expansion of assets of the financial intermediaries is much greater. They contribute toward inflation in a period of rising demand by accepting cash and putting it to use. Often this cash represents a transfer from demand deposits where the reserve requirements are high.

13. *The independence of the Federal Reserve*

Indeed, the independence of the Federal Reserve has been debated many times, as Chairman Martin noted in the hearings (p. 1258):

It (the Congress) has reaffirmed its original judgment that the Federal Reserve should be independent—not independent of Government, but independent within the structure of Government. That does not mean that the reserve banking mechanism can or should pursue a course that is contrary to the objective of national and economic policies. It does mean that within this technical field in deciding upon carrying out monetary and credit policies it shall be free to exercise its best collective judgment independently.

Unfortunately, there have been serious differences between the Federal Reserve and the Treasury. There is need for coordination and integration of policy, and as long as the Federal Reserve is independent, the path to coordination is rough. In fact, one may argue that failure to use fiscal policy adequately is the result of the independence of the Federal Reserve and hence excessive trust in monetary policy.

It is important to have a national economic council as has been suggested by Elliott V. Bell, editor and publisher of *Business Week*, and also by Senator Anderson. Mr. Bell, for example, said:

I venture * * * to suggest the desirability of a national economic council which would function in respect to economic policies somewhat as the National Security Council functions with respect to defense policies. * * *

If the Federal Reserve is independent, one can be sure that other agencies and departments of the Federal Government will be more independent. Note, for example, the independent policy of the Treasury in early 1953 when they introduced a dear-money policy through the issue of long-term securities. It is not clear to what extent the Federal Reserve supported this policy or rather merely acquiesced. Or again, consider the failure of the Treasury to issue long-term securities which were required by the monetary situation in 1956 and early 1957. Or consider the conflict of policy in 1958 between the Federal Reserve that had reversed its dear-money policy and the Treasury which issued large volumes of long-term securities.

The failure to make recommendations of fiscal policy and complete independence of the Federal Reserve have resulted in excessive emphasis on monetary policy, and a growing feeling that monetary policy is more potent than it really is and, therefore, in a failure to use alternative weapons of control. These failures may be a result of the difficulties of the agencies and departments in keeping up with modern economic trends; but the results are also related to the great powers that have been bestowed upon the Federal Reserve as an independent agency.

The powerful Bank of England long ago recognized that it could not operate independently and that the potency of its instruments had been considerably dulled by fiscal policies. It is time for the Federal Reserve to make a similar admission. The President's internal committee for discussion of monetary and fiscal issues with the Federal Reserve is not an adequate substitute for a genuine national economic council which would rob the Federal Reserve of its complete independence. Even the periodic needling by congressional committees of representatives of the Federal Reserve is not sufficient. The Federal Reserve still continues to operate independently of the wishes of Congress. The power to manufacture money and determine its value rests with the Congress and not with the Federal Reserve. So long as the operation of the Government is such an important matter in our economic life, it is preposterous to expect to have an independent Federal Reserve, which through its policies may jeopardize or delay recovery or reduce output.

14. Money and output

Perhaps the most striking aspect of the hearings and particularly of the public officials who appeared before the Senate Finance Committee, namely, Secretary Humphrey, Under Secretary Burgess, and Chairman Martin, was how little attention was paid to the problem of output. The emphasis was on inflation, stability of prices, rates of interest, and the like. An example of the lack of attention to GNP growth and the like is had from the index of the first three volumes, which deal with the three Government witnesses. Of about 2,500 entries in the index, 14 relate to gross national product, none to growth, and 10 to other aspects of income. The explanation, of course, is that the representatives of the Government and the Federal Reserve were primarily concerned with the stability of currency and were pretty much unaware of other aspects of economic policy.

In one significant discussion of the issue, Chairman Martin showed that physical output had increased by 7 percent in the year ending the second quarter of 1955, 3.3 percent in the year ending the second quarter of 1956, and 2.2 percent in the year ending the second quarter of 1957. He also showed that in these 3 successive years the percentage rise of gross national product in current dollars, explained by rise of prices, was 14, 45, and 62 percent, implying that the inflationary effect had become increasingly important (hearings, p. 1218).

The effects of monetary policy on output are very important. Indeed it is important to have a monetary unit that serves adequately as a measure of value. In this connection, it is of some interest that Dr. Goldsmith recently pointed out to the Joint Economic Committee hearings on "Employment, Growth and Price Levels" (pp. 242-243)

that in a period of 120 years, that is, from 1839 to 1959, the average rise in prices per year had been slightly above 1 percent, and from 1919 to 1959 the increase was 1.4 percent. He also noted that relative pressure of rising output on prices had been more pronounced in 1879 to 1919 than it had been in the last 40 years. In other words, we have had creeping inflation now for 120 years and yet we have not had disastrous inflation, although undoubtedly uncomfortable inflation during war periods.

It is a fair assessment of Federal Reserve policy to say that fearing inflation, the Federal Reserve reduced the supply of money, raised interest rates, and contributed toward a recession. This policy is based partly on the premise that when wages, and so forth, rise too much, the medicine is to reduce the supply of money, and reduce output, and increase unemployment and therefore reduce the bargaining power of labor. The history of wages in the depression years of 1957-58 also suggests that this medicine works to some extent. But the price, of course, is a good deal of unemployment.

In this connection, we should compare the rise of GNP in recent years.

	<i>Percent</i>
1948-58 average increase in stable dollars.....	3.5
1948-52 average increase in stable dollars.....	5.0
1952-58 average increase in stable dollars.....	1.7
1953-59 average increase in stable dollars (an assumption of 8 percent rise in 1959).....	2.5

We cannot afford to have a rise in GNP of only 2 percent a year. With the Russians expanding at the rate of 7 percent, and our earlier history suggesting at least a reasonable goal of 4 or 5 percent, we are likely to get into serious difficulties if our rise is not at least 4 percent. Actually, with a rate of 2 percent and the Russians gaining at the rate of 7 percent, inside of about 15 years Russian GNP would be as large as that of the United States. In view of their greater control of the distribution of resources, this would have very serious security implications.

PART IV

LEGISLATIVE ISSUES

In this part, I raise relevant legislative issues that arise from the hearings on the financial condition of the United States. I start with a few legislative proposals that probably should not be supported.

1. The objective of price stability incorporated in the Employment Act of 1946

I think it would be unwise to incorporate this provision in the Employment Act of 1946—not that price stability should not be an important objective of government, but largely for strategic reasons we should not make price stability an objective under the Employment Act of 1946. The point is that the administration and the Federal Reserve in particular tend to put excessive emphasis on price stability against other objectives of economic life. Hence with this provision in the Employment Act of 1946, the Federal Reserve would be encouraged in its excessive fear of inflation, and its penchant for restrictive monetary policy.

2. Measures to save the dollar

In the hearings there was very little attention paid to the gold problem except by Senator Malone in long discussions with Secretary Humphrey and Chairman Martin. Malone expressed great fear about the shortage of gold and stressed the rights of the Treasury to withhold gold demanded by foreigners in exchange for their dollar balances. Since that time the problem has become much more serious with the loss of \$3.3 billion in 1958, inclusive of an increase of dollar balances held by foreigners of \$1.3 billion. As the result of these losses, there has been much urging of a devaluation policy which would increase the price of gold, or *general* import restrictions or a reduction of foreign aid or other measures to improve the balance of payments of the United States.

Though the dollar problem should be watched and the losses in 1958 and 1959 so far are serious, they may very well reflect nothing more than a normal competitive relationship between the United States and other countries.

A devaluation policy would be unwise, especially since the net result would be to increase the dollar resources of gold-mining countries, and especially of South Africa. Our aid would then be given primarily to sellers of gold, and not on the basis of our own interests. This is only one argument against the devaluation program. Nor is the situation serious enough yet to justify general import restrictions or even a reassessment of our foreign aid and foreign investment policies. But I do believe strongly that all these policies should be watched carefully and especially in relation to our gold reserves and foreign holdings of short-term dollars.

3. *A National Economic Council*

The Employment Act of 1946 provided for an economic council which is largely a planning agency which advises the President on the general economic situation, and suggests policies to the President. But we also need a national economic council composed of the *operating* agencies that are in the areas of money, credit, and fiscal policy. A suggestion along these lines has been made by Elliot Bell as well as by Secretary Anderson. Such a council should include representatives of the Treasury, the Federal Reserve, all credit agencies such as the National Housing Administration, FNMA, ICA, the Commodity Credit Corporation, Veterans' Administration, etc.

The major objective of this organization would be to integrate credit and fiscal policies within the limits set by the Congress in such a manner as to give the country the maximum output consistent with a reasonable degree of stability of prices. This council should be strong enough to prevent the Treasury going one way and the Federal Reserve going another, or the Treasury and Federal Reserve agreeing on restrictive policies, and all other credit agencies expanding greatly.

Indeed, to some extent the credit agencies are not absolutely free to operate in such a manner as to satisfy our major objectives of economic policy. A credit agency, for example, may be required by the Congress to buy surpluses or to issue housing mortgages or guarantees of certain amounts. But within these limits credit agencies should conform in that policy to the general objectives of the Federal Government. These, of course, should include not only maximum employment and reasonable stability of prices but also effective exploitation of anticyclical policies. At the present time the Housing Administration has certain rights to change conditions of mortgages, downpayments, and the like, but these should be more closely integrated with the policies of other agencies and the Federal Reserve. The Congress might also take into account the need of this kind of integration, and give the credit agencies somewhat greater latitude in their lending and guarantee policies.

4. *Selective credit control*

There is much to be said for general credit control, that is, control through raising rediscount rates, open-market operations, and changes in reserve requirements. But these have an overall effect, and often are unequal in their incidence. It may be desirable to avoid increasingly these general measures that increase the general rate of interest in a period of restriction, and deal with the problem more through selective measures. For this reason, there is much to be said for consumer credit control and also, of course, for housing credit control. The latter is already to some extent in the hands of the administration. But Congress might seriously consider giving to the Federal Reserve, though they do not seem to be anxious to have it, control over consumer credit. In hearings before the Senate Finance Committee, Secretary Humphrey was against this type of credit control on the grounds that it means too much operation from Washington. I see little difference between general control of a credit mechanism from Washington and another type of control which is more selective and therefore not quite so pervasive in its incidence. In this connection, it should be noted also that the Government does control the credit going into the stock market through margin control, and that in the

past we have had control of consumers' credit. Nothing exactly revolutionary is in these proposals, and they might avoid unnecessary rises of unemployment in periods when the Federal Reserve has occasion for restriction.

5. *Control of intermediaries*

For many years now the financial intermediaries other than commercial banks have become increasingly important in the financial market. They control a much larger percentage of assets than they did 10, 25, or 50 years ago. They also make it more difficult for the Federal Reserve to control the money market, because the Federal Reserve has only limited and indirect control of an intermediary through control of the total reserves of member banks. It is, therefore, important to suggest legislation in this area. Obviously since the intermediaries deal to a considerable extent with housing and consumer credit, any control over these might indirectly affect the activities of the intermediaries. Another approach is to set up reserve requirements for intermediaries, especially since their growth of activity reflects in part transfers of funds from demand deposits that require relatively small reserves to time deposits. It has also been suggested that one approach is to increase the profitability of member banks through reducing the requirements of reserves against demand deposits. This would, however, have the effect of making banking even more profitable than it is at the present time. (More on this later.)

6. *Administered prices*

Many have proposed that Government discourage rising wages and rising prices in a number of crucial industries where prices are administered; that is where there is not free competition and the control of the market lies in a relatively small number of sellers. The implication is that monetary policy cannot treat administered prices. Inflation in the last 5 to 10 years, as, for example, Dr. Means claimed before the Kefauver committee, is held to be the result of the administered prices. Then obviously the proper approach would be to deal with prices and wages in the administered areas. Behind this is the view that monetary control, that is, control of the supply of money, does not prevent a large corporation from increasing their prices beyond a level set by increasing wages and other costs. A really restrictive monetary policy, however, might discourage many of these rises in prices because they have to be validated by adequate supplies of money. But the effects on the employment situation of a policy that really stifles rising prices in the administered area might have a considerable adverse effect on the whole economy.

I am not convinced that the rise of prices is primarily explained by increases in the administered area. For example, in consumer prices the increase from 1955 to March 1959 was 8 percent (1947-49 equals 100), but among 13 categories the only ones that were much above the average were solid fuels and fuel oils, a rise of 12 percent; transportation, 15; medical care, 16; personal care, 13. Solid fuels and fuel oils, and transportation alone may be considered areas in which administered prices are very important. But I hasten to add that such overall price studies conceal to some extent the genuine incidence of administered prices.

In the wholesale price index the increase from 1955 to March 1959 was from 110.7 to 119.6, or an increase of about 8 percent. Large rises were in hides, skins, and leather products, 16 percent; pulp, paper, and allied products, 11 percent; metals and metal products, 13 percent; machinery and automotive products, 17 percent; nonmetallic minerals (structural), 11 percent. The evidence is not too clear that the major rises are in the administered areas. For example, in rubber and products where there is a considerable amount of monopoly the increase was only 2 percent.

But undoubtedly the administered area does make some contribution to rising prices. It might be wise to introduce experimental legislation, a bill which would require compulsory publicity for any substantial increase of wages or prices that is likely to affect the economy in a serious way. This publicity might very well discourage excessive increases of wages or prices though without sanctions the likelihood does not seem great. Unless the general price level keeps on rising considerably more than it has in recent years, I do not think that a case for price control is strong.

7. Area Development

An area development program, which has once been vetoed by the President and is now up again for his consideration and now known as the Douglas bill, is relevant legislation, because this is one way of reducing the importance of monetary and fiscal policy. Once we reach 3 or 4 millions of unemployed then the transitional and hard core of unemployment are the major residual. By the latter I mean unemployment in depressed areas, and also in the depressed industries which are likely to be located in depressed areas. A substantial part of total unemployment then is this depressed area unemployment. One way of dealing with this problem is to pour out more and more money and more and more Government spending as well as tax reduction as a means of improving the overall situation sufficiently so that excess purchasing power will spill over and wipe out a large part of this stubborn form of unemployment. This is not the most effective, and is a very wasteful method because it is like treating the whole circulatory system in order to cure a local infection. The area development program is an attempt to deal with this problem by direct attack on the areas involved and not through pouring out vast sums of money or Government expenditures in the hope that they will ultimately reach these specific areas.

8. Ceiling on Treasury debts and Treasury rates

I see little use for the debt ceiling. In the past it has interfered with the integrity of the budget. It is not the most effective way of keeping spending down. It forces the Treasury into rather dubious accounting methods and insupportable trading practices.

The removal of the ceiling on the interest rate to be paid on long-term securities is another matter. At the present time it would be a mistake to grant the Treasury request. This would be an invitation for the Federal Reserve to pursue dear money policies irrespective of the effects on the Treasury, because the absence of a ceiling on rates would give the Treasury virtually unlimited access to the security market. The policy is also unwise since it is unnecessary at the present time and since much could be accomplished by a stronger

support of the Federal market by the Federal Reserve, and continued reliance on the short-term market for sales of securities.

9. *Budgetary integrity*

The present situation of the budget is anything but defensible. It is almost impossible to compare the budgetary situation in one year with another because of the great changes in practices and policies.

The Congress should require an honest accounting of the budget.

The Budget Director should be required to present expenditures and receipts, as he does now, as well as cash expenditures and receipts. But in the budget presentation, as is now practiced, the total volume of guarantees should be indicated, as well as insurance, both currently and the preceding years, trust receipts and expenditures—not on pages 877 et seq., and 957 et seq., but early and as prominently as the regular budget account.

Again tax receipts should be distinguished from receipts from sales of capital items such as mortgages and supplies.

The growing practice of setting up trust funds which disguise the actual budgetary situation should either be discouraged or else an honest accounting be made. For example, even from fiscal year 1955 to 1958 trust fund receipts have risen by \$6.8 billion or more than 70 percent and expenditures by \$7.5 billion or by 88 percent. Particularly dubious is the practice which prevailed in the early years of the Eisenhower administration of not appropriating all the cash received from civil service retirement payments. For example, \$500 million are received and less than \$100 million are spent. Economic policy may indeed suggest that it might be wise instead of increasing taxes by \$400 million to use \$400 million of the civil service receipts of this particular year. But the budget should show expenditures of \$500 million and not \$100 million, even though it may be indicated these expenditures were withheld for the time being.

10. *A general directive on fiscal policy and debt management*

It would be helpful to have a resolution from the Congress suggesting or telling the administration that in its fiscal policy and debt management it should take account of the effects of these policies on the economy, and should weigh the net effects on the economy as against alternative policies. The Government generally should estimate the costs of particular policies for the economy and also for the Government.

11. *The cash vault bill*

This bill has unfortunately already (June 28) passed both Senate and House of Representatives. The bill makes possible a reduction of reserve requirements for member banks of more than \$10 billion, with the net effect that Government securities now yielding income to reserve banks and hence to the Government, may now become the property largely of the banks, thus increasing their profits substantially. This follows as reduced reserve requirements have to be offset by sales of securities by the reserve banks to control inflationary effects of more free reserves.

Is this a supportable windfall? Another effect would be a rise in rates on Treasury issues. To sell billions more requires higher rates.

CHAPTER III
VIEWS OF SENATOR WALLACE F. BENNETT

At the conclusion of the Finance Committee hearings on the financial condition of the United States in April 1958, and in the absence of a formal committee report at that time, I made a series of four statements (during the summer months of 1958) in which I summarized in a lengthy manner, my impressions of the committee's investigation.

In my opinion, the principal topic of discussion during the hearings was the problem of inflation; and accordingly, my statements center around that problem. In these statements I discuss four aspects of the topic:

- I. The problem of inflation.
- II. Monetary policy and inflation.
- III. Labor unions and inflation.
- IV. Inflation and the recession (1957-58).

Much of my supporting data and all of my supporting statements came from the committee record—from both witnesses who testified in person and from respondents to the committee questionnaire. All references are footnoted in the text of each statement.

With the permission of Senator Byrd, I am submitting the first three of these statements to be printed in full with the committee analysis. Because the fourth statement was so specialized and so closely tied to the recession of 1957-58, which is now past, I am not asking that the text of that statement be included. However, I would like to include the summary paragraphs from the fourth statement because of their timeliness and because they summarize my whole series.

I. THE PROBLEM OF INFLATION

It is interesting to note that the two sessions of the Finance Committee investigation in 1957 and 1958, were held under entirely different economic conditions. The setting during the 1957 hearing was one of inflation, characterized by full utilization of the labor force and a capital goods boom. While the April 1958 hearings were in progress we were in the midst of a business downturn, characterized by a slump in private capital investment and some unemployment.

In setting for itself the problem of investigating so many aspects of the financial conditions of the United States, the committee left the door open for a discussion of a wide variety of issues. Therefore, it is not surprising that virtually every question or topic bearing on the Nation's finances was encountered and discussed. Nevertheless, in reviewing the printed record, I have been impressed by the fact that running through all the discussions was a single unifying thread, namely, the problem of inflation.

During the 1957 sessions, when prices were rising fairly rapidly and most of our resources were fully utilized, much of the discussion centered around two questions: First, how could inflation be stopped; second, was the anti-inflationary action then being taken necessary or harmful? Concern over inflation did not diminish during the hearings this spring, despite the business downturn and a slowing down of the rate of the price rise. A scrutiny of the testimony and questioning during these later sessions will indicate that the major issues were, first, whether the anti-inflationary policy of 1957 was primarily responsible for the current business downturn; second, the extent to which antirecession action should take into account the danger of further inflation.

Because the general problem of inflation ran through all the hearings, it has naturally become the central theme of these reports. In fact, I am convinced that it has become our basic, longtime economic problem, and that until we, as a people, understand the danger it creates and take the necessary steps to stamp it out, we cannot count on a future of sound growth and prosperity.

The committee gathered a great variety of material on the general nature of the problem of inflation. I shall begin by reviewing this background information. Without such a review, it seems pointless to consider the separate, basic issues developed at the hearings.

To me, the most serious aspect of inflation is the moral one. Inflation is essentially a process by which someone attempts to get something for nothing, a disguised form of theft, in which the poor and helpless are the first victims, but which can eventually engulf a whole economy. It is a narcotic which produces the illusion of prosperity and growth, and conceals the real damage. The committee devoted little or no time to this aspect of the problem, probably because most of its members are in agreement that inflation is an evil, whether it be judged on moral or on economic grounds. Instead, most of the time was devoted to the definition and mechanics of inflation.

In its search for information in this field, the committee literally began at the beginning. Throughout the entire course of the hearings, the committee sought to find a workable definition of inflation. Most of the witnesses were asked for, or volunteered, a definition. In addition, a request for a definition was included among the questions sent to business and university economists and to the presidents of the Federal Reserve banks. The committee never attempted to make a final selection from all the answers; but I think it probably true that by the end of the hearings the simplest of all the definitions gained the most acceptance; namely, that inflation is simply a general rise in prices.

In looking over all the definitions of inflation suggested at the hearings, I am impressed by the fact that many of the witnesses agreed that inflation is basically a phenomenon of money. For example, Mr. Baruch defined inflation as an abnormal and disproportionate increase of money and credit in relation to the production of goods and services. At other times during the hearings, inflation was defined as a flow of spendings in excess of the flow of goods and services, or too much money for the goods and services offered, or too many dollars chasing too few goods. On the other hand, it should also be noted that inflation was described by some witnesses as being a result of pressure on costs, particularly wage pressures. Thus, Professor Slichter, of Harvard, rejected the monetary definition as inaccurate, and added that the recession is helping the public see more clearly than ever that rising wages are a principal cause of rising prices.¹ Similarly, Dr. Abbott, dean of the graduate school of business administration, of the University of Virginia, emphasized that our current problem is a wage-push inflation.

Personally, I believe it is possible to oversimplify the statement of any specific cause of inflation. For that reason, I was impressed with the statement on the inflationary process, which was made by Chairman Martin, of the Board of Governors, in his appearance before the committee last summer. It was supplemented by an excellent account of inflationary processes, given by Mr. Edward Wayne, first vice president of the Federal Reserve Bank of Richmond. Neither of these presentations attempted to attribute the blame for inflation to one specific element. As Chairman Martin pointed out:

Inflation is a process in which rising costs and prices mutually interact upon each other over time with a spiral effect. At the same time, demand must always be sufficient to keep the spiral moving.²

Although they were greatly concerned with the causes of inflation, the committee members spent very little time on questions having to do with its consequences. It is precisely here that its greatest danger lies. All of us are against it in theory, as we are against sin; but in practice some of us think we can profit by it. Too often Pope's lines on vice can also be used as an accurate description of our attitude toward inflation.

Vice is a monster of so frightful mien,
As to be hated needs but to be seen;
Yet seen too oft, familiar with her face,
We first endure, then pity, then embrace.

¹ "Investigation of the Financial Condition of the United States," hearings before the Committee on Finance, U. S. Senate, 85th Cong., pp. 1842-1843.

² *Ibid.*, pp. 1262-1263.

It is a simple fact that inflation results in a transfer of economic resources. Perhaps in theory we can imagine a situation in which as prices rise, all incomes rise at precisely the correct rate, and all money contracts change to just the right degree, so no loss is suffered by anyone. But in real life, such a situation does not, and could not, exist. There is simply no way to avoid the fact that in an inflationary process, some gain, on net balance, while others lose; and the losers are those least able to protect themselves or to make their voices heard: pensioners, savers, white-collar workers, small businessmen, the great body of unorganized workers. One great trouble is that the transfer is involuntary. Resources are literally stolen from those who have no way of protecting themselves, and they are left without any claim to future output, or even the satisfaction of knowing that, if the levy had been in the form of a tax, others would also be sharing the burden.

If the only consequence of inflation were the slow, but insidious, transfer of resources from one group to another, some of us might possibly resign ourselves to the process, and might provide for relief by way of legislation, for those affected by it. But inflation has other consequences. It provides a misdirected stimulus for business. Anyone who has been in business knows that sound business decisions are made within a framework of price stability; and that the principal beneficiaries of inflation in the business world are speculators and gamblers. Also, by destroying the use of money as a store of value, inflation stimulates the production of other items which can serve the same function. Thus, we must devote a part of our energies to the production of articles which we would not have needed in the absence of inflation. A good current example is the concentration of investment in partly filled office and apartment buildings in some Latin American countries—which capital is withheld from productive industry.

Finally, a creeping inflation must, in the absence of specific controls or other unwarranted interference by Government, become a runaway inflation. Even the inflationists fear this. When the time comes that a majority of the people throw up their hands in resignation and accept the inevitability of rising prices, inflation will immediately cease to creep, for just as soon as those who have a stake in inflation can be absolutely certain that society has become resigned to the process, we see the inevitable development of a completely destructive wage-price spiral. Said Ralph J. Cordiner, president of General Electric, in his reply to the committee:

If creeping inflation were accepted as a permanent feature of American economic life, it would not create jobs; it would only feed on itself in a rising spiral of costs and prices. To accept creeping inflation, instead of using every possible means to combat it, would be to apply to our economy the greatest of all inflationary pressures—the pressure of inflation psychology. Expecting continued price increases, businesses and individuals would have a continuing incentive to spend their money before its value depreciated further, and would thus be tempted into a flight from money. The inadequate volume of purchasing characteristic of the current recession would be replaced by an increasingly excessive rate of spending, with far more destructive effects. The volume of savings would continually diminish, cutting off the only real source of investment funds. The efforts of businesses to continue expanding the volume of production and improving the attractiveness of their products, so as to maintain high levels of employment, would require

continued expansion of money and credit. Thus the inflationary spiral and the profitless prosperity would be accelerated toward inevitable collapse.³

Professor Haberler, of Harvard University, had this to say regarding the dangerous creeping inflation:

I admit that the present method of wage fixing and the attitude of the powerful trade unions, which expect every year a large wage rise exceeding the average annual increase of labor productivity, poses a serious dilemma. But the problem cannot be solved by acquiescing in a continuous rise in prices. The trouble is that when prices rise by only 2 or 3 percent per year for a few years in succession, more and more people become alarmed and take steps to protect themselves. The labor unions themselves, whose policy is largely responsible for the continuing rise in prices, will ask for larger wage increases (or insist on escalator clauses) when they see that their wage rises are swallowed up by rising prices. Hence soon the price creep will become a trot and the trot a gallop. This is simply an application of the homely truth that while you may fool all people some of the time and some (though not the same) people all the time, you cannot fool all people all the time.

It has been objected to that argument that a galloping inflation is impossible in the United States. I am inclined to accept this proposition, but I submit that it misses the point. Why is galloping inflation impossible? Because the Federal Reserve will keep money sufficiently tight to prevent inflation from galloping away. But what the advocates of creeping inflation overlook is that after a while the mere attempt to keep inflation at a creeping pace (to prevent the creep from becoming a trot or a canter) will be suffering [sic] to bring about unemployment and depression. This is after all what happened last year. The advocates of creeping inflation themselves blame the tight-money policy for the present depression. I personally would say that it was a contributing factor—but let me for argument's sake, accept the proposition that it was the main cause. Then it is undeniable that a policy which held the inflation at a creep—it did not do more than that—brought on unemployment and depression. If money had been less tight, prices would obviously have risen even faster. Sooner or later the price rise had to be stopped or slowed down. It should be observed that if it had been stopped by fiscal measures (tax increases or lower Government expenditures) as some experts had recommended, the reaction would have been the same. In that respect monetary and fiscal policies are not different in their operation. If demand is controlled either by monetary or fiscal measures and wages continue to be pushed up, the consequence must be unemployment.⁴

When I say there seemed to be general agreement over the proposition that inflation is a situation which must be avoided, I do not mean to be understood as saying that there was total agreement on the degree to which it should be avoided. For example, the testimony of Professors Harris and Slichter quite clearly indicated only slight concern over inflation so long as the rate was slow. In addition, questioning by some of the members of the committee suggested a similar attitude. I shall expect to discuss this issue in more detail later.

To return now to the consideration of the general nature of inflation as it was developed during the hearings, I must say that one of the most significant conclusions I drew from the testimony is that inflation today as a problem is a great and increasing threat to our economy, with several new aspects.

I do not mean that the present inflation itself is of some hitherto unknown variety, but, rather, that the conditions under which we must combat inflation today are very different than anything we have faced before in this country.

The conclusion that our present inflation is dangerous was reinforced, in my opinion, by the testimony of Bernard Baruch. In the

³ "Investigation of the Financial Condition of the United States. Comments of Executives of Corporations in Response to the Questionnaire of the Committee on Finance," U.S. Senate, 85th Cong., ch. 2, p. 107.

⁴ *Ibid.*, ch. 5, p. 624.

midst of a business downturn, when he could easily have been expected to direct his attention toward other matters, Mr. Baruch made the flat statement:

Inflation, gentlemen, is the most important economic fact of our time—the single greatest peril to our economic health.⁵

I think it is important that we look behind this statement to see why inflation remains our No. 1 problem.

If there is one thing which stands out above all else with respect to our recent history, it is the persistency of inflation and inflationary pressures. This development must reflect the fact that we are now facing new economic problems, for, contrary to some opinions, this country has not had a continuing and persistent inflationary condition until recently. I was happy to see this point developed by Chairman Martin during his questioning by the Senator from Oklahoma (Mr. Kerr). Mr. Martin placed in the record information on prices which reveal that over the period from 1800 to 1930, the trend of prices was generally downward. In other words, during the major portion of the life of this Nation we have had stable or declining prices. I refer my colleagues to page 1938 of part 6 of the hearings.

Although we did not have a persistent inflationary problem during the most of our history, I do not mean to imply that we had no problems at all. The basic difficulty was that the price level changed too suddenly and swiftly—first in one direction, and then in another. The erratic movement of prices was terribly serious. On some occasions price increases and consequent declines were so sharp as to stimulate the wildest and most reckless kind of economic activity. When this happened long periods of depression and economic distress always followed and we had panics, of which the years 1873 and 1893 are tragic examples.

It is noteworthy that during those periods prior to 1930 when we had price stability—and there were a number of such periods—as well as during some of the periods in which the price level drifted downward, this Nation enjoyed a remarkable rate of economic growth. Today we hear much loose talk about the necessary relationship between inflation and growth, as if we needed the first in order to have the second. I challenge any one to find any period in the history of this country when we had price stability which was not accompanied by substantial economic growth.

If it is true—as I believe it to be—that we are today facing the old problem of inflation in a new and more dangerous setting, let us see what this setting consists of. In the first place there is the role of organized labor, a factor not present to any important degree before the 1930's, and which has only become really significant since World War II. Because of the growth in size and power of labor unions, we are now faced with continuous upward pressure on wage costs and thus prices, regardless of productivity increases. This development was cited by most of the committee's witnesses. For example, Dean Abbott noted that wage increases in excess of productivity "push up prices when, as is the case in this country, there is a flexible money supply."⁶ Professor Slichter also took note of this situation, as did

⁵ Investigation of the Financial Conditions of the United States," hearings before the Committee on Finance, U.S. Senate, 86th Cong., p. 1636.

⁶ Ibid., p. 2061.

former Chairman of the Board of Governors of the Federal Reserve, Marriner Eccles, who said:

The main cause of rising prices has been the use which labor union monopolies are making of their power to force up wages and numerous costly fringe benefits far in excess of increased productivity.⁷

There are several other aspects of this problem which, I believe, warrant notice. For example, it is important to note that if organized labor were required to depend only on its bargaining power to force wage increases in excess of productivity, the program would eventually fail. That is to say, costs and prices can be pushed up only so far before the public would become unable to purchase all the output and there would be resulting unemployment. Recognizing this, much of organized labor has placed itself squarely in the camp of the new inflationists, supporting monetary programs which will validate higher wages. Thus we have a two-pronged attack on price stability on the part of organized labor; and I think that we have perhaps paid less attention to labor's devotion to inflation than we should have done.

I do not wish to give the impression that all the blame for the wage-price spiral must rest with organized labor. Industry pricing policies and attitudes must also carry their part of the responsibility. As Mr. Eccles pointed out:

Business generally has been willing to grant excessive demands of labor rather than face a strike, so long as it was able to pass on to the public the increased costs.⁸

Also, we must recognize that some business firms, because of their dominant positions, have the power to set prices which, within limits, are not immediately subject to traditional competitive forces.

It goes without saying that the entire question of the relationship between wages and prices deserves more attention than I can give it here. I am concerned only with the development of relatively new factors which have made inflation a major problem, and one such factor is the rise in the economic power of organized labor, unchecked by the traditional rules applied to business. This is a most significant new development.

Second among the factors contributing to our new inflationary problem is the changed role of Government. In many quarters the Employment Act of 1946 is interpreted as a virtual commitment on the part of the Federal Government to undertake expansionary programs at the first sign of a downturn. This act quite naturally reflected the fears of many people that the long depression of the 1930's would be resumed in the postwar period. Unfortunately the goal of price stability was not included in the objectives of the act, and because this was not done, the act seems to have had the effect of requiring the Government to act more vigorously when prices need to be raised, and less vigorously, if at all, when prices need to be lowered. As Dean Abbott put it:

It seems clear that both these objectives (maximum employment and price stability) will not be achieved so long as one has the blessing of the Federal Government and the other does not.⁹

⁷ Ibid., p. 1695.

⁸ Ibid., p. 1695.

⁹ Ibid., p. 2062.

Another facet of the changed role of Government is the large place which Government expenditures occupy in the stream of our total national expenditure. Because so much Government spending is of a nature which cannot easily be changed, a business downturn always results in disproportionately lower tax receipts, and automatically produces a substantial Government deficit. On the other hand, during periods of prosperity in which inflationary pressures may be strong, it is difficult for the Government to have much of a surplus, since there are always strong pressures for still larger Government expenditures of tax reductions.

The third factor in our new inflationary problem is in many ways the most important, for it relates to the public attitudes which, in a democracy, ultimately determine our course of action. To put it plainly, inflation seems to be becoming acceptable. We had several illustrations of this attitude during the hearings held by the Committee on Finance. For example, Professor Slichter argued that inflation—as long as it proceeded at a slow rate—was not a particularly worrisome problem. As he put it:

I do not think it is very dangerous. I think we are likely to have it and I think it is an important problem, but I would not use that expression "very dangerous." I would describe it as unfortunate.¹⁰

Professor Harris went even further when he appeared before the committee, indicting that he would be more or less content with a slow inflation so long as there was a larger proportional increase in output. His words were:

I would be very happy with a 1-percent rise of prices and a 5-percent rise in output.¹¹

On another occasion he made it clear that he was unconcerned over the loss which will be suffered by savers in inflation when he said:

I wouldn't be unhappy about a 1-percent inflation, even if it does, say, over 40 years, wipe out 50 percent of your savings, as it would.¹²

I might remark that although such a development might not make Professor Harris unhappy, the same cannot be said for the millions who depend on fixed incomes, many of them already at minimum levels. I am reminded of a remark made recently by Malcolm Bryan, president of the Federal Reserve Bank of Atlanta:

If a policy of active or permissive inflation is to be a fact, then we can secure the shreds of our self-respect only by announcing the policy. This is the least of the canons of decency that should prevail. We should have the decency to say to the money saver, "Hold still, little fish. All we intend to do is gut you."

The importance of this changing attitude toward inflation was reflected in many ways during the course of the hearings. I am sure that I do injustice to no one when I say that the Federal Reserve Board was quite severely criticized by some of the Senators during the questioning last summer. Many of these criticisms reflected legitimate differences of opinion, but it was, nevertheless, quite apparent that in the eyes of some members of the committee the major fault of the Federal Reserve Board was that it was even attempting to fight the inflationary price rise which was then occurring, using the only means at its disposal. It is significant, also, that during the most

¹⁰ *Ibid.*, p. 1944.

¹¹ *Ibid.*, p. 2030.

¹² *Ibid.*, p. 2038.

recent committee sessions the only criticism which we heard from these same people with respect to the present policy of monetary ease now being followed by the Federal Reserve is that it had not gone far or fast enough. Thus, we had the ironic situation of hearings, held to determine what could be done to stop inflation, which devoted a large part of the time to criticism of a responsible agency which was attempting to do exactly that.

The increasing acceptability of inflation, or the opposition to any anti-inflationary program, was also illustrated by the frequent discussion during the hearings of the question of the compatibility of a policy of price stability and a policy of maximum employment. For my own part, I am of the firm opinion that the two goals are not only compatible, but go hand in hand; that we cannot have one without the other. I would agree, for example, with former Chairman Eccles, who said:

I think they are equally important * * * I would undertake to maintain a stable economy rather than having runaway inflation which will wreck employment and production * * * you have got to use such tools as you have through monetary and fiscal policy to prevent inflation * * * in the long run [this] will create more production and employment than if you do not do it.¹⁸

I believe that this viewpoint is shared by most of the witnesses and most of the persons submitting answers to the written questions prepared by the committee. Nevertheless, it was quite evident that there were some members of the committee, and perhaps one or two witnesses, who assign a secondary role to the goal of price stability and who believe that any attempt to achieve price stability will result in frequent or continuous unemployment. I merely observe that if one believes that price stability can only be achieved at the cost of unemployment and also believes that maximum employment should be the only goal towards which we should be striving, it must follow that one also is willing to accept inflation as a permanent fact of our economic life.

I have not given a complete list of all the factors which have appeared in recent years to give the old problem of inflation a new face. One which was raised by some witnesses, and partially developed in limited questioning, referred to the role of the modern financial intermediaries outside the banking system; savings and loan associations, insurance companies, and finance companies. Dr. Abbott described these generally as "important financing institutions often governmentally sponsored, not subject to the credit policies or influence of the Reserve System." Dr. Abbott also called our attention to the problem created by the fact that a large segment of the huge Federal debt has found lodgment in the banking system.

In other statements, I plan to discuss the role of the Federal Reserve Board in dealing with inflation through its responsibility for monetary policy, the effects on inflation of the policies of organized labor, and the impact of the present recession on the continuing inflation.

As I conclude this, the first statement, I want to say again, that the one thing that concerns me above all others is the apparent belief on the part of so many Americans that "easy money" which encourages "easy debt" is a sound and constructive policy. Those who are attracted by this idea denounce any attempt to control inflation by

¹⁸ *Ibid.*, pp. 1777-1778.

restraining the too rapid growth of the money supply, particularly if it coincides with the heady exuberance of an inflationary boom. The resulting recession is then blamed on the restraint, which actually had dulled its potential damage, rather than on the boom, which had made recession inevitable.

The sad fact is that inflation is no economic fairy godmother. There is no magic in money to produce something for nothing, and when government creates money faster than its citizens create value, it does not create wealth, it only creates inflation, which is the illusion of wealth. While inflation may seem at first to provide some people something for nothing, it is only transferring value from one group to another, and if continued, eventually robs everyone—even the “smart” boys.

When the American people can courageously face up to the fact that there is no such thing as something for nothing; that there is no real security without risk; that money cannot be manipulated to produce wealth; that there is no substitute for human endeavor and individual wisdom and responsibility; then, and only then can we bring America back to economic reality, which in turn will put our feet on the path to sound growth and true prosperity.

II. MONETARY POLICY AND INFLATION

Despite the wide variety of topics covered during the Finance Committee hearings, monetary policy claimed the major share of attention. The committee inquired closely into the activities of the Federal Reserve System during two appearances of Mr. Martin, its Chairman, and much of the questioning of other witnesses related to Federal Reserve operations.

Before discussing recent Federal Reserve policy and the issues developed from it, let me review the high points of our monetary history during the past 5 years. Throughout 1954, monetary policy was directed toward encouraging recovery from the recession of that year. Discount rates were twice reduced, and reserve requirements lowered. Early in 1955 it became evident that recovery was turning into a boom. Hindsight evidence shows consumer credit rising \$6.4 billion in 1955, the largest rise in a single year in our Nation's history. With increasingly strong credit demands the Federal Reserve Board began its change in direction. Margin requirements on loans for purchasing and carrying listed securities were raised twice during that year, to a high of 70 percent in April, while discount rates were raised three times. When it was seen that these restrictions had failed to dampen the inflationary overtones of the boom, more stringent measures were introduced in 1956 and up to August in 1957. Discount rates were raised twice again, to a high of 3½ percent in August 1957. Open market operations were directed toward the objective of "restraining inflationary developments in the interest of sustained economic growth."

Yet even early in 1957 there were signs of an approaching business slowdown. This was shown by a fall off in new orders for machinery and equipment in the earlier months of that year and by the development of a margin of excess capacity in many key industries. When an expected business upturn failed to develop in the fall of the year, it became evident that the economy had reached a typical cyclical turning point, and the Federal Reserve began to alter the course of its policies.

As Chairman Martin stated in the hearings:

In the latter part of October and early November, open market operations were used to relax somewhat pressures on commercial bank reserve positions. In mid-November, a one-half point reduction in discount rates signaled a decisive change in System policy. From this point on, restraints on bank credit expansion were progressively relaxed.¹

Within 5 months the discount rate was dropped from 3½ to 1¾ percent. Margin requirements on loans for purchasing or carrying securities were reduced from 70 to 50 percent of market value. As additional reserves were provided by two reductions in reserve requirements and through open market operations, member banks reduced their indebtedness at Reserve banks. The easing in bank

¹ "Investigation of the Financial Condition of the United States," hearings before the Committee on Finance, U.S. Senate, 85th Cong., p. 1851.

reserve positions was reflected in a sharp expansion in bank credit and an exceptionally sharp drop in interest rates.

Federal Reserve actions which attracted most attention during the course of the hearings were the restrictive actions taken during 1956-57. These were bitterly attacked as harsh hard money policies, and yet as I look back upon that period one impression seems unmistakable: The restrictive monetary policy pursued by the Federal Reserve was about as mild a policy as could have been adopted if the System was to make any attempt at all to combat inflation. This is clearly apparent when we realize that prices rose considerably during 1957—and are still creeping upward today—despite the fact that the Federal Reserve has always had it within its power to enforce a contraction in prices.

The changes that occurred both in circulating medium and in interest rates are indicative of the lack of severity in Federal Reserve policy during 1956-57. If we take as a measure of circulating medium, total deposits—adjusted—plus currency in circulation outside of the banking system, we find that during 1956 and 1957 the rate of increase was about 2½ percent in each year. Since the rate of use of money—its velocity—was increasing fairly rapidly during this time, these increases were more than sufficient to provide for sustainable economic growth with price stability.

So far as interest rates are concerned, it was made clear during the hearings that at their peak in 1957 rates were still substantially below levels which had prevailed as late as the 1920's and the very early 1930's. As Sumner Slichter pointed out in his testimony this April:

Although one has heard much about the scarcity of savings in recent years, interest rates have been extraordinarily low by historical standards.²

A chart showing long-term interest rates since 1920 was placed into the record as part of Secretary Burgess' statement last summer, and I refer my colleagues to that chart, on page 720 of the published volumes, for a graphic illustration of Professor Slichter's appraisal.

In summary, therefore, Federal Reserve policy during 1957, while restrictive, cannot be classed as severe. The very fact that it was not expansionary, but was directed toward combating inflation, quite naturally resulted in a situation in which more persons and firms than usual were unable to borrow all of the funds which they desired. Therefore we had the cries of "tight" money and "hard" money, which presented a far more harsh picture of the policy than was true in fact.

Federal Reserve policies in general were subjected to a wide variety of criticisms during the course of the hearings, both from Senators and from some witnesses. Some of these complaints were, in my opinion, frivolous; others should receive our full attention. I should like to list and discuss each of these major criticisms.

First. The first issue in my informal tabulation is one that to me is the least serious, although a surprising amount of time was devoted to it. Briefly stated, this issue arose out of the charge that the restrictive monetary policy of the Federal Reserve was the cause of the inflation, and that, therefore, the way to stop the rise in prices was to adopt an easy money policy. This claim seemed to rest upon two pieces of evidence: first, that the period during which prices were

² *Ibid.*, p. 1816.

rising coincided roughly with the period in which the Federal Reserve was following a restrictive monetary policy; and second, that the pronounced rise in interest rates affected business costs and therefore prices.

This contention with respect to Federal Reserve policy was most frequently heard during the sessions of the committee last summer. I was therefore interested to observe that none of the witnesses in the spring session—including some who were quite critical of one or more aspects of Federal Reserve policy—adopted this particular brand of "Alice in Wonderland" logic.

If inflation in 1957 was indeed due to the restrictive monetary policy of the Federal Reserve System and the way to bring prices down was to increase the money supply, then it would seem to follow that in a deflation, as prices are falling, the way to bring prices up is to contract the money supply. In the spring of 1958 we were in a recession and there was indication that the price level is about to decline, but I heard no suggestion from the proponents of the view I am discussing that the Federal Reserve should now begin to contract the volume of credit.

So far as the effects of interest costs on prices are concerned, the answer given by Secretary of the Treasury Humphrey was, I believe, never successfully challenged, namely, that interest charges comprise only about one-third of 1 percent of the average sale price of manufactured goods. Of course interest is a cost, but it is ridiculous to attribute a broad inflationary movement such as that of 1956-57 to a rise in this almost insignificant business cost element in the price structure.

I do not think it is necessary for me to devote any time to the contention that the Federal Reserve program caused the inflation because it was being carried out at the same time as prices were rising most rapidly. This is equivalent to saying that if a disease continues to persist after a course of treatment is begun and the two exist together, then this coincidence is accepted as proof that the cure actually caused the disease. I will agree that a restrictive monetary policy, in its first stages at least, will increase the rate of turnover of money, as firms and individuals attempt to make more efficient use of the circulating medium available to them. To that extent, the job of the central bank is made much more difficult, but it is an anticipated consequence in the early application of a restrictive monetary policy. In the final analysis increases in velocity can proceed only so far during a restrictive monetary policy, and they can always be overcome if sufficient pressure is placed on the money supply.

In summary, these arguments that the Federal Reserve's policy caused the inflation fall of their own weight.

Second. The second issue I observed developed out of the fact that prices continued to rise during 1957 and into 1958, and relates to the ability of the Federal Reserve to exercise decisive influence over the price level. The claim was advanced that a restrictive monetary policy, which necessarily applies temporary brakes to the expansion of the economy, is indefensible if it cannot at least attain the objective of price stability.

The validity of this claim is hard to appraise. The basic difficulty is that we do not know—as we can never know in such instances—what would have happened if the Federal Reserve had not followed a re-

strictive policy. The weight of opinion in the testimony was clearly to the effect that if the Federal Reserve had not followed such a policy in 1956 and 1957, the rise in the price level would have been much more severe. As former Board Chairman Marriner Eccles put it:

The monetary and credit policy did not prevent a certain amount of inflation from taking place, but it certainly curbed the spread of inflation and the extent to which it would have taken place.³

Even Professor Slichter, who has been critical of some aspects of Federal Reserve policy, agreed that restraint was desirable. As he put it:

Certainly in 1956 and probably in the early part of 1957 credit restraint was desirable. About the middle of 1957, a relaxation, not a shift to an easy credit policy but some relaxation, would have been desirable.⁴

As I have already noted, this relaxation did occur at the end of October, so that Professor Slichter's criticism with respect to this point apparently involves a question of timing, rather than of direction.

Of the witnesses, only Professor Harris seemed to adopt the view that Federal Reserve was largely ineffective in preventing price increases. He attributed this ineffectiveness to the increasing importance of financial intermediaries, the high liquidity of business concerns, and the tendency of wage rates to rise faster than productivity. All these are important points and I discussed some of them in my previous remarks. It is perhaps regrettable that the committee was not able to devote more time to each of them. However, it appears to me that Professor Harris weakened his point when he claimed that the Federal Reserve possesses sufficient power to cause a business contraction, thereby implicitly agreeing that the System and its policies are far from ineffective.

My own view is that Federal Reserve policy definitely prevented the inflation from becoming far more severe than it has been. I am aware that during his questioning the Senator from Oklahoma [Mr. Kerr] preferred to dismiss such claims as speculation; but in this case, as in many others in life, such speculation is all that is available to us.

Third. The third issue in this tabulation arises out of the charge that Federal Reserve policy hurt only small business, and did not affect large corporations. On occasion, this charge was broadened to the claim that the restrictive monetary policy hurt the "little man," both business and individual, but did not affect the wealthy.

Before discussing this issue, I should like to call attention to one apparent inconsistency in this charge. Those who maintain, along with Professor Harris, that the Federal Reserve policy "on the whole favored corporations against small business"⁵ are generally those who also attribute the current business downturn to the same restrictive monetary policy. I plan to discuss in a later speech the relation of inflation and recession; but I pause here to observe that the large corporations which produce durable goods have suffered great shrinkage in volume, and this has produced the greatest areas of unemployment. We have seen this reflected in the first-quarter earning reports of large corporations, which are down significantly. I do not much care which horse the critics of the Federal Reserve policy

³ *Ibid.*, p. 1731.

⁴ *Ibid.*, p. 1855.

⁵ *Ibid.*, p. 2015.

prefer to ride; but I do say that they cannot at one and the same time claim that monetary policy did not bear to any extent upon large corporations, and also say that it was the cause of the present downturn, which is quite obviously working a hardship on the same corporations.

So far as the charge itself is concerned, I feel that the evidence presented during the hearings was insufficient to support the conclusion that restrictive monetary policy during 1956 and 1957 was directed at, or bore more heavily upon, small business, as compared with large business. During the questioning of Secretary Humphrey by the Senator from Florida [Mr. Smathers], for example, there were presented numerous tables which purported to show that small business was suffering. But as Secretary Humphrey pointed out, in most instances the figures used to illustrate small-business distress could not be related solely to the years of restrictive monetary policy, but, instead, showed long-term trends, running through several periods of easy-money policies, as well as restrictive policies. As a matter of fact, in a number of instances the Secretary was able to point to the fact that the position of small business improved subsequent to the introduction of the restrictive monetary policy. For example, the data of the Senator from Florida [Mr. Smathers] showing the percentage of sales going to manufacturing corporations with assets of less than \$1 million, as well as the data showing profits after taxes for companies of the same size, revealed that the position of smaller sized business firms had improved in 1956—a year of restrictive monetary policy—over their position in the years immediately preceding. I refer my colleagues to pages 370–372 of the printed hearings.

So far as business failures are concerned, the trend for small firms has been generally upward ever since the end of World War II; but this is a development which is to be expected, in view of the rapid growth in our economy and the increasing number of business firms. As a matter of fact, in the 2 years of so-called tight money, 277,472 new business incorporations occurred, compared with 257,000 during 1954–55, 2 years of so-called easy money. And, of course, the total number of businesses operating in this country has continued to increase during recent years, totaling 4,232,300 as of June 30, 1955; 4,297,200 as of June 30, 1956; and 4,322,000 as of June 30, 1957.

The question of increasing personal bankruptcies was also raised. The overextension of credit, of which they were the inevitable harvest, most probably occurred during earlier periods when credit was too easy. I have learned this out of my 30 years of experience with retail credit. This is another instance where the cure is confused with the cause.

There is one very important and significant set of facts which often is overlooked by those who charge that restrictive monetary policy bore most heavily on small business. The truth is that the effects of this policy were felt most severely in the large financial centers and in the large banks, and were felt least in small communities and among small banks. All of us know that a very important part of the bank financing of small business is done by our small country banks, which, indeed—because of statutory loan limits—are unable to loan to any

but small businesses. During my questioning of Secretary Burgess, for example, the Secretary called my attention to the fact that—

During the past year, from May 1956 to May 1957, the New York City banks, the Chicago banks, and the Reserve city banks, which are the other large city banks, show a minus position on their free reserve; on the other hand, during that entire period the country banks, month by month, had free reserves, which is a very interesting indication that this squeeze has come much more in the money centers than it has in the country banks.⁶

Differences in the impact of restrictive monetary policies are also reflected in the deposit changes of Federal Reserve member banks over the period during which such policies prevailed. For the 22 months beginning with January of 1956, and ending with October 1957, total deposits in central Reserve city banks in New York City declined by well over \$2 billion; and in Chicago, by three-quarters of a billion dollars. In the smaller member banks—those classified as country banks—total deposits during the same 22-month period of restrictive monetary policies rose by well over \$2 billion. While the capacity of big banks to make loans was restricted, that of the small banks was increased. For them, money became easier, not harder.

I should also like to observe that Professor Slichter called our attention to the fact that during the period of restrictive monetary policies, the interest charged on large-sized loans went up much faster than did the interest on small loans. This is to be expected, in view of the fact that the monetary stringency was being felt primarily by the large banks. As Professor Slichter pointed out, the spread between the two rates "narrowed during the period of credit restraint. In 1955 there was a 1½-percent difference. By 1957 the difference had dropped to 1 percent."⁷

I am, of course, aware that connected with small business there are special problems which may deserve attention. All I want to say here is that there is no evidence to show that a restrictive monetary policy during 1956–57 either added to or took away from these problems. It may be of interest to note that during his testimony Professor Slichter made the following observations on this matter:

The assertion that the new enterprises as a whole are failing in substantial measure to get the amount of capital which they could put to good use is unproved. * * * There is some shortage of medium-term loan capital, but there is a greater shortage of attractive risks. * * * Attractive investment opportunities suitable for small, medium-term loans are more scarce than investment funds.⁸

It was Dr. Slichter's strong contention that there are more fundamental problems than money shortages standing in the way of a more rapid business growth. He made this statement in his testimony:

The high infant mortality rate among new enterprises shows that a large proportion of business starters have more courage and hope than judgment and skill.⁹

The fourth in this tabulation of issues is one of the most important. This issue was present, but was more or less dormant in the hearings last summer, and did not break out into the open until the sessions this year. This is the question whether the Federal Reserve has any responsibility at all with respect to the maintenance of price stability. For example, the Senator from Oklahoma [Mr. Kerr], in his questioning of Chairman Martin this spring, made it quite clear that he doubted

⁶ *Ibid.*, p. 1106.

⁷ *Ibid.*, p. 1818.

⁸ *Ibid.*, p. 1817.

⁹ *Ibid.*, p. 1817.

the Federal Reserve had such responsibility, for after reading the declaration of intent in the Employment Act of 1946 the Senator stated:

You cannot point to any specific language that says to the Federal Reserve bank, "maintain the stable value of the dollar."¹⁰

Professor Harris made the charge more specifically when he said:

I might say, Mr. Chairman, that I once wrote an 800-page book on the Federal Reserve System and have not discovered, and have not still, that the Federal Reserve is given any authority to stabilize the price level. Its job is to accommodate trade and commerce.¹¹

Perhaps I was wrong in stating that this is a single issue, for it is quite apparent that a number of very important issues come to focus at this point. For example, what is the duty of the Federal Government as a whole with respect to price stability? Few would quarrel with the statement of the Senator from Virginia [Mr. Byrd] at the opening of the hearings:

This committee can never lose sight of the fact that the Government's integrity depends upon a stable currency.¹²

I, for one, am in hearty agreement. Yet if it is to be seriously maintained that the Federal Reserve has no duty in this field, is it not the same as saying that the Government itself has no such duty?

Personally, I did not expect, prior to the hearings, that the right and duty of the Federal Reserve to fight inflation would ever become an issue. As I saw it, there could well be disagreement over the manner in which the Federal Reserve was acting, but not over the goal it sought. In the past, congressional committees have concluded that the goal of price stability was so well accepted it would be almost redundant to provide for it by legislation. In view of the appearance of this issue, however, I believe it has become of the utmost importance that the Congress add the goal of price stability to the various other objectives of the Employment Act of 1946, and to the basic Federal Reserve law, in order that there may no be question on this fundamental point.

My fifth issue relates to the independence of the Federal Reserve System. It was a big issue 8 years ago, and I shall not take much time with it now. However, I do not wish to imply that it is unimportant today. During the entire hearings the question of the independence of the Federal Reserve System was never far below the surface. Like the question of the proper function of the Federal Reserve, it really came out into the open during the spring sessions, when Professor Harris stated flatly he did not believe that Federal Reserve should be independent, a statement which seemed to be concurred in by the Senator from Oklahoma [Mr. Kerr] and the Senator from Louisiana [Mr. Long].

My own belief is that it would be a tragedy if the Federal Reserve should be made subordinate to another agency or branch of the Government to such an extent that it would not be free to take quick and effective action when faced with the prospect of either inflation or deflation. I always thought that the fight carried on by the Senator from Illinois [Mr. Douglas] and others, which culminated in the restor-

¹⁰ *Ibid.*, p. 1899.

¹¹ *Ibid.*, p. 2022.

¹² *Ibid.*, p. 3.

ation of the Federal Reserve's independence in 1951, was one of the most praiseworthy accomplishments in the financial field within recent years. I do not believe that the Federal Reserve can be completely outside of Government, but I am firmly convinced that, within Government, it must retain a maximum degree of independence if it is to accomplish its objectives.

Most of the questions I have discussed up to this point were opened up in the 1957 hearings. Let me now turn to the monetary policy issues which dominated the 1958 sessions of the committee. There were two, which would become Nos. 6 and 7 in my tabulation. First, there was the question of the extent to which Federal Reserve policy in 1956-57 was responsible for the current business downturn. Second, there was the charge that Federal Reserve policy today has not gone far enough in providing monetary ease. Let me deal with these one at a time.

Sixth. The question of Federal Reserve responsibility for the current downturn has one very interesting aspect, since Chairman Martin and his critics are in some measure of agreement, although for quite different reasons. The critics claim that the Federal Reserve was responsible because, to quote Seymour Harris again:

Undoubtedly monetary policy contributed to the recession. * * *¹³ To stabilize prices with a large cost inflation could only be done by inducing unemployment through a restrictive monetary policy. This the Federal Reserve accomplished.¹⁴

On the other hand, Chairman Martin indicated in his testimony before the committee that he, too, felt the Federal Reserve should bear a part of the blame for the downturn, but not because its policies during 1956-57 were too restrictive. Rather, as he put it:

The real criticism * * * is that we were not more aggressive and did not make more of an effort to slow (the economy) down in 1955 and early 1956 when this got out of hand.¹⁵

If Federal Reserve policy in 1956-57 did in fact make a significant contribution to the current business downturn, then we should be able to trace the influence of that policy to the various segments of the economy which are presently causing the most trouble. The significant characteristics of the current downturn are probably three: First, a slump in the manufacture and sale of durable goods, particularly automobiles; second, a decline in new private capital expenditures; and, third, a decline in inventories. I doubt that anyone could seriously argue that the restrictive Federal Reserve policy of 1956-57 was reflected a year later in the decisions of consumers to hold off the purchase of automobiles and other durables. Despite the recession, both disposable personal income and the rate of savings remain high; credit was eased before this year began—the buying power is there. There has been no significant change in the interest rates applicable to automobile or appliance loans, nor has there been any change in the terms of payment which prevail. It appears to me that the real reasons for the slump in this sector of the economy are: First, high prices; second, some disenchantment with the product; and third, a shift in buying habits, reflected in the fact that consumers have apparently decided to spend less on durables and more on other things.

¹³ *Ibid.*, p. 1088.

¹⁴ *Ibid.*, p. 1090.

¹⁵ *Ibid.*, p. 1097.

So far as the downturn in private capital expenditures is concerned, other factors seem to be of more importance than Federal Reserve policy. We should remember that the high level of business expenditures since 1954 led to a situation in which many firms acquired all the facilities necessary for the next few years, so that some slowdown was inevitable. As Professor Slichter pointed out in his testimony:

The high level of investment activity * * * made the economy vulnerable to contraction, since it was natural for enterprises to slow down the increase in their investment spending.¹⁰

Somewhat the same thing can be said with respect to inventories. A rapid buildup of inventories is a natural consequence of inflation. What we are witnessing today in this sector is a readjustment to a more normal level.

In short, my own view of the particular issue is that Federal Reserve policy necessarily had some effect on the business downturn, but that by no stretch of the imagination can it be assigned the sole, or even a major, role. It seemed to me that Professor Slichter provided the committee with perhaps the most thoughtful and well-rounded discussion of the causes of the present recession. In that presentation he assigned, if I understood him correctly, major responsibility to the dropoff in business capital expenditures; that is, expenditures for plant and equipment. This decline, he felt, reflected decisions made in 1956-57 and was attributable not to Federal Reserve policy but to the perfectly natural tendency for business to take a breather after maintaining a particularly high level of such expenditures. Professor Slichter then went on to point out that other factors, such as Federal Reserve policy, Government fiscal policy, and consumer reluctance to accept the new automobiles, were aggravating rather than casual forces. And, in answer to a U.S. News & World Report interview on this same point, Professor Slichter said:

No, I think the fundamental causes of the recession lie deeper than Federal Reserve policy.

Seventh. My last issue is one which could only have appeared during the spring of 1958 sessions, since it involves the claim that the Federal Reserve has been halfhearted in its recent policy of monetary ease. This charge was made by Professor Harris, who pointed to the fact that since the change in policy in the fall of 1957 the bank reserves have fallen slightly and holdings of Government securities by the Federal Reserve have risen by only 2 percent. Professor Harris also cited the activity of the Federal Reserve in 1930-32 with respect to the purchase of Government securities as an illustration of what he considered to be a genuine policy of monetary ease and suggested the Federal Reserve today follow in the same course.

By the time Professor Harris appeared before the committee it was quite clear that the major tool which the Federal Reserve was using to provide monetary ease was its authority to change reserve requirements. There had been three successive decreases in reserve requirements beginning on February 27 of this year. The last decline took effect on the day Professor Harris testified, although it had been announced much earlier. The professor must certainly have known of these reductions, just as I am sure he knows full well that the powerful expansionary effect of a reduction in reserve requirements is

¹⁰ *Ibid.*, p. 1822.

through the release of existing reserves for credit expansion and not through a change in the dollar volume of reserves. Thus I am at a loss to understand why Professor Harris mentioned the reduction in reserve requirements only briefly—and then only the first of the three reductions—and chose to appraise current Federal Reserve policy in terms of purchase of Government obligations and the dollar volume of reserves. The only explanation I can think of is that perhaps his statement was written when only the first reduction had taken place, but if this was the case he did nothing to clear it up in his oral testimony. As a matter of fact, in his oral testimony he did not mention even one of the three reductions in reserve requirements, and emphasized again that the dollar amount of reserves had not grown.

As I said earlier, we cannot yet pass judgment on whether the Federal Reserve has gone too far or not far enough in its present course, but we can at least review factually what the system has done. Since the decision to ease credit in November, the discount rate has been lowered in four steps, from $3\frac{1}{2}$ to $1\frac{1}{4}$ percent. These are, presumably, what Professor Harris had in mind when he referred to "a few rather inconsequential cuts in rates," a phrase I find somewhat amusing in view of the furor of last summer when these same rates were being raised. Moreover, the three successive reductions in reserve requirements against demand deposits have released roughly \$1.5 billion of reserves, or three times the amount mentioned in Professor Harris' prepared statement. This, plus the effect on open market operations, has permitted an easing in the free reserve position of member banks of almost \$1 billion since the end of October, in addition to providing the base for a \$7 billion expansion in bank assets and deposits. The trend in free reserves has been steadily upward, moving from a negative figure of about \$550 million last October to a positive figure slightly more than \$600 million in April. Free reserves are excess reserves less member bank borrowings.

The easing of bank reserve positions has been reflected in a substantial expansion in bank credit and an exceptionally sharp drop in interest rates. The total of bank loans and investments increased almost \$5 billion in the 6 months ending in March. This expansion of bank credit has been mainly in the form of U.S. Government security holdings, and its effect has been to enlarge holdings of cash balances and to increase the economy's overall liquidity. Business loans outstanding at banks have tended to decline with economic activity. However, loans on securities, which provide important support to the capital markets, have risen.

As Federal Reserve policy shifted from restraint to ease, the financial markets reacted vigorously. The recent drop in interest rates has been as rapid as any in the Nation's financial history. For example, the rates on short-term Treasury obligations—maturities under 1 year—have declined about two-thirds since last fall. In contrast, after the onset of recession in mid-1953, such rates fell only about 45 percent over a 7-month period from their mid-1953 peaks. Similarly, the rates on prime commercial paper have fallen over 50 percent recently, but in the comparable 1953-54 period declined only about 20 percent. Long-term rates, too, have declined more rapidly in the current than in the earlier recession; for example, the yields on high-grade municipals declined about 25 percent and 20 percent, respectively, in the 2 periods.

The drop in the price of money during the recession was a good deal faster than was the rise under the preceding conditions of heavy credit demands and restrictive monetary policies. Money market rates—the yields on such instruments as short-term Treasury issues, prime commercial paper and directly placed finance company paper—were last at current levels back in the winter and spring of 1955. It took these rates 30 months or more to rise as much during the boom as they have fallen during the last 7 or 8 months. Market rates on money market instruments are now quite generally less than half as high as they were at their peaks.

Market yields on longer term securities issued by the Treasury, State and local governments and corporate borrowers have not fallen nearly so far as money market rates, but, nonetheless, have declined much faster than they rose in 1955, 1956, and early 1957. Bond yields have dropped one-half to three-quarters of a point, representing a decline of about one-sixth for long-term Treasury issues, one-eighth for high-grade corporate issues and nearly one-fourth for high-grade State and local government bonds. Most, if not all of these declines had occurred by late January. Thus, in 4 or 5 months, bond yields declined as much as they had risen in the previous year.

Before leaving this question of present Federal Reserve policy I cannot refrain from commenting on another of Professor Harris' claims, to the effect that the Federal Reserve today can profit by the example of action taken by the System in 1930-32, action characterized by Professor Harris as "tremendous" and worthy of emulation. I do not pretend to be a student of monetary history but I am aware of no responsible study of that period which attributes a policy of monetary ease to the Federal Reserve between 1930 and 1932. As a matter of fact, even the 1932 annual report of the Federal Reserve itself implied regret over having kept banks short of reserves. What Professor Harris did, of course, was to select one of many factors bearing on reserves—purchases of Government obligations—and with the selection of appropriate dates and a bit of statistical manipulation he came up with the conclusion that an equivalent policy today would require officials to purchase Government securities in excess of \$50 billion. Both the illustration and the conclusion were to me utterly ridiculous—as the professor himself seemed to imply—but if so, why mention the subject at all, unless it was calculated to leave the committee with the impression that there had been a true policy of monetary ease in 1930-32 and that present policy suffers by comparison. Surely the committee deserved better than this on such an important question.

With the discussion of this issue I should like to conclude my informal presentation of monetary policy issues raised during the hearings before the Committee on Finance. I am aware that there were other issues and that I have not even covered all of those which properly fall in the area of monetary policy. Nevertheless, I have attempted to cover those monetary issues which seemed, in my opinion, to be fundamental. If I have succeeded, it is my hope that this summary will be of some use to those who have not been able to attend what has been a most interesting and important series of meetings.

III. LABOR UNIONS AND INFLATION

This is third in my series of statements summarizing my impressions gained from the testimony developed in the hearings of the Finance Committee on the financial condition of the United States.

In the first statement I discussed inflation as the general theme of the hearings. In the second I reviewed the testimony presented with respect to the role played by the Federal Reserve System in our present economic situation. In this speech I shall try to develop the relationship between increases in wages and the rise of prices. I am focusing attention on the wage problem because this seems to be one of the more important of the recent economic developments making this inflation different from previous ones.

When we define inflation simply as a rise in prices, we are guilty of inadequacy and oversimplification. We need to look deeper at the elements of current price rises to discover what forces play on them to force them up. Each inflation is the result of the interaction of many forces, both psychological and economic. But regardless of the refinements, there are fundamentally two forces at work: First, a demand-pull force, involving excessive spending on the buyers' side of the market, and second, a cost-push force, operating from below on the supply of materials and labor. Today I shall concentrate on the latter, the cost-push force.

First, however, let us look at the interaction of the two forces. The demand-pull involves excessive spending by business, Government, and consumers for the economy's goods and services. Likewise, as the buyers of the productive services bid in competition for these resources, secondary demand-pull elements, which raise prices, are set up. On the supply side, higher wage rates, rising raw material prices—which again may be attributed in large part to wage increases—taxes, and some other factors all operate as cost-push forces to raise prices. By far the most important of the cost-push forces is wages, which account for 78 percent of the national income originating in manufacturing.

While most of the witnesses and questionnaire respondents to the Finance Committee named demand-pull chief villain in inflation causes, it was recognized by all who testified on this point that cost-push forces aggravate or amplify the inflation generated by excessive spending, while many said that the cost-push forces may themselves even initiate or be the direct cause of the current inflation.

I think it is significant that the recent wave of inflation, though probably originating in the capital boom of 1955, and in other conditions earlier, has gone on in the face of what was up until last fall a tight monetary policy. It has persisted in fiscal years 1956 and 1957, in the presence of a Federal surplus although it has required a huge Federal deficit to produce past historic inflations. It was not touched off by a speculative fever in either consumer or producer goods or in stocks and bonds. Rather than an expansion of profit margins which usually accompanies a strictly demand inflation this one was accom-

panied by a shrinkage of profit margins. Consumer stocks were high rather than depleted by wartime scarcity or rationing. And finally the current recession has not stopped the steady upward climb of prices.

Is there some new force in this inflation which has not received sufficient attention? I think there well may be. To me it is significant that practically every witness who appeared before the Finance Committee made reference to the inflationary power of labor unions. This was the case regardless of the background, philosophy, or politics of the individual witnesses. Practically every respondent to the questionnaire made the same observation about labor. Certainly such an array of testimony is more than mere casual coincidence and deserves more than casual attention.

THE ROLE OF WAGE COSTS IN INFLATION

Before referring to the testimony of the witnesses themselves, I shall outline the understanding I have gained of the general role of wage costs in inflation.

Wage rates may operate in several direct and indirect ways to initiate or sustain inflationary conditions.

First. Wage rate increases, not fully offset by improved productivity in the industries concerned, increase costs per unit which producers will attempt to recover through higher prices. I shall take a look at this in detail in a few minutes.

Second. Increased labor costs and prices, particularly if they occur in basic or supplier industries, will spread as higher nonlabor costs—cost of material and components—to other industries, in later stages of production, thus forcing up the prices of these industries as well.

Third. Because of wage leadership in collective bargaining and the influence of widening wage differentials on other workers, higher wages will be demanded in the industries not directly involved in the original wage-push.

Fourth. The prevalence of long-term labor contracts even in segments of the economy remote from each other tends to produce general rigidity and prevent offsetting downward adjustments of cost, and therefore, even though these wages have not risen, they contribute indirectly to the general upward pressures of the wage-price structure.

Fifth. As prices rise, upward wage pressures become cumulative and self-reinforcing. New wage and salary demands in all sectors are made to offset the rising cost of living. Escalator clauses in wage contracts tying money wage rates to the Consumer Price Index have become widespread in recent years. These wage increases are significant cost-push forces, whatever the initial or generating cause may have been. It is significant that these escalator clauses are most prevalent in the so-called strategic industries—industries which can cause repercussions throughout the rest of the economy. Examples are the steel, automobile, railroad, trucking and transit, electrical machinery, aircraft and parts, agriculture machinery, meat-packing, aluminum, and iron ore mining industries.

How likely is it that these five direct and indirect wage factors will push prices up in a particular situation? Referring to separate action in a single industry, if wages are increased without the creation of additional demand for the products of that industry, one or more of

these three things will probably occur: (1) There will be increased unemployment in that industry; (2) there will be a downward pressure on wages in other industries; or (3), there will be a downward pressure on prices in the softer or more flexible parts of the economy.

If we are to speak of the effects on these five factors on the economy as a whole, our answer depends on the vigor and elasticity of the demand and on the direction and strength of current monetary and fiscal policies. If the demand is not expansive, increased unemployment will probably occur. Some authorities lay the present recession to this very situation. While the relative importance of the demand-pull and cost-push forces differ from one inflationary period to another and from one phase of each inflation to another, the two always exist when inflation is present, as it is now. Referring to the present inflation, Gerhard Colm, chief economist of the National Planning Association, had this to say in response to the committee questionnaire:

Thus, I would explain the price rise of 1957, in part as a delayed aftermath of the preceding demand inflation; in part, as a cost inflation resulting from the rise in administered prices and increase in wage rates in excess of productivity gains.¹

That both elements are usually mutually present in each inflation was made clear by Federal Reserve Board Chairman Martin when he appeared last August before the committee. He said:

These distinctions present an oversimplification of the problem. Inflation is a process in which rising costs and prices mutually interact upon each other over time with a spiral effect. Inflation always has attributes, therefore, of a cost-push. At the same time, demand must always be sufficient to keep the spiral moving. Otherwise the marking up of prices in one sector of the economy would be offset by a reduction of prices in other sectors.²

WAGES, PRODUCTIVITY, AND PRICES

With the above discussion as benchmark and background, let us turn to labor's role in the cost-push inflation. It is my considered opinion, based in large part on my review of the Senate Finance Committee hearings, that a primary factor in the rise of consumer prices since early 1956 has been the increase in payroll costs in excess of increases in productivity. The same testimony was borne out by such men as Marriner Eccles, Dr. Sumner Slichter, and others.

Said Marriner Eccles:

I believe the main cause of rising prices has been the use which labor union monopolies are making of their power to force up wages and numerous costly fringe benefits far in excess of increased productivity.³

And Dr. Sumner Slichter, of Harvard, pointed out that the recent rise of prices reflects more than the typical strong demand for goods. He related his comments more specifically to the present recession:

Wages have continued to rise throughout the recession in the face of falling demand for labor and goods. Thus the recession has given the public a clearer picture than ever of the responsibility of rising wages for rising prices. The more plainly the public sees the relationship between wages and prices, the more carefully it will appraise the demands of unions.⁴

¹ "Investigation of the Financial Condition of the United States," comments of economists, professors, and others in response to the questionnaire of the Committee on Finance, U.S. Senate, 85th Cong., ch. 5, p. 684.

² "Investigation of the Financial Condition of the United States," hearings before the Committee on Finance, U.S. Senate, 85th Cong., p. 1210.

³ *Ibid.*, p. 1695.

⁴ *Ibid.*, p. 1843.

These are the opinions, and I could cite several others;
What are the facts?

At this point, I ask unanimous consent to have printed in the Record a table showing the increases in hourly wages¹ in manufacturing and productivity in manufacturing from 1947-57. This same table is found on page 2088 of part 6 of the Finance Committee hearings.

TABLE I

Year	Average hourly earnings in manufacturing ¹	Indexes of output per man-hour (index: 1947-49=100) ²	Year	Average hourly earnings in manufacturing ¹	Indexes of output per man-hour (index: 1947-49=100) ²
1957.....	\$2.07	134.5	1951.....	\$1.59	111.6
1956.....	1.98	133.5	1950.....	1.47	111.8
1955.....	1.85	130.0	1949.....	1.40	105.4
1954.....	1.81	125.6	1948.....	1.35	99.8
1953.....	1.77	119.7	1947.....	1.24	90.6
1952.....	1.67	116.3			

¹ Manufacturing employment totaled 26 percent of total civilian employment in 1957.

² Computed from data prepared by Department of Labor.

Over the period 1947-57 hourly wages in manufacturing increased from \$1.24 to \$2.07, a percentage rise of 67.3 percent. Productivity in manufacturing—the output per man-hour—during the same period increased only 41 percent, or a difference of 26.3 percentage points. Professor Slichter, of Harvard, and A. D. H. Kaplan, of the Brookings Institution, refer to this spread between wage and productivity increases as the inflationary gap. It is interesting to compare this so-called gap with the rise in industrial wholesale prices over the same period. These increased from an index of 95.3 to an index of 125.6 from 1947 to 1957, or a rise of 32 percent.

The changes since the beginning of the latest wave of inflation show hourly wages increasing 10.1 percent in the 2 years from 1955 to 1957, while productivity increased only 3.5 percent over the same period, thus creating a gap of 6.6 percent. This corresponds to a wholesale industrial price increase of 7.3 percent over the period. In 1 year, from 1956 to 1957, manufacturing wages increased 4.5 percent, while output per man-hour increased only 0.7 percent, creating a gap of 3.8 percent. This compares with an industrial price increase of 2.8 percent during that year.

Obviously, the increase in labor costs in excess of productivity will not nearly match the rise in prices every year. As noted above, demand and other complex conditions enter in. In showing year-to-year changes, we find some cases where productivity moves ahead of wage increases, where prices lag behind costs, and where prices take the lead. We can also find that this pattern will vary from industry to industry within the same year. The purpose of the comparison here is merely to prove that cost-push forces are present in the overall inflationary process.

COST-PUSH INFLATION AND THE DISTRIBUTION OF INCOME

Another important aspect of the cost-push inflation deserves some careful attention. This is founded in the intense desire of unions and

workers in every industry and firm to match their particular wage increases with the increase in productivity for their own industry or for the economy as a whole, whichever is higher. Thus, the figure for the whole economy becomes the irreducible minimum for all workers in wage negotiations with their employers. To outline the problem created by such misuse of statistics, let me refer to the response of Professor Haberler to the committee:

Technological progress and the rise in output per man-hour is, of course, not uniform over the whole economy. Some industries, let me say, certain branches of manufacturing and perhaps agriculture, display faster technological advances than some others—let me say most service industries. Hence, if the overall price level is to remain stable, the prices of the products of the more progressive industries must fall and the prices of the less progressive industries must rise. This presupposes, however, that wages in the more progressive industries cannot rise as fast as productivity in those industries. If stability of the price level and full employment are to be maintained, wages in these industries cannot be allowed to rise faster than average productivity of labor in the whole economy.

Suppose that labor in the progressive industries is organized in powerful unions which force up wages in proportion to the rise in productivity in those particular industries—an assumption which does not seem unrealistic—then, it is true, prices of the products of these industries need not rise. But since the American economy is sufficiently competitive to generalize, sooner or later, such a wage rise, if not fully, then at least to a large extent, over most of the economy, including the less progressive industries which cannot absorb the higher wage cost without a rise of prices at which they sell, the overall price level will go up.

It follows that the policy of wage increases in proportion to (let alone those in excess of) the rise in productivity in each particular industry is highly inflationary.⁵

The problem of the wage-price spiral, then, includes the conflict over the distribution of real income, not so much between labor and nonlabor elements, but among various labor groups themselves. Human nature demands that the various groups try to protect themselves by pressuring for higher money incomes. The workers in the least progressive industries will not settle for less than the average, and those in the most progressive industries will certainly not reduce themselves to the average. Strategically placed, highly organized unions usually play a special role as catalysts in this mad scramble. And the union leaders are right there on the spot with the figures for their particular situation, using every device and skill to raise the hopes of every worker—and thus create more cost-push pressure.

In our present collective bargaining society, therefore, inflation becomes almost a matter of arithmetic. There is an almost inevitable persistent upward pressure on the cost-price structure. The constantly increasing power of organized labor will continue to put an increasingly heavy burden on our monetary and fiscal policy unless we can find acceptable means of controlling the wage-push factors of inflation.

PROFITS AND WAGES

The rather popular claim is frequently made that increasing profits, rather than increasing wage costs, are the real cause of rising prices. None of the witnesses who appeared before the Finance Committee or submitted statements for the record made this red-herring argument, but it was freely offered by labor leaders and other witnesses related to labor who appeared before another Senate committee while our finance hearings were going on, and is frequently presented in speeches by labor leaders and appears in reports of major labor nego-

⁵ Questionnaire, ch. 5, p. 622.

tiations. Because a few companies have large profits, this is frequently used as an argument to apply to business as a whole. Those who accept this fallacy then build a whole economic philosophy on the idea that to increase profits is to diminish purchasing power, and that the way to cure our economic problems is to increase purchasing power by increasing wages, regardless of related increases in productivity.

Before turning to the facts of the case, I wish to point out that the subtle false logic of this argument has great appeal to the ordinary citizen. On the surface this reasoning has its foundation in a sound economic doctrine—the purchasing power concept—but in reality, it merely perverts the idea. For an answer to this false reasoning, I turn again to the able testimony of Professor Haberler:

It is one of the most pernicious fallacies that a boost to wages is an effective method of increasing purchasing power and thus alleviate depression. A tax cut or increase in public expenditures strengthens purchasing power. On the other hand, a rise in wages may or may not increase purchasing power of the workers (depending on what it does to employment). But in any case, whether it does or does not raise the purchasing power of the workers concerned, it boosts cost of production, it pushes up prices (or prevents prices from falling) and so reduces the real purchasing power of all consumers, including labor itself, adds to the fires of inflation and thus makes it more difficult for the monetary authorities to relax credit restrictions.⁶

What do the facts say with regard to wages versus profits as an inflation force? I wish to have printed in the Record at this point another table which I had inserted in the hearings. It shows the percent increase to 1957 from preceding years of total corporate profits, and total compensation of employees, both, of course, before taxes.

It will be seen by examining the table that the increase in wages of employees exceeded the increase in corporate profits before taxes for each year from 1947 to 1956.

TABLE II.—*Profits and wages for 1947-57*

(Dollars in billions)

Year	Profits		Total wages	
	Total corporate profits before taxes	Percentage increase from specified year to 1957	Total annual compensation of employees	Percentage increase from specified year to 1957
1957	\$41.0	-----	\$254.4	-----
1956	43.0	-4.7	241.4	5.4
1955	42.5	-3.5	223.1	14.0
1954	33.5	22.4	206.8	23.0
1953	37.0	10.8	208.1	22.2
1952	35.9	14.2	195.1	30.4
1951	41.2	-5	180.4	41.0
1950	40.0	2.5	154.3	64.9
1949	26.2	56.5	140.9	80.6
1948	32.8	25.0	140.9	80.6
1947	29.5	30.0	128.8	97.6

It will be noted that during the years of the latest inflation, 1955-57, profits increased slightly from 1955 to 1956, but decreased from 1956 to 1957. Profits in 1957 were lower than in both 1955 and 1956.

⁶ *Ibid.*, p. 623.

On the other hand, employee compensation increased dollarwise and percentagewise between 1955 and 1957. Referring to the table inserted earlier, it will be seen that the same is true for hourly earnings in manufacturing.

Although unincorporated business and professional incomes are not shown in the table, I might point out that from 1955 to 1957 these incomes increased from \$27.3 billion to \$28.7 billion for a percentage rise of 5.1 percent. This is less than half of the increase in compensation of employees over the corresponding years.

Yet the question may still be asked: Could not a general wage increase come out of profits? It might for a few companies and for a few years, but it could not be true for all companies or for every year. This should be clear from the data already presented; but for additional evidence, I have shown in table III the national income by years from 1947, and the percentage which corporate profits before taxes and compensation of employees are of that income.

TABLE III
[Dollars in billions]

Year	National income	Compensation of employees as a percent of national income	Corporate profits before taxes as a percent of national income	Year	National income	Compensation of employees as a percent of national income	Corporate profits before taxes as a percent of national income
1957.....	\$358.2	71.1	11.5	1951.....	\$277.0	65.1	14.4
1956.....	343.6	70.3	12.5	1950.....	240.0	64.3	16.7
1955.....	324.1	68.8	12.4	1949.....	216.2	65.2	12.1
1954.....	299.0	69.2	12.2	1948.....	221.6	63.6	14.8
1953.....	302.1	68.9	11.1	1947.....	197.2	65.3	15.0
1952.....	290.2	67.2	12.4				

NOTE.—The remainder of the distribution within 100 percent is made up of farm business and professional, rental, and net interest income.

From this table it is obvious that wages have in fact increased their relative share of the national income during the past 3 years from 68.8 percent in 1955 to 71.1 percent in 1957. Corporate profits, on the other hand, have correspondingly declined from 12.4 percent to 11.5 percent of national income during the same period.

A general wage increase of even 5 percent in 1957 not compensated by an increase in productivity or prices would reduce nonwage income by one-eighth, and if it all came out of corporate profits it would mean a reduction of 31 percent in this sector—nearly one-third. A 16-percent wage increase would wipe out all profits. Thus, it does not take much imagination to see what an additional profit squeeze would do to the economy.

On the other hand, one of the most potent factors in our economy to damper inflationary forces is increased productivity. If production is increased as fast as demand is enlarged, price inflation will probably not occur. I submit that productivity will be increased only if profit margins are large enough to provide businessmen with incentive to borrow, and savers with incentive to invest or to lend the funds to finance the new capital improvements. In this sense, therefore, profit margins are an indirect defense against inflation rather than a cause of inflation.

From the pamphlet, the "Mechanics of Inflation," published by the U.S. Chamber of Commerce, I borrow this paragraph:

If temporarily high profits in expanding industries become the basis for monopolistic wage demands, and those profits are reduced before they can perform their most important economic function, the expansion of the industry desired by consumers is cut off. The whole community is thereby robbed in higher prices, uneconomic use of our resources and foregone improvements in living standards. If a free market is to be preserved, we enforce competition and rely on competition to grind down temporarily high profits. This is not the function of the labor leader, however sincere and public spirited he may be.⁷

Another point is worth noting here. Normally, profits, being a residual share of national income, increase faster than other income shares in a boom period. On the other hand, they fall more rapidly in a recession—for example, 1931 and 1932. They are not inflexible downward, as are wages; nor on the rise do they establish higher rigid cost plateaus, as do wages.

Before I leave this discussion of the relative inflationary effect of rising wages and rising profits, I wish to turn briefly to a philosophical comment on the subject made by Mr. Theodore O. Yntema, vice president and economist of Ford Motor Co., which appears in his testimony before the Subcommittee on Antitrust and Monopoly. He said:

We would like to see the productivity advances in the economy distributed more in lower prices and less in higher money wages of reduced purchasing power. * * *

Certainly, we should not tolerate attempts by any power group to grab such benefits for themselves. * * *

The productivity of society is reflected in the physical volume of output per man-hour worked. This output per man-hour is usually called the productivity of labor. The term, however, is a misnomer because laborers are not responsible for much of the increase in productivity. The increases in productivity come mainly from management's utilizing capital and putting into operation the improvements discovered by scientists, engineers, and others. It is somewhat ironical that productivity should be expressed as output per man-hour, and it is most unfortunate that the term "productivity of labor" should be misinterpreted as productivity attributable to labor.⁸

CONCLUSIONS—RECOMMENDATIONS

If the owner of labor to exact wage increases in excess of productivity is a major cause of inflation, what course should the Government pursue to stem this inflationary force? The monetary authorities, and those responsible for fiscal policy—and a major responsibility for these rests squarely on this body—have a mandate to control the demand type of inflation. What forces or agencies have the responsibility to stem the cost-push type of inflation? Fiscal and monetary policy could handle this type of inflation, too, but only at the cost of increased unemployment.

I have not as yet reached any conclusions for myself as to the best course to follow. However, the witnesses to the Finance Committee offered some individual suggestions which are worth considering.

I think it should be obvious to everybody that the place to begin, and in the long run perhaps the only source of a solution, is with the public itself—through a program of economic enlightenment. Sumner

⁷ P. 39.

⁸ Prepared testimony of Theodore O. Yntema before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, U.S. Senate, Feb. 4-5, 1968, pp. 40-41.

Slichter concluded his testimony before the committee with these words:

The more plainly the public sees the relationship between wages and prices, the more carefully it will appraise the demands of the unions. The public is obviously getting tired of the stiff annual rounds of wage increases that far exceed the contribution of the workers to productivity. An atmosphere is being built up in which employers who take long and costly strikes in an attempt to hold wage increases down to increases in productivity will have strong public support.⁹

Gerhard Colm offered these suggestions:

1. Develop more facts on prices, wages, and productivity, and a better understanding of these facts.
2. Implement the price stabilization objective of the Employment Act.
3. Give consideration to an annual informal conference of business and labor leaders and research economists, for the purpose of discussing along general lines price and wage policy which would give support to high and rising employment and production without causing inflation or deflation. Whether or not agreement on price and wage policy is reached at these sessions, the resulting public information would lead at least to a clearer understanding of the areas of disagreement. "A better informed public opinion in its will exert a restraining influence on price and wage policy."
4. Set up a special Government commission on price and wage policy. Require producers and labor leaders to inform the Commission of contemplated price increases and new collective bargaining agreements before they become effective. After study by the Commission, and review by the Council of Economic Advisers, the President could then approve or suspend the effective date for a period of say 60 days if they are deemed to be contrary to the public interest.¹⁰

Though Mr. Colm's first three suggestions merit further study, I hope we can reach a solution more in keeping with private free enterprise than his fourth suggestion.

There is one other suggestion which received only a little attention in the committee hearings, but which also deserves some careful study. The idea has been suggested by many responsible men in other places. It is a call to extend present antitrust laws to cover labor union activity, or in some way limit the size of unions. George Romney, president of American Motors, in testimony before the Subcommittee on Antitrust and Monopoly, called for a dividing of the power of national unions. Two of this specific proposals were:

1. The combining of the national unions for the establishment of common bargaining demands or use of economic power, should be prohibited.
2. Affiliated unions should be free to combine in bargaining with employers having less than 10,000 employees, but only within prescribed geographical limits. However, those representing more than about 10,000 employees of a single employer should be prohibited from combining to establish collective bargaining demands or exercising joint economic power against more than one company.¹¹

Theodore O. Yntema in his response to the Finance Committee questionnaire gave it as his opinion that the most desirable solution to wage inflation, and its cause—the labor monopoly problem—is the development of antimonopoly laws comparable to those which govern business.

I quote in length from Mr. Yntema's words, both because of their vital nature, and because they summarize my feelings on this matter:

Competition in business is not perfect—in the everyday sense; it can be and needs to be improved. By and large, however, there is enough competition in most industries to keep prices and profits down to levels roughly equal to those

⁹ Hearings, p. 1843.

¹⁰ Questionnaire, ch. 5, pp. 580-581.

¹¹ Prepared testimony of George Romney before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, U.S. Senate, Feb. 7, pp. 38-39.

necessary to compensate for the risks of the business. * * * And there are laws on the books prohibiting monopoly and monopolistic practices—laws that have maintained reasonably workable competition in business.

A different situation exists in labor. Labor unions are monopolies established under the aegis of law. They are given special protection and even immunities and privileges that are not accorded ordinary citizens. They are not subject to such regulation or restraint in the use of their monopoly power.

During the boom of 1955-57 and in the recession of 1957-58 the unions have displayed their power to drive up wages faster than productivity and to squeeze profit margins. There is no reason to expect different behavior in the future from labor unions unless their powers are reduced. We can look forward, therefore, to continued and probably accelerated cost-push inflation in the future unless appropriate action is taken. * * *

This problem of labor monopoly and cost-push inflation cannot be solved merely by increasing the degree of competition in business. * * *

Industrywide organization of business to oppose industrywide organization of labor is not a happy solution. * * *

Wage and price controls are still worse as a solution.

Cost-push inflation, though relatively new, is an American economic problem of major proportions. It is a complex problem, and likewise the solutions to it are still beclouded. But the difficulty of our task should not deter us from tackling it.

SUMMARY OF STATEMENT NO. IV—INFLATION AND THE RECESSION

To summarize this particular statement on the relationship between the present recession and the continuing inflation: After analyzing all the ideas suggested by the Committee witnesses as being causes of the recession, I believe they all bear out the basic assumption that this has been a typical period of readjustment following an economic boom. Of course, it is different in detail from the other two postwar cycles of boom and recession. This one has been spotty, with respect to certain industries, and clearly reflects a change in the buying pattern of consumers. While the personal disposable income has dipped only very slightly, consumer use of it has so changed as to bring a serious drop in the volume of consumer durables. While this was going on, industry, after an investment boom, was reacting with a drop in expenditure for capital durables. From these, and other less important factors, consequent recession touched most of the economy.

In spite of this, inflation has persisted even in the face of the downturn, and though dormant since the upturn, has not permitted the downward price adjustments which usually occur in times of lowered economic activity.

The presence of both these economic diseases at the same time has posed a serious problem for us, and apparently we have decided that the short-time, close-range recession was more serious than the inflation, because we have embarked on a vast new Federal spending program and created our greatest peacetime deficit, totaling more than \$12 billion, which will not be felt until after the economy has turned upward. Recent statistics from the National Bureau of Economic Research show that the "lead" indicators have been rising for 2 months now, yet the large Government deficit is still to come.

The time has come to fit this statement into the whole picture of this series. In the first statement, I identified inflation as the most serious problem revealed by the hearings, and their central theme. In the second, I discussed the monetary policies used to check the force of the inflation, and discussed the reasons they were not completely successful. In the third, I reported on the role of wage policies in producing the cost-push force in the inflationary spiral, and tried to focus attention on the central problem here—the fact that over the past dozen years, wages have risen faster than productivity. And in this fourth discussion, I pointed out how inflation helped create this recession, how it persists in spite of the economic downturn, how it is being started off again, under the guise of a cure for the recession. Through all this it must be obvious to those who read these statements that I believe inflation has been, and still is, our No. 1 economic problem, and that unless we face it and control it soon, it will do immeasurable damage to our economic future.

What can we do about it? Where shall we begin?

First, We cannot find our answer entirely in Government policies and programs. We cannot pass laws to cure inflation. Rather than curing it, increased Government interventions tends to sustain and intensify it. Certainly, that is the record of the last quarter century; and I believe that will be the result of many actions taken by this last

session of the 85th Congress. When we try to give help without cost, greater spending without added taxes, special privileges for special groups, we are not creating something out of nothing. Rather, we are being political Robin Hoods in reverse, creating inflation which robs the poor for the purpose of rewarding political supporters. Inflation robs the past and future for the present. Once we intervene for one group, we are soon called upon to equalize this inequity by another intervention. Thus, we are always giving, but seldom counting the cost. The elected representative who tries to stem this tide risks being swept out of office by it. And the man who has courage to stand up to it is scorned and castigated.

Second. The fires of inflation can only be brought under control by the people themselves, beginning in the management of their own lives and money.

While some Members of Congress have been trying to whip this current mild recession into an excuse for a whirlwind of frantic Government economic action, there has been no great supporting public outcry. Of course, there have been some special-interest groups who have tried to take advantage of the apparent mood of Congress to push their particular programs, either tax cuts or spending programs beneficial to them. But while this has been going on, the ordinary people have been quietly going about their individual and personal programs, putting their own economic houses in order. These people have been stepping up the payments on their debts, saving more, and stretching out the life of their cars and other durables. By these policies and by exercising caution, prudence, and self-reliance in their buying of consumer goods, they are using the safest and most powerful kind of inflation control in the world. Perhaps we might call their actions the only true and effective method. At least we can be sure that unless backed up by such personal programs, no Federal programs will ever work successfully.

Since June 18, 1957, when the Finance Committee started on its hearings on the financial condition of the United States, we have seen both phases of the third postwar business cycle. We saw it rise to its peak in the third quarter of 1957. From then until April of this year, we lived through the natural adjustment which followed, which we call a recession. Now it looks as though we have begun the longer and slower climb to another summit—either in steady, sustainable growth or in a headlong rush to another boom and bust. What lies ahead we cannot tell. But so far as the cycle of 1954-58 is concerned, we can now feel that the worst is over. But while we may be on our way out of the woods on the current recession, the greater of our twin problems is still with us. The inflation born in World War II has persisted through three such cycles of both boom and recession—and while its fires seem dormant now, the deficits created by this very Congress may well be storing up the fuel which will cause them to flare up again soon in a wilder and more consuming flame.

As the hearings developed, the risks and problems of inflation became their central theme. Now as they close, it remains our dominant economic threat. If our country is to continue to grow in sound prosperity, control of inflation must be our chief economic goal. To me, this is the ultimate meaning and lesson of the Finance Committee hearings of 1957-58.