

Public Debt Management

AT THE OUTSET, I should like to state that the Board of Governors of the Federal Reserve System agrees that the debt management proposals transmitted to you by the President are necessary and desirable and we urge their favorable consideration.

There are only a few points that I would like to make, but before turning to them, I think it is important that you should understand that I come before you in connection with these proposals not as spokesman for the Administration, but as Chairman of the Board of Governors.

We are living today in a country of unprecedented wealth. It is wealthy, in part, because of abundant natural resources; and, in part, because of the energy and initiative of our people. An even more important distinction between the United States and most other countries is the size and quality of the accumulated stock of capital goods in the hands of producers and consumers. Due to past saving, we enjoy the benefits which flow from a reservoir of housing and durable goods in the hands of consumers, of public facilities, such as highways, school buildings, and waterways, and of industrial plant and equipment. The society in which we live has been popularly characterized as affluent, and despite our proper concern for certain depressed areas—both economic and geographic—I am sure that we can all agree with this characterization.

NOTE.—Statement of William McChesney Martin, Jr., Chairman, Board of Governors of the Federal Reserve System, before the Ways and Means Committee of the House of Representatives, June 11, 1959.

One consequence of affluence is exposure to instability in the pace of general activity and also in interest rates which rise in periods of boom and decline in periods of recession. In a very primitive economy, where everyone must work as hard as he can to eke out a bare living, additions to stock of capital are largely made by diverting effort directly to production of capital goods. Such borrowing and lending as does take place is effected at interest rates which we would regard as fantastically high. In this type of economy, there is little threat of instability except from natural causes. A drought or an unusually good season may produce relative poverty or plenty. But the range of economic fluctuation will tend to be fairly small.

The greater the accumulation of wealth the greater are the possibilities for economic fluctuation. These may stem from shifts in the peoples' preferences among the wide range of expenditure opportunities open to them, from changing attitudes toward saving and investment, from over-speculation which undermines the solvency of financial institutions, or, perhaps on some occasions, simply from the arrival at a point where even a high rate of technical innovation fails to induce investment decisions adequate to sustain capital expansion.

It is not surprising that, in a free and wealthy economy, we are unable to counter-balance perfectly, through changes in public policy, the wide shifts that can take place. We always have had, and, I think, always

will have, changes in the pace of our economic progress. We can and should work to reduce these fluctuations and strive for the goal of stable growth. At the same time, however, we must recognize that it is highly unlikely that we shall ever achieve perfection.

Fluctuations in our economy express themselves in various ways, and we attempt to gauge them by various statistical measures. If we look at the movements in any of the broad measures of economic activity and compare them with fluctuations in interest rates, the conclusion is inescapable that interest rates tend generally to move upward in periods of prosperity and downward in times of recession or arrested growth. Hence, concerned as we may be about the impact of rising interest rates on the burden of the public debt or on necessitous borrowers, we must recognize that rising interest rates are, in fact, a symptom of broad prosperity and rapid economic growth.

Since the stabilization of monetary systems in key countries after World War II, interest rates have been higher in most other industrial countries than in the United States. This has been a period of great economic growth, very active demands for credit, further monetary expansion, and continuing, though perhaps abating, inflationary pressures. This past year's rise in interest rate levels here, accompanying economic recovery, has been in contrast to some decline in interest rate levels in Western European countries, where a modest recession came somewhat later than in the United States and Canada.

In the United States, the rise in interest rates has affected all types and maturities of debt instruments. Yields on long-term securities have generally risen by about 2 per-

centage points since the low point reached shortly after the end of the war. Yields now range from 4 to 4½ per cent on U. S. Government securities of long- and medium-term, over 4½ per cent on many outstanding Aaa corporate bonds, and average over 5 per cent on outstanding Baa corporate bonds. New issues necessarily have to be offered to investors at higher rates.

Despite their recent upward movement, interest rates in the United States are still at levels comparable with those prevailing during much of our history. Long-term rate movements since last summer have been within the range of the period from the early part of this century through 1930. The level is still substantially lower than during most of the nineteenth century. From an historical viewpoint, the present level of rates can hardly be regarded as "out of line" for a period of wide prosperity and growth.

In comparing present rate levels with those of past periods, one of the important things sometimes overlooked is the effect of our necessarily high tax structure on the effective rate of interest. For example, if both the borrower and lender are subject to the 52 per cent tax on corporate profits, the borrowers' net cost and the lenders' net return is a little less than half of the expressed rate. Thus, a market rate of say, 4 per cent, implies for both parties a net rate of a little less than 2 per cent. On its own taxable bonds, the Federal Government, through the income tax, recaptures a substantial share of the interest it pays. When we look at interest rates in long-term perspective, we must bear in mind that net yields after taxes are lower today than a comparison of market rates would suggest, because of the fact that taxes are higher.

Aggressive demands for financing, which.

as I have said, are characteristic of prosperous times, represent efforts to attract resources away from current consumption in return for the payment of interest. In a free economy, no matter how affluent, it follows that, when borrowers attempt to attract a larger share of the total product for their purposes, they will have to pay for doing it.

The presence of strong demands on the credit markets from borrowers of all kinds does create a difficult financial problem. Recently credit demands have been pressing on the banking system, and the banks have been accommodating a growing volume of loans. As borrowers have sought accommodation, banks have raised their prime rate from 4 to 4½ per cent. This is the interest rate that banks charge top-quality customers on short-term loans.

More recently, the discount rate of the Federal Reserve Banks has been raised from 3 to 3½ per cent. The discount rate is the interest rate that is charged by a Federal Reserve Bank when a member bank borrows money from it. This money is often called high-powered money. It is high-powered because it is credited directly to the reserve account of a member bank, and, unless used to finance a payment of currency into public circulation or an outflow of gold or some other development which drains the member bank reserve base, it forms the basis for a multiple expansion of bank credit and money.

For some months, we have been having rapid expansion of bank credit and money, based largely on borrowed reserve funds. The seasonally adjusted money supply—demand deposits at banks plus currency in circulation—has increased by more than \$2 billion in the last four months, an annual rate of growth of about 5 per cent. In the face of developing high-level prosperity and

the potential threat of inflationary boom, the Federal Reserve should not be in the position of encouraging an undue expansion of bank credit and money. Hence, the appropriate discount rate under present circumstances is one that does not encourage member bank borrowing and is generally above current rates on short-term market obligations, such as bills.

It is sometimes asserted that the Federal Reserve System should step in and halt the upward trend of interest rates resulting from active demands for loans by supplying sufficient Federal Reserve credit in one form or another to keep interest rates from rising. This cannot be done without promoting inflation—indeed without converting the Federal Reserve System into an engine of inflation.

When such a program was adopted during and following the war, it did succeed for a time in actually pegging interest rates on Government obligations. But, at the same time it promoted and facilitated the dangerous bank credit and monetary expansion that developed under the harness of direct price, wage, and material controls. The suppressed inflation that resulted, we are now well aware, burst forth eventually in a very rapid depreciation of the dollar and even threatened to destroy our free economy.

This experience is very recent and the effects are widely and well remembered. It is now very doubtful whether the Federal Reserve System could, in fact, peg interest rates on Government obligations under today's conditions even if we accepted the inflationary costs, which would be high and would eventually lead to severe collapse. It is certain that the Federal Reserve could not extend interest rate stability to all markets.

The trouble is that the world has learned from wartime inflationary experience. It now knows that inflation follows any effort to keep interest rates low through money creation as the night follows the day. Any attempt on the part of the Federal Reserve to peg rates today would be shortly followed by an acceleration of the outflow of gold in response to demands from abroad, by further diversion of savings from investment in bonds and other fixed interest obligations into stocks and other equities, and by a mounting of demands for borrowed funds in order to speculate in equities and to beat the higher prices and costs anticipated in the future.

Those familiar with the investment markets will confirm to you that such developments would inevitably follow a Federal Reserve attempt to peg interest rates. A simply tremendous volume of bank reserves would have to be thrown into the market through Federal Reserve open market purchases in the attempt to stem the upward pressure on interest rates. As these reserves enhanced inflationary pressures even further, the rush from money and fixed obligations into gold and physical property, as well as the mounting demands for credit to reap speculative profits and to hedge against future inflation, would overwhelm even the most heroic efforts to hold interest rates down. Ultimately, if the gold reserve requirements to which the Federal Reserve is now subject were eliminated, the System might acquire a large proportion of publicly held Government debt of over \$200 billion in this way. True, the interest rate on Government obligations might be said in some distorted sense to have been stabilized by such an operation. Interest rates generally, however, would spiral upward as they always have in every major inflation.

People who save will be unwilling to lend their money at low interest rates even when they expect the depreciation in the value of their dollars to be limited. This is understandable. Take, for example, a corporate financial institution subject to a 52 per cent tax. The after-tax income from a bond yielding $4\frac{1}{4}$ per cent interest would amount to just a little over 2 per cent with the dollar stable in value. If this potential investor had reason to fear that the value of the dollar would depreciate even 1 per cent a year, he would anticipate a very low real return. If the investor had reason to expect a price rise of just over 2 per cent a year, he would foresee a negative real return. Investors are alert today to this way of figuring interest returns.

It might be added that to suggest holding interest rates down by supplying the banking system with reserves through Federal Reserve open market purchases of Government securities, on the one hand, and taking them away with higher reserve requirement increases, on the other, represents a fundamental misunderstanding of how the credit system functions. Obviously, if the net effects on the credit base are, in fact, offsetting, they make no net addition to the total supply of bank credit, nor do they reduce the demands of borrowers. If they are not fully offsetting, the net result is inflationary. We are all acutely aware of the gigantic size of the publicly held debt that is outstanding and available to provide a basis for such monetary inflation. There is no magic formula by which we can eat our cake and have it too.

If the Federal Government should substitute artificially created money for savings in an effort to prevent interest rates from rising, it would have a reverse effect. It would worsen the very situation that the ac-

tion was intended to relieve. If you really want to encourage rising interest rates, you have only to follow the prescription of those who argue that interest rates on Government or any other obligations can be pegged by inflating the money supply.

In connection with this discussion, it should be re-emphasized that the Federal Reserve System does not "like" high rates of interest. We are anxious, always, that interest levels be as low as is consistent with sustained high levels of economic activity, with a steady rise in our national well-being, and with reasonable stability for value for the dollar. We cannot, moreover, put interest rates where we would whatever our "likes." Federal Reserve policies can, of course, influence interest rates to some extent through their influence on the rate at which the banking system can add to the credit and money supply. The effectiveness of Federal Reserve policies is always subject to the reaction of borrowers and savers as expressed through the market.

In an economy in which people are alert and sensitive to price changes, the only way to bring about a lower level of interest rates is to increase the flow of real savings or to decrease the amount of borrowing. One important way to do this is to reduce substantially the deficit at which the Government is operating. This will not only relieve immediately some of the demand pressures that are pushing interest rates up in credit markets, it will also reassure savers as to the future value of the money they put in bonds and savings institutions and thus increase the flow of savings into interest bearing obligations.

The proposals before you do not relate to the levels of rates that will prevail in the market, but rather to whether or not the

Government will be able to use savings bonds and marketable bonds effectively as parts of its program of debt management. The forthright management of the public debt is an essential part of any program to encourage saving and lower interest rates. We should not force the Treasury to resort to undesirable expedients in order to comply with arbitrary ceilings on either the size of the debt or the rate of interest it pays.

International levels of interest rates among industrial countries are now more closely aligned than in earlier postwar years. This realignment, together with removal of most restrictions on the movement of capital, reflects progress towards a closer relationship among international money markets, which is the financial counterpart of progress toward sustained growth in output and trade in the free world generally. It also signifies a state of affairs in which capital demands are becoming international in scope and in which they will converge rapidly on the market that is cheapest and most readily prepared to accommodate them. Under these circumstances, interest rates in this country must increasingly reflect worldwide as well as domestic conditions.

We need to remember that today the dollar is the anchor of international financial stability. That anchor must be solid. Realistic financial policies of Government are essential to that end as well as to the end of a wealthy and strong domestic economy. At this juncture of world development, the least evidence of an irresponsible attitude on the part of the United States toward its financial obligations or of its unwillingness to face squarely the issues that confront it in meeting greater demand pressures on resources and prices, would have very serious repercussions throughout the free world.