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THE FEDERAL RESERVE PORTFOLIO

STATEMENTS BY INDIVIDUAL ECONOMISTS

MATERIALS SUBMITTED TO THE
SUBCOMMITTEE ON ECONOMIC PROGRESS

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES



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LETTERS OF TRANSMITTAL

JANUARY 28, 1966.

To Members of the Joint Economic Committee:

Transmitted herewith for the use of the Joint Economic Committee and other Members of Congress are the replies received from members of the American Economic Association in response to a letter of inquiry sent out by the Subcommittee on Economic Progress on September 1, 1965.

The letter of inquiry was sent to all those members of the American Economic Association who are listed as having indicated a special interest in monetary policy. The only exceptions made were in those cases where individuals by reason of official positions might feel constrained in responding freely, or where they lived abroad and presumptively were less likely to follow monetary affairs in this country.

The questions on the portfolio that were set forth in my letter of September 1 were designed objectively to elicit the opinions of monetary experts on the present constitution and management of the Federal Reserve portfolio which, of course, now exceeds \$40 billion. The statements are printed verbatim as they were received, with the exception of some minor editorial changes made by the staff in the interest of uniformity. In addition, the staff letter of transmittal contains a general summary of the replies.

It is hoped that this volume will add measurably to the knowledge of one of the most fundamental elements in our economic life; namely, the open market activities of the Federal Reserve System, which are basic in controlling the money supply in the United States. The 86 respondents who gave the committee the benefit of their judgment and experience have made a very real contribution, which is appreciated.

WRIGHT PATMAN,
Chairman, Joint Economic Committee.

JANUARY 27, 1966.

HON. WRIGHT PATMAN,
*Chairman, Joint Economic Committee,
U.S. Congress, Washington, D.C.*

DEAR MR. CHAIRMAN: Replies have been received from 86 monetary economists in response to the inquiry of September 1, 1965, sent to almost 500 economists by the Subcommittee on Economic Progress. These are transmitted herewith along with a summary of the responses, prepared by John R. Stark, the Deputy Director. He was assisted in the preparation of this summary by Mrs. Eleanor H. Aeschliman of the committee staff.

To insure objectivity, the selection of those to whom the inquiry was to be made was based upon the directory of membership published by the American Economic Association. In this directory the associa-

tion provides a listing grouping economists by their major fields of interest as indicated by the economists themselves. The questionnaire was sent to those members of the association who indicated a special interest in monetary policy. The only exceptions were instances of individuals living abroad or those whose official positions might provide reason for some constraint on their part in replying. Every effort has been made to make sure that the questionnaire itself is completely objective and that the summary is as fair a representation of the opinions of the respondents as could be prepared in view of the wide range of responses. In addition, the full texts of the replies are published with only such editing as was necessary to bring them into a uniform format for publication and to arrange them alphabetically.

The staff is hopeful that these materials will prove useful to the committee members and others in the study of the open market activities of the Federal Reserve System and the management of their portfolio.

Sincerely yours,

JAMES W. KNOWLES,
Executive Director.

JANUARY 26, 1966.

JAMES W. KNOWLES,
Executive Director, Joint Economic Committee.

DEAR MR. KNOWLES: Transmitted herewith is an analysis of the replies received from 86 monetary economists in response to the Economic Progress Subcommittee's inquiry of September 1.

The questionnaire was sent to all members of the American Economic Association who indicated a special interest in monetary theory and policy, or in commercial banking and other short-term credit. The only exceptions were instances of individuals living abroad and therefore presumably more remote from the domestic monetary scene, or those who by reason of their official positions might have felt constrained in replying freely. Following is a summary of the opinions expressed by the respondents.

SIZE OF THE FEDERAL RESERVE PORTFOLIO

I. How large a portfolio should the Federal Reserve System hold in relation to the money supply, the gross national product or aggregate liquid assets?

Most of the respondents were of the opinion that it was impossible to apply quantitative yardsticks to gage the adequate size of the portfolio. While an appropriate ratio of any yardstick, i.e., the money supply, gross national product or aggregate liquid assets, to the size of the Federal Reserve's portfolio might be determined for any specific time, they maintained that various conditions would prevent using such a ratio as a general standard. The majority opinion was that a minimum size necessary to carry on open market operations was of more concern than a maximum size. The Federal Reserve's holdings of governments in excess of the amount needed to control the money supply were not considered to be a serious problem by most respondents.

II. If the portfolio grows too large, what should be done with the excess? How should the interest be handled?

The conclusion that the Federal Reserve holds a large amount of governments in excess of that necessary to carry out its monetary function was generally accepted. Most respondents considered interest payments on the Federal Reserve's holding of governments to be a burden to the taxpayers only to the extent of the Federal Reserve's operating expenditures. Approximately one-third of those replying preferred to maintain the status quo; i.e., for the Federal Reserve to hold the excess, draw interest and return the unexpended balance to the Treasury. While very few favored outright cancellation of the excess portfolio holdings, about 30 percent indicated that some improvement could be achieved through replacement of excess holdings with non-interest-bearing governments which could be reconverted to marketable securities, if needed. They expressed the opinion that such a revision would simplify bookkeeping arrangements between the Federal Reserve and the Treasury. Some of the supporters of this idea pointed out that it is not now obligatory for the Federal Reserve to return excess earnings to the Treasury.

About one-sixth of the economists replying favored subjecting the Federal Reserve to the budgetary control applied to other Federal agencies to solve the issue of the Federal Reserve's earnings. A few of these respondents suggested reinstating the requirement that excess earnings be returned to the Treasury.

Approximately one-eighth of the group replying favored greater reliance upon controls other than open-market operations, which would have the result of easing the problem of secular growth in the Federal Reserve portfolio of governments. Six respondents suggested reducing the reserve requirements of member banks and offsetting this reduction with open-market sales of Treasuries. In addition to lowering the reserve requirement on demand deposits, a few respondents also suggested abolishing the reserve requirement on time deposits.

Other suggestions included (1) requiring financial institutions to hold part of their reserve in governments; (2) selling excess governments back to the public over a period of time (suggested by three economists who felt open market operations were inappropriate and favored the return to traditional central banking techniques); and (3) expanding credit by issue and recall of currency from the Treasury directly to banks rather than relying on open market operations to expand and contract the money supply.

COMPOSITION OF THE FEDERAL RESERVE PORTFOLIO

I. Should the Federal Reserve expand its operations to dealing in private and municipal debt instruments?

About one-third of the respondents expressed the opinion that the current policy of the Federal Reserve should be maintained. Two considerations were commonly raised by this group as objections to expanded operations of the Federal Reserve in selective markets: first, these markets tend to be narrower than the Government market, and would involve an unnecessarily heavy burden of credit analysis for Federal Reserve personnel; second, purchases and sales in selective issues would subject the Federal Reserve to political pressures and criticisms which these respondents felt should be avoided.

Less than one-tenth of those replying preferred to give the Federal Reserve as much flexibility as possible in this area. These respondents generally felt that it might be desirable for the Federal Reserve to deal in private and municipal securities at different times, but that the Federal Reserve should be free to determine its own policy in this area.

Approximately one-sixth favored extension of Federal Reserve operations to the private and municipal markets. The arguments of these respondents were as follows: (1) it would increase the ability of the Federal Reserve to directly influence the cost and availability of credit to various classes of borrowers; (2) it would aid the objective of stimulating given sectors of the economy or certain types of spending; (3) it would provide more selective control of inflationary pressures by selling debt instruments of the sectors experiencing excess demand while still maintaining credit ease in other markets; and (4) it would prevent the Federal Reserve from obtaining too large a portion of governments to the detriment of private investors should the supply of governments be insufficient to meet demand. In general, the respondents in this group felt that purchases and sales of private and municipal issues would speed up the impact of credit policy on financial markets. One economist pointed out that dealings in the private or municipal markets in addition to their monetary significance could well have the same effect as subsidies, and might be more properly handled in the latter fashion separate from money creation. The balance of the respondents did not address their replies to this point.

With respect to dealing in specific issues, the most common suggestions were high-grade corporates and municipals. One economist specifically recommended dealing in certificates of deposit, as the CD's constitute a wide market and have to some extent replaced Treasury bill holdings by the banks. There was no support for dealing in commodities or commercial loans. Although most of the respondents did not mention foreign exchange dealings, those who did felt that this was a proper function of the Federal Reserve.

II. Should standards be laid down relative to the maturity composition of the Federal Reserve's portfolio of Government bonds?

Although several economists indicated a preference for dealing in short term ("bills only") or longer term issues, there was no support for setting specific standards. The general consensus was to allow the Federal Reserve as much flexibility as possible in this area. One respondent was of the opinion that the maturity composition should be determined by the Treasury Department.

The chairman's letter of September 1, setting forth the questions on the portfolio, is reprinted herein.

JOHN R. STARK,
Deputy Director, Joint Economic Committee.

CHAIRMAN PATMAN'S LETTER TO ECONOMISTS

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
September 1, 1965.

DEAR DR. _____: The Joint Economic Committee solicits your views concerning the structure and management of the rapidly growing portfolio of financial assets held by the Federal Reserve System.

Ten years ago, the System held about \$24 billion of Federal Government securities in its portfolio. At latest report, their portfolio of "Governments" had grown to about \$39 billion, an increase of about \$1.5 billion per year over the 10 years. As you know, portfolio growth is a natural consequence of the need to expand the money supply to meet the growth needs of our economy. But what is not so generally recognized is that only a small fraction of this portfolio is needed for the current, day-to-day conduct of Federal Reserve open-market operations.

The committee believes that the growth of this portfolio and how it is operated raise issues affecting monetary policy, debt management, and fiscal policy. The attached excerpt from a colloquy between Chairman Martin and me during the July 7 hearings of the Banking and Currency Committee will help to highlight the basic issues about the portfolio's size. We are inviting you, as one of a group of experts, to comment on this situation and, especially, the following issues:

How large a portfolio should the Federal Reserve System hold in relation to the money supply, the gross national product, or aggregate liquid assets? Is any other measure more appropriate? If the portfolio grows too large compared to this standard, what should be done with the excess? Should the assets be transferred to the Treasury for cancellation? Should the Federal Reserve continue to hold them, draw the interest, and return the unexpended balance to the Treasury?

Can we design other objective standards by which to guide Federal Reserve portfolio operations? Should we lay down standards relative to the kind of assets to be held, maturity composition, private versus public instruments? Should the Federal Reserve supplement its portfolio of Federal Government securities with other types of assets such as commercial loans, foreign exchange, municipal securities, corporate bonds, mortgages, commodities?

It is the committee's hope that these valuable expert views can be published. With this in mind, brevity is desirable, of course. We are more interested in the specific recommendations and reasons for them than in elaborate argument or citation of source materials.

We appreciate your participation in this project, which will be of assistance to the committee and the Congress in dealing with a number of emerging issues. Kindly mail your reply to John R. Stark, Deputy Director of the Joint Economic Committee, G-133, Senate Post Office, Washington, D.C.

Sincerely yours,

WRIGHT PATMAN, *Chairman.*

COLLOQUY BETWEEN CHAIRMAN WRIGHT PATMAN AND WILLIAM
MCCHESNEY MARTIN, CHAIRMAN OF THE FEDERAL RESERVE BOARD

[Taken in testimony on H.R. 7601, a bill to provide for the retirement of \$30 billion of interest-bearing obligations of the United States held by the 12 Federal Reserve banks, on July 7, 1965, pp. 78-80 of the transcript.]

Chairman PATMAN. I want to clarify this for the record one more time, Mr. Martin. How in the world can you insist that bonds that are paid for once should continue in existence with the taxpayers having to pay interest on them after they have been paid for once? Now, of course, you claim that these bonds have to be there to back up Federal Reserve notes. But that does not conform with your reasoning in 1959 when you presented to Congress a bill, and it was passed on by this committee, which said that you wanted the power to lower reserve requirements and count vault cash as reserves; and that, if you got that power, you would transfer \$15 billion of the then portfolio of \$24 billion to the private banks. You further stated that the private banks needed the income from these bonds, and that the Federal Reserve does not need it. You do not need the \$15 billion. The remaining \$9 billion in the portfolio, as you stated in a staff report, would provide enough flexibility for you to operate. Now, then, when the Open Market Committee owns \$38.5 billion worth of bonds—which of course is about \$14.5 billion more than it was then, you insist that it is impossible for those bonds to be canceled, although \$15 billion under the same circumstances could be given to the private banks, after giving them (through reducing reserves) the reserves to buy the bonds.

The Fed pays nothing for them; it merely creates new reserves. Then it continues to get interest on those bonds and, when the bonds become due, they can collect the principal again.

I cannot get the reasoning there at all, Mr. Martin. If that makes sense, I am unable to comprehend it. Of course, there may be something in my background—lack of knowledge—that would account for it, but I do know this: No one should be compelled to pay his debts more than once, but in this instance you would compel the Government to pay its debts more than once. You would compel the Government to continue to pay interest on bonds that have already been paid for. When you bought these bonds, you paid for them. You will admit that, will you not, Mr. Martin?

Mr. MARTIN. The bonds were paid for in the normal course of business.

Chairman PATMAN. That is right.

Mr. MARTIN. And that is the only time they were paid for.

Chairman PATMAN. Just like we pay debts with checks and credits.

Mr. MARTIN. Exactly.

Chairman PATMAN. In the normal course they were paid for once; you will admit that, will you not?

Mr. MARTIN. They were paid for once, and that is all.

Chairman PATMAN. That is right.

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THE FEDERAL RESERVE PORTFOLIO

STATEMENT BY E. SHERMAN ADAMS, VICE PRESIDENT, FIRST NATIONAL CITY BANK, NEW YORK, N.Y., AND SECRETARY, SUPPORT GROUP FOR PROGRESSIVE BANKING, WASHINGTON, D.C.

At the outset, let me say briefly for the record that I would be opposed to H. R. 7601, a bill to provide for the cancellation of \$30 billion of Government obligations held by the Federal Reserve banks. I fail to see how this bill would achieve any constructive purpose and it would violate accepted principles of accounting and public finance. Having said this, I leave it to others better qualified than myself to deal with the broad issues it involves. There is, however, one aspect of the subject to which I have devoted considerable thought and study and which your committee will doubtless wish to consider because of its direct bearing on the questions raised in your letter. I refer to the outmoded structure of member bank reserve requirements and specifically to the requirement that member banks must hold a cash reserve against savings deposits.

There are many who hold that the entire structure of member bank reserve requirements needs reform. Be that as it may, I shall confine my comments here solely to the legal reserve requirement against savings deposits because this segment of the subject can be dealt with separately and because the issue involved is so clear cut.

The situation is indeed simple. The reserve requirement against savings deposits of member banks makes no significant contribution to the effectiveness of monetary policy and it obviously penalizes and discriminates against member banks as against other types of institutions which compete with member banks for personal savings—notably nonmember banks and mutual thrift institutions. There is widespread agreement among economists and others that this requirement should be abolished.

The Federal Reserve authorities obviously should have an ample period of time in which to accomplish the elimination of this requirement, presumably in stages, so that reductions can be timed so they will not interfere with, and may even assist, monetary policy. Excess reserves created by the reductions could be mopped up by means of open market sales of Governments by the Reserve banks to whatever extent may be regarded as desirable by the Federal Reserve authorities. When the requirement has been completely eliminated, the Federal Reserve's portfolio will be something like \$3 billion smaller than it would otherwise be.

From the standpoint of both logic and equity, the only reasonable alternative to eliminating this requirement would be to impose a comparable cash reserve requirement on other types of institutions which compete for personal savings. This has been advocated by certain economists and was a matter of some debate among academicians

several years ago. However, less has been heard about this proposal since the publication of the report of the Commission on Money and Credit in 1961. The Commission made a careful study of this proposal and concluded that a requirement of this kind adds nothing to monetary policy, that such a requirement should not be imposed upon other financial institutions, and that the existing requirement on savings deposits of member banks should be abolished.

I can understand how someone could disagree with these conclusions and argue that this kind of a requirement should be applied to all financial institutions which compete for personal savings, but I do not see how anyone could try to defend the existing situation which is so obviously illogical and so clearly discriminatory against member banks.

Incidentally, the alternative of imposing a comparable cash reserve requirement on other thrift institutions would lead to a further increase in the amount of Government securities held by the Reserve banks.

I realize that there may be some persons who might wonder whether any kind of lowering of member bank reserve requirements should be regarded as some kind of a "giveaway program" for the sole benefit of these institutions. This would be a distortion of the true situation. To the extent that existing requirements are much higher than they need to be, they are inequitable and the removal of such injustice cannot fairly be characterized as being a "giveaway." It would be a restoration of rights of which these institutions are now unjustifiably deprived, not a granting of special privileges. It would be a cutting back of an unfair "takeaway program."

Member banks would benefit some, of course, at least temporarily, because they would be able to lend and invest a larger percentage of their own assets—just as competing institutions are presently able to do. But members banks would obviously not be the only beneficiaries of this increased lending capacity. So would bank customers and, assuming the reductions are well timed, so would the entire U.S. economy.

Sooner or later the lending capacity of the banking system is going to have to be augmented in one way or another to meet the growing needs for bank credit in our expanding economy. There is clearly something to be said for accomplishing this simply by unlocking some of the bank funds that are now unnecessarily locked up.

The alternative method of open market operations by the Federal Reserve would result in a further enlargement of the portfolio of Government securities held by the Reserve banks. Failure to use one of these two alternatives could lead to an undue tightening of bank credit.

Elimination of the reserve requirement against savings deposits would result in a difference of something like 10 percent in the Federal Reserve's holdings of Governments. It may be that other measures may be desirable as well. However, be that as it may, it seems clear that there is a very strong case for the elimination of this requirement, either as a separate action or as an item of first priority in any program in this area.

STATEMENT BY WESLEY C. BALLAINE, DIRECTOR, BUREAU OF BUSINESS AND ECONOMIC RESEARCH, UNIVERSITY OF OREGON, EUGENE, OREG.

Before answering the specific questions posed in your letter to me dated September 1, 1965, I would like to state certain aspects of my general philosophy regarding monetary policy. If I do not do this, my answers might seem contradictory.

(1) Monetary policy should contribute to a high level of employment, economic growth, and price stability. These objectives may prove to be in conflict, especially the third with the first two. Should an order of preference have to be set up, I would favor that given above (high employment, economic growth, and then stable prices).

(2) Monetary policy and fiscal policy can both affect the quantity of money. Of the two, monetary policy is the more easily regulated because it can be adjusted on virtually an hour-by-hour basis. On the other hand, monetary policy can affect output and prices only through member bank reserves. This may be clumsy compared to fiscal policy which directly affects spenders. Monetary policy can either augment or tend to offset fiscal policy.

(3) With the relatively high level of employment we are now experiencing, I believe that a quick and substantial change in the Fed's portfolio (both governments and member bank borrowings) would have an effect upon prices unless offset by fiscal policy. Bad as would be a price rise more rapid than we are now experiencing, a sharp price decline would have disastrous effects upon employment and output.

(4) Although you do not mention exchange rates, it is a part of the complex of monetary policy that cannot be ignored. I believe stable exchange rates highly desirable; however, the price of their continued maintenance can become too high long before we run out of gold. I do not know how to express quantitatively the situation which would prevail so that it would become desirable to abandon stable exchange rates. I have the feeling that the British may soon be making a greater sacrifice on the altar of stable exchange rates than is merited.

Now to turn to questions listed in the fourth and fifth paragraphs of your letter.

A. *How large should the Fed's portfolio be?* I do not believe any fixed rule can be set for this. Probably the best criterion would be for the portfolio to increase at a rate which will result in the growth of GNP reflecting only increases in physical output with no element of price rise. Desirable as this criterion may be, refer to No. 1 above for modifications that might result in a more rapid growth of the Fed's portfolio. It should also be pointed out that the statistical measures of price change in the various sectors of the economy (consumer goods, raw materials, manufactured products, labor, capital, etc.) are not now sufficient to provide an accurate measure of deflated GNP.

B. *Is any other criterion more appropriate?* Answered in A above.

C. *If the portfolio grows too large?* If the economy is characterized by underemployment of resources, the Fed should create excess reserves and no effort should be made to reduce the portfolio. On the other hand, if an increase in the size of the portfolio has already resulted in higher prices, nothing should be done that might cause a fall in prices. If it should occur that at a time of relatively full employ-

ment, not all of the portfolio (member bank reserves) had been translated into deposits, it might be possible to reduce the portfolio by a small amount. I doubt if this last situation is likely to occur frequently.

The above discussion has been in terms of "excess" reserves and not whether the portfolio consists of more short-term Governments than is essential. This question is dealt with in the next answer.

D. *Should the assets be transferred to the Treasury for cancellation?* Since the Fed should have an adequate short-term portfolio so that a contraction can take place by normal maturities, there should be a portfolio of, say, \$10 billion of the sort now held. It seems to me that it makes little difference what is done with the remaining \$29 billion as long as it does not affect bank reserves. My preference would be to have the \$29 billion exchanged for Government securities having no maturity but subject to call by the Treasury Department. The rate of interest seems irrelevant, although I can see no reason why it should not be zero except that this might make the interest on the public debt appear too small.

E. *Should the assets continue to be held by the Fed?* Answered in (1).

F. *Should the Fed's portfolio consist of assets other than Governments?* From a purely monetary point of view I can see no reason why the portfolio should not include commercial paper, municipals, corporate bonds, and mortgages. As to foreign exchange, I thought the Federal Reserve Bank of New York now held deposits in foreign central banks on behalf of the 12 Federal Reserve banks. There are practical reasons for hesitating to invest in non-Government assets. For example, municipals already receive an artificially high price (low interest) by virtue of their tax exemption and it is doubtful if an additional stimulant is desirable by including them in the Fed's portfolio. Also, there is the whole question of equity among the various types of assets that might be acquired—why pick one and not another?

STATEMENT BY NEVINS D. BAXTER, ASSISTANT PROFESSOR OF FINANCE,
UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA.

THE HOLDINGS OF FINANCIAL ASSETS BY THE FEDERAL RESERVE SYSTEM

It is generally agreed that the Federal Reserve System is presently holding a portfolio of Government securities far in excess of the amount needed to conduct open market operations. This portfolio has been expanding over time, as the Federal Reserve has purchased Governments to make necessary additions to the reserve base of the banking system. It has been proposed by Representative Patman that the Fed transfer a portion of its portfolio to the Treasury for cancellation, in order to save the Government the cost of interest payments on the debt. The reasoning behind this proposal is that since the Federal Reserve paid for the securities when it purchased them, it is unfair for the Treasury to continue to pay interest on the debt, and ultimately, to redeem the principal at maturity.

I do not agree with Representative Patman's reasoning; whether, in fact, the Federal Reserve should turn over the securities to the

Treasury for cancellation must be decided on political rather than economic considerations. On economic grounds, such a transaction would have no effect. Since the Fed returns its profits to the Treasury (after meeting its own operating costs), the Treasury is, in effect, paying interest to itself on securities held by the System. When the Federal Reserve decided to purchase the securities from the public, it was, in effect, monetizing existing debt. No further interest payments would be made to the public as long as these securities remained in the Federal Reserve portfolio. It is the publicly held debt alone which is relevant when evaluating the degree of liquidity in the economy. So long as the Federal Reserve System is charged with the responsibility of monetary policy, the Treasury should continue issuing interest-bearing debt to meet its budget deficits (rather than printing money), and Fed should buy and sell such quantities of securities as may be necessary to achieve the desired degree of monetary restraint. It is a matter of economic indifference whether the securities are turned over to the Treasury for cancellation, for such a transaction would do nothing but alter subsequent bookkeeping entries. The Treasury would cease to credit the Fed with the interest on the securities but, by the same token, the earnings of the Federal Reserve which are turned over to the Treasury would be smaller by the same amount. The money supply, interest rates, and public liquidity would all remain unaffected.

On political grounds, however, I would strongly oppose the Patman proposal since it might lead to a reduction in the degree of independence of the Federal Reserve. Under our system, fiscal policy is the responsibility of the Treasury. The Treasury sells securities to meet budget deficits and retires debt if a surplus develops. Debt management policies should be designed to minimize the total cost—in interest and administration—of servicing the debt. Given the Treasury's operations, it is in the domain of the Federal Reserve to formulate monetary policy so as to achieve the optimal level of bank reserves and the desired degree of liquidity in the hands of the public. Such a division of responsibility would have prevented the situation which occurred in the late forties. At that time, the Treasury felt the need to keep interest rates pegged at unrealistically low levels because of the cost of servicing the large wartime debt; the Federal Reserve was prevented from taking the steps necessary to fight inflation. If the Federal Reserve were to turn over the securities which it buys to the Treasury for cancellation, pressure might develop from the latter agency for the Fed to step up its purchases in the interest of "saving the Government money"; also, open market sales might be criticized by Members of Congress as "spending the taxpayers' money." Certainly, in the literal sense, these transactions presently have such effects, but it must be recognized that the economic cost involved (in terms of the increased "tax burden" due to servicing the publicly held debt) should be far outweighed by the benefits of an optimal monetary policy. Politically, it has always been much easier for Congress to justify low interest rates than high. Since the Federal Reserve is, or should be, independent of political pressure, its members are much freer to pursue that monetary policy which is best in the public interest.

Turning to the question of the maturity structure of the Federal Reserve portfolio, I believe that it would be a good idea to increase the emphasis placed on securities over 1 year. Up until 4 years ago, open

market operations were confined to "bills only," because it was felt these operations would be least disturbing to the money market. The reasoning was that the bill market is the most developed and can absorb large transactions; also given interest rate changes in short-term securities lead to smaller price changes and are thus less upsetting to the asset holders. While these arguments still apply, the Federal Reserve has moved into the long-term area in an attempt to "twist" the yield curve. Because of balance-of-payments considerations, the aim has been to keep short-term rates high; but because of the desire to encourage private domestic investment, the goal has been to keep long rates relatively low. Although operations in the long-term area have been rather limited, they apparently have been successful at altering the structure of rates. Since different institutions hold securities of different maturities, and since the average maturity of the publicly held debt is a relevant liquidity consideration, the Federal Reserve might be able to increase the scope of domestic monetary policy by expanding its operations in the longer maturity ranges. In addition, although the evidence is by no means conclusive on this point, it can be argued that such operations would improve the market for longer term securities.

It would be interesting to explore the possibility of the Federal Reserve acquiring securities issued by the private sector. Virtually since its inception, the Fed has dealt in bankers' acceptances with the expressed aim of improving the market for these instruments. Because the total volume of acceptances is very small and the market is relatively thin, the Fed cannot substantially expand its operations here, nor can acceptances become a major vehicle for monetary policy. It is conceivable, however, that open-market operations could be conducted successfully in the negotiable time certificates of deposit (CD's) issued by the major commercial banks. The CD market is fast becoming a close second to the Treasury-bill market in terms of depth, breadth, and resiliency; dealer bid-ask spreads are usually only two or three basis points for certificates in the 90-day range and outstandings are in the neighborhood of \$16 billion. Therefore, the Federal Reserve could probably operate in this market without being an unduly disturbing influence. By buying and selling CD's, the Fed could directly influence the interest rates paid on time deposits by major commercial banks. Since CD's are a major source of funds, rates in this instrument probably have a strong influence on the lending policies of the big banks. Therefore, operations in CD's, which ultimately would have the same effect on bank reserves as dealing in Governments, would have an additional effect which might reduce the lag in monetary policy. Finally, it can be argued that the CD has replaced the Treasury bill as the fulcrum of the money market, that is, that various short-term instruments are very close substitutes to the CD, and their yields revolve around the rate on CD's. Recently, 3-month CD rates have averaged some 40 basis points above the Treasury-bill rate; commercial paper, acceptances and municipals have been offering yields comparable to the CD. The historically high spread over Treasury bills may reflect in part the fact that bills are appealing to a somewhat different group of investors. Open-market operations which directly affect rates on CD's could perhaps alter more quickly the rates on commercial paper (since the two instruments are sharp competitors for

corporate short-term investment funds) than could operations directly affecting Treasury-bill yields. In turn, lending policies of finance companies might be more promptly influenced. In short, open-market operations in CD's coupled with discretionary changes in regulation Q (which sets the maximum interest rates payable on time deposits) could add a potentially powerful weapon to the monetary policy toolkit. The apparent success of "operation nudge" would seem to indicate that institutional factors do exist which lead to a somewhat different impact when the vehicle of open-market operations is altered. This experience tends to buttress the possibility of advantageous effects resulting from operations in CD's.

To summarize, I believe that there would be no substantial economic effects if the Federal Reserve were to turn its portfolio of Governments over to the Treasury for retirement. I would oppose such a development on political grounds as it might reduce the independence of the Federal Reserve. I would recommend that the Federal Reserve expand its open-market operations in the longer term issues. Finally, I suggest that serious consideration be given to conducting some open-market operations in certificates of deposits since such a move might increase the effectiveness of monetary policy.

STATEMENT BY BENJAMIN HAGGOTT BECKHART, PROFESSOR EMERITUS
OF BANKING, COLUMBIA UNIVERSITY, NEW YORK, N. Y.

In response to your letter of September 1, 1965, respecting the open-market portfolio of the Federal Reserve System, if I may, I should like to reply to your questions seriatim:

1. I do not believe that the open-market portfolio of the Federal Reserve System should bear any definite or mathematical relationship to the money supply, to gross national product or to the aggregate of liquid assets.

2. The amount of Government obligations in the open-market portfolio of the Reserve System and the maturity distribution of those obligations should be determined exclusively by the Federal Reserve System in the light of its general credit policies of the moment.

3. The Federal Reserve System has on occasion used bankers' acceptances and foreign exchange to supplement its portfolio of Government obligations and might well do so in the future.

In fact the U.S. Treasury and the Reserve System have intimated that they might hold substantial amounts of foreign exchange, once the deficit in the U.S. balance of payments was eliminated. If they were to hold, for example, as many German marks as the German banking system has held American dollars, the total might reach the equivalent of \$2 billion.

4. The Federal Reserve System should not purchase municipal securities, corporate securities, mortgages, or commodities. The System would have to pass on the credit risks involved and make comparisons, for example, between one municipality and another. Comparisons of this type, would soon place the Reserve System in the center of political controversy. Similarly it should not purchase commodities. Action of this type would shortly involve it in price raising and fixing operations.

The Government obligations which the Reserve banks have purchased over the last 5 years have been acquired to offset the effect of gold exports and of the rise of money in circulation on member bank reserves. The System has, in effect, pegged the long-term rate of interest, no doubt with the full support and approval of the Treasury Department. In my opinion, action to offset the full effects of gold exports and of currency increases has been a mistake. The long-term rate of interest should be permitted to rise to rectify the imbalance in our balance of payments. Such is the policy which has been followed by other nations.

If the U.S. Government insists on a pegged long-term rate, the Federal Reserve System will not be able to protect the dollar in freely functioning foreign exchange markets. Either very extensive foreign exchange controls will have to be adopted, supplementing those already in existence, or the dollar will have to be devalued.

If one keeps in mind the fundamental accounting equation, that assets equal liabilities plus proprietorship, one realizes that assets cannot be transferred from the Reserve System to the Treasury without impairing the capital funds of the Reserve banks. Even if the capital were not to be impaired, such an operation would be completely unjustified. The Reserve banks turn over the bulk of their net earnings to the Treasury.

STATEMENT BY RICHARD L. BOLSTER, LONGMEADOW, MASS.

The question regarding transfer to the Treasury of some of the Federal Reserve System's portfolio as a means of debt reduction appears as academic since that portion of the debt held by the System is already effectively canceled in much the same way as a credit balance in the cash section of a stock account offsets the debit balance in the margin section. Moreover, the System pays over to the Treasury its earnings after subtracting operating expenses. Since these are very small compared to earnings they are likely to be largely covered by discount earnings leaving most or possibly all of the portfolio income for the Treasury in any event.

More constructive may be the removal of reserve requirements for time deposits since loans originating from the latter represent a conversion of saving rather than credit in the true sense as generated from demand deposits, the latter being the proper province of credit control.

STATEMENT BY W. ROBERT BRAZELTON, PROFESSOR OF ECONOMICS,
UNIVERSITY OF MISSOURI, KANSAS CITY, MO.

The question of the Federal Reserves' "holdings of Governments" to the extent of \$39 billion is an important one. I wish to make some comment on this subject. First, however, I would like to give my views on a letter mailed to me and others from E. Sherman Adams on the issue of reserves behind saving deposits.

On two points Mr. Adams is correct. The present reserve requirements of banks in relation to savings deposits as compared to other thrift organizations is discriminatory against banks. Also, the reserve

requirements against savings deposits serve no purpose in relation to monetary policy. However, he errs when he maintains that since the reserves do not serve a policy purpose, they should be eliminated. Reserves were not instituted for purposes of monetary policy. They were instituted for purposes of liquidity and safety. Therefore, instead of abolishing reserves behind savings, I would urge that all savings institutions have similar reserves and that these reserves need not necessarily be substantial.

One advantage that Mr. Adams claims for the freeing of these reserves is an increase in credit for expansion. True. However, it seems to me that a more effective and dynamic method of increasing long-term credit for growth is already available to us in the effective use of monetary and fiscal policy. Thus, Mr. Adams will have to use another argument to win my support on that issue.

The central issue of Representative Patman's interest and that of the Joint Economic Committee is of the substantial holdings of Governments by the Federal Reserve. The total is now \$39 billion. As Representative Patman pointed out, not all of this \$39 billion in Government holdings at the Federal Reserve is necessary for open-market operations. From June of 1964 to June of 1965 gross sales of all U.S. Government securities by the Federal Reserve on the open market never exceeded \$1 billion and only in November of 1964 was the net change in U.S. Government securities held by the Federal Reserve in excess of a billion dollars. Why then does the Federal Reserve hold \$39 billion in Governments? The answer is obvious. The increase in the Federal Reserve holdings has been necessary to expand the money supply so that the growth of the economy can take place.

The debt held by the Federal Reserve, however, should not be canceled as Mr. Patman desires. I do not say this from a strictly economic viewpoint. A cancellation of the repaid debt that the Federal Reserve owns (as is, I understand, the purpose of H.R. 7601) would lower the outstanding debt, allow the Treasury more leeway in deficit financing to stimulate the economy, and lower the interest payments necessary to service the debt at its present level. It is my professional opinion that all of these effects would be economically desirable. However, a question must be asked. Would the cancellation of even part of the debt held by the Federal Reserve lead to (1) the lack of confidence in the money market over the safety of holding Government debt for fear of further cancellation and/or (2) the opening of the door for the cancellation of the public debt held by other financial institutions? If either or both of these developments occurred a financial panic might be brought upon the entire money and capital market system. For this reason and for these fears (and as an economist perhaps I understand the importance of confidence more than a noneconomist) I am reluctantly forced to oppose the bill for cancellation of the Federal Reserves' holding of bonds regardless of whether they are matured or not.

There is, however, another reason for my not supporting the bill for cancellation of the matured Government holdings of the Federal Reserve. These holdings serve as part of the base for the entire monetary system. Thus, any question concerning the holdings of the Federal Reserve is not solely a question of open market policy but is also one of the backing of the monetary system itself. This point should not be missed. Representative Patman's proposal stresses the

fiscal effect of the bond holdings of the Federal Reserve as a cost to the Treasury without considering the bond holdings of the Federal Reserve as a significant part of our monetary backing. Therefore, even if the present matured bonds were canceled they would have to be at least replaced by non-interest-bearing notes on the Treasury with a firm guarantee of repurchase by the Treasury on the demand of the Federal Reserve unless we were willing to take the illogical step of weakening the "liquidity" of our monetary backing. Even this policy may have problems concerning public confidence. Let us not disturb the monetary system over a more or less minor point. We need to concentrate on the major problem that confronts us in relation to the Federal Reserve.

At the present time the more basic problem is not that the Federal Reserve holds \$39 billion in Government bonds of one type or another. The actual cost of this is more of a paper accounting cost than a real financial cost. The real problem is that the Federal Reserve has not allowed for an increase in the liquidity of the economy so that a faster rate of economic growth can be achieved. For example, in an article appearing on page 1 of the October 4, 1965, issue of the Wall Street Journal there is a report in the lead column that bankers are considering an increase in the interest rate. It is further reported that several large banks have already raised the rate which they charge to finance companies which, of course, is not going to cost the consumer of the final goods nothing. Furthermore, according to page 1282 of the September 1965 issue of the Federal Reserve Bulletin, free reserves of the banking system stand at minus \$143 million as of the week ending on August 25, 1965. A further look informs one that free reserves have been on the minus side since March of 1965 as well as in November of 1964. This is clearly not an "easy" money policy and may indeed be a "tight" money policy. The Federal Reserve is not making reserves available or is absorbing any excess reserves so that interest rates must eventually increase as there becomes a dearth of funds in the banking system for lending purposes.

Much economic analysis based upon Keynesian analysis seemed to prove that "money didn't matter." More recent Keynesian, neo-Keynesian, and post-Keynesian analysis realizes that Keynes never made such a statement. Keynes was talking about the special condition of a liquidity trap but did not say that a liquidity trap was a perpetual state of affairs. As a result, money does matter most of the time and so monetary policy is not neutral in its effect at all times. Because of this it is unfortunate that economists in Government and outside of Government have paid so little attention to the proper role of the Federal Reserve in relation to economic policy. It is proper for the Federal Reserve to act in an anti-inflationary manner when inflation threatens. It is not proper for the Federal Reserve to decrease growth rates when inflation is not threatening or when they merely fear that it might. It is true that there seems to be an upward bias in prices. Recently, however, this upward bias has been slight and has been due to institutional factors in our economy instead of inflationary economic policy. Some way must be found to make the Federal Reserve more effective in maintaining higher long-term growth rates and, when necessary, acting as an anti-inflationary agent. At present it seems to me that the Federal Reserve's policies are so consistently anti-

inflationary that they do decrease our long-term growth rates. I would suggest closer collaboration with the Council of Economic Advisers. This, of course, is not going to be an easy task but it is nevertheless the more basic problem.

In conclusion, I wish to say I do not agree with cancellation of the Government debt held by the Federal Reserve because I fear that this might bring about either a decrease in confidence or an excuse to extend this cancellation to private held debt, as well as a diminution of the monetary system's backing. For long-term growth, the economy needs an increase in the money supply and thus an increase in the means to back it, not less. I feel that a more important problem is the Federal Reserve's policy of independently acting in such a way as to decrease long-term growth rates by what I believe to be a too consistent tight monetary policy for the needs of the present times.

STATEMENT BY DWIGHT S. BROTHERS, PROFESSOR OF ECONOMICS (ON LEAVE), RICE UNIVERSITY, HOUSTON, TEX.

The large volume of Government securities held by the Federal Reserve System does raise a number of issues pertaining to monetary, fiscal, and debt management policy, as you and your fellow committee members well recognize. Instead of attempting to comment on the full range of these issues I shall, as you request, restrict myself to several specific points.

Government securities and the institutional practices which have been developed for effecting transactions in these securities between the Treasury, the Federal Reserve System, and the private commercial banks—as well as between these institutions and other financial intermediary, industrial, and individual investors—provide a sophisticated basis for our monetary and financial system. It would not be desirable to radically alter present arrangements because to do so would be disruptive and involve unnecessary risk. This is not to say, however, that some alterations—well planned and gradually introduced—would not be desirable. In the following paragraphs, three such alterations which I believe warrant serious consideration are indicated.

First, a useful extension of the role of Government securities in the monetary system would result from requiring commercial banks (and perhaps, also, other types of financial intermediary institutions) to hold some part of their reserves in this form. The advantages of such an arrangement would be as follows:

(a) The Government would be afforded a large and stable volume of relatively low-cost credit;

(b) Monetary policy would be more effective because greater control over the volume of bank holdings of Government securities would be possible;

(c) Federal Reserve holdings of Government securities in excess of amounts deemed necessary for effective open market operations and avoidance of debt management difficulties could be reduced; and

(d) Banks would be permitted to hold a greater portion of their reserves in interest-bearing form.

A second alteration in the Federal Reserve System's portfolio of financial assets warranting consideration by your committee is that

of a relative increase in holdings of other than Government securities. This could be brought about by expanding the role of rediscounting and also by extending open market operations into additional sectors of the securities market. The advantages of this procedure (which would amount to a revision in the direction of practices followed prior to establishment of the present dominant position of Government securities in the operation of the monetary system) would be as follows:

(a) The ability of the Federal Reserve System to directly influence the cost and availability of credit to various classes of borrowers would be increased, thereby permitting effective selective credit control;

(b) The Federal Reserve System would be better able to foster the development of various sectors of the securities market and the use of various financial instruments and, thereby, promote the development of desirable financial practices; and

(c) In general, the scope and effectiveness of both open market operations and rediscounting would be increased.

My third and final suggestion which has a bearing on the structure of the Federal Reserve System's portfolio of financial claims (but which relates more directly to the liability side of the System's balance sheet) pertains to the question of how increases in the currency component of the money supply should be reflected in governmental accounts. Because of the convenience which currency affords, the public, over time, is willing to hold a growing volume of this type of non-interest-bearing debt instrument. Under present arrangements the Federal Reserve System is the direct beneficiary of this interest-free financing in the sense that some portion of its asset acquisitions (and also of its operating profits) is attributable to the currency issue function. In fact, issues of Federal Reserve notes are usually associated with Federal Reserve acquisitions of interest-bearing Government securities. While the matter is perhaps not of fundamental importance since Federal Reserve assets are really public property and also because Federal Reserve earnings are largely transferred to the Treasury, nevertheless it might be a better arrangement to have all currency issues (as in the case of coinage) recorded as a direct obligation of the Treasury. The advantages of such a modification of the presently established arrangements between the Federal Reserve and the Treasury in this connection would be as follows:

(a) With the termination of functionless transactions between the Federal Reserve System and the Treasury associated with the currency issue process, the risk of public misunderstanding of our monetary system would be reduced.

(b) Instead of incremental currency issues being associated with increases in interest-bearing public indebtedness these issues would be in lieu of such additions.

(c) The resulting reduction in the growth of interest-bearing Government indebtedness and in the volume of Government interest payments would work to make the reported figures easier to interpret and thereby increase their usefulness as a basis for intelligent discussion and policy.

In conclusion, let me state that I do not believe arbitrarily determined criteria should be imposed on the management of the Federal Reserve System's portfolio of financial assets and that for this

reason I have not addressed my response to the specific questions asked in the fourth and fifth paragraphs of your letter. However, I do believe that some alterations in policies and practices currently being followed might be desirable—alterations which would certainly affect the Federal Reserve System's portfolio of financial assets—and I have attempted to present the cases for each of these in the previous paragraphs.

JOINT STATEMENT BY O. H. BROWNLEE, PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA, MINNEAPOLIS, MINN., AND IRA O. SCOTT, JR., ASSOCIATE PROFESSOR OF FINANCE, COLUMBIA UNIVERSITY, NEW YORK, N. Y.

1. How large a portfolio should the Federal Reserve System hold in relation to the money supply, the gross national product, or aggregate liquid assets?

Changes of the size of the Federal Reserve System's portfolio may provide the means whereby the central bank brings about changes in the money supply. Such changes in the money supply may be effected by other means, such as, for example, a change in reserve requirements. Therefore, there need be no necessary connection between the size of the portfolio and the money supply, or the GNP, or the aggregate level of liquid assets. It is true however, as a matter of practice, that changes in reserve requirements are employed infrequently and, as a consequence, changes in the portfolio are regularly used to bring about changes in the money supply and to maintain the desired relationship between such changes in the money supply on the one hand, and the changes in the GNP and aggregate liquid assets on the other hand. In a growing economy, the money supply should grow in corresponding fashion, allowing, of course, for the growth of other liquid assets. Such a growth in the money supply may be provided through increases in the Federal Reserve System's portfolio. That is to say, if the Federal Reserve System increases the size of its portfolio, the money supply and the reserve base of the money system is automatically increased at the same time, assuming that other factors affecting bank reserves are held constant. So long as the size of the portfolio is growing, there is no particular need to have a portfolio of any particular size. Only if the Federal Reserve System wished to induce a contraction in the money supply might there be a need to reduce the size of the portfolio. In this case, it might be useful to have securities available to sell. In principle, however, it would not be absolutely necessary to have securities on hand; for the Federal Reserve System might be given the authority to create its own obligations which in turn could be sold in the open market and thus used as a means of reducing or restricting the money supply. Central banks in other countries possess growth of such statutory authority.

2. Is any other criterion more appropriate?

As explained in question No. 1, there is no particular criterion which is necessarily appropriate. However, given the present operating practices of the Federal Reserve System, the minimum size of the portfolio might readily be determined by taking the maximum reduction in the size of the portfolio during, let us say, the past decade

and a half. Such a figure, with allowance for unforeseen contingencies, would provide a suitable standard.

3. If the portfolio grows too large compared to this standard, what should be done with the excess?

The disposition of such an excess should be determined by the decision of Congress with respect to the desirable degree of independence that should be exercised by the Federal Reserve System.

4. Should the assets be transferred to the Treasury for cancellation?

If it is the sense of Congress that the Federal Reserve System should regularly apply to the Congress for annual appropriations in order to finance its operations, any portfolio excess should be transferred to the Treasury for cancellation.

5. Should the Federal Reserve continue to hold them, draw the interest, and return the unexpended balance to the Treasury?

If, on the other hand, it is felt that the Federal Reserve System should, unlike the Department of Defense or other governmental agencies, be free to operate independently of the congressional appropriations system, then the current practice should be followed according to which the Federal Reserve continues to hold and draw interest upon its portfolio while returning any excess income to the Treasury. The implications of this arrangement are, of course, that the taxpayer in effect finances the operations of the Federal Reserve System although Congress exercises no direct control over these operations via the appropriations system.

6. Can we design other objective standards by which to guide Federal Reserve portfolio operations?

The size of Federal Reserve portfolio operations should be thought of as a means to an end, not as an end in itself. In other words, these operations should be used in whatever way is appropriate as a means of achieving the overall objectives of monetary and related economic policies.

7. Should we lay down standards relative to the kind of assets to be held, maturity composition, private versus public instruments?

Normally, the Federal Reserve System will execute monetary policy in a way designed to provide the economy with price stability and full employment. Its intermediate objectives will involve the level of interest rates and the quantity of money. These intermediate objectives can be achieved without varying the maturity composition or private-public mix of its open-market portfolio. There are persuasive technical reasons for limiting Federal Reserve operations to relatively short-term obligations of the U.S. Treasury.

8. Should the Federal Reserve supplement its portfolio of Federal Government securities with other types of assets such as commercial loans, foreign exchange, municipal securities, corporate bonds, mortgages, commodities?

In a period of severe economic crisis, consideration might well be given to the possibility of open-market operations in assets other than Government securities. Again, some central banks abroad enjoy such statutory authority. Barring a serious crisis, however, it would probably be better to restrict the central banks' acquisitions to U.S. Treas-

ury securities. The reason for this lies on the difficulty of determining precisely which of the alternative sectors of the capital market should be selected and for how much support.

Thank you again for the opportunity of participating in your survey.

JOINT STATEMENT BY KARL BRUNNER AND ALLAN H. MELTZER, GRADUATE SCHOOL OF INDUSTRIAL ADMINISTRATION, CARNEGIE INSTITUTE OF TECHNOLOGY, PITTSBURGH, PA.

No critical issues of monetary policy, debt management, or fiscal policy are raised by the size of the Federal Reserve's portfolio of securities. From the standpoint of monetary policy, the most important items on Federal Reserve's consolidated balance sheet is the volume and rate of change of Federal Reserve monetary liabilities—reserves plus currency, the monetary base. Unless the proposed changes in the volume of securities held by the Federal Reserve banks produce changes in the monetary base, they will have no important monetary consequences for the economy. If H.R. 7601 or similar legislation is enacted and \$30 billion of interest-bearing securities are replaced by the same amount of non-interest-bearing, nonnegotiable Treasury securities (or by a \$30 billion reduction in the net worth of the Federal Reserve banks), the monetary base would be unaffected. Such legislation would have no monetary effect.

Debt management and fiscal policy also would be largely unaffected. Since the Federal Reserve is part of the Government sector, any relevant measure of Government debt outstanding excludes the Federal Reserve's holdings. Moreover, the Federal Reserve repays to the Treasury by far the largest part of the interest payments received from the Treasury. The possible consequences of interest payments by the Treasury to the Federal Reserve are, therefore, minimized. Refunding operations that affect the portion of the debt held by the Federal Reserve are, or can be, carried out in a routine way. In short, the ownership of approximately \$39 billion of Government debt by the Federal Reserve reflects accounting and institutional arrangements that do not have important consequences for the economy.

The question of the use of objective standards to guide Federal Reserve operations opens an important issue for discussion. Open market operations are dominated all too frequently by so-called defensive operations directed toward reducing interest rate fluctuations in a narrow corner of the securities market. It would be highly desirable to eliminate defensive open market operations. To achieve that end; to provide more stable monetary growth; and to reduce fluctuations in prices, output, and employment, we recommend the following procedures:

1. The Federal Open Market Committee should decide on the appropriate growth rate of the money supply, currency, and demand deposits for a 6-month or longer period.
2. The desired growth rate of the money supply should be translated into a desired growth rate of the monetary base.
3. At each meeting, the Committee should ascertain that the Manager is achieving the target growth rate of the monetary base.

4. Authority and explicit responsibility for dealing with changing money market conditions should be delegated to the Manager with the requirement that he must maintain the desired growth rate of the base.

5. The discount windows should be open at a penalty rate.

6. Bankers should be permitted to borrow as much as they desire at the penalty rate, but changes in the volume of borrowing should not interfere with the maintenance of the chosen growth rate of the base.

The essence of the proposal is that banks would solve the problem of distributing reserves, which is a large part of the money market or day-to-day problem, by borrowing at a penalty rate. The Federal Open Market Committee would devote principal attention to choosing the growth rate of the monetary base that is appropriate to achieve policy objectives and would assure that the selected growth rate of the base is maintained.

Attainment of objectives of monetary policy does not depend on the use of a particular type of security or maturity class in the conduct of open market operations. Determination of the securities eligible for purchase or discount should be left to the Open Market Committee. Their discretionary authority should not be restricted by the use of formulas or other restrictions on the portfolio composition of the Federal Reserve banks. Abolition of the restriction which requires that a portion of the monetary liabilities be covered by gold or gold certificates would be a useful step in this direction.

STATEMENT BY HOBART C. CARR, CHAIRMAN, DEPARTMENT OF BANKING AND FINANCE, SCHOOL OF COMMERCE, NEW YORK UNIVERSITY, NEW YORK, N. Y.

The series of questions asked by the subcommittee may be classified into three main issues:

1. The determination of the optimal size of the Government security portfolio of the Federal Reserve.

2. The disposition of the securities in excess of this optimum or the income on those excess securities.

3. The determination of the appropriate composition of the Federal Reserve portfolio whatever its size both as to maturity and the type of security.

Underlying these three issues is an unstated fourth; namely, the issue of how much latitude the Federal Reserve policymakers should have in determining policy in general and the three listed issues in particular.

My position on the last, unstated but implied, issue is this: The Federal Reserve should have the widest latitude possible within its field as is consistent with broad national economic objectives. I believe that the "independence" of the Federal Reserve serves a useful "check and balance" purpose and I have no fear that the Fed will use that independence even mistakenly, to oppose an important and appropriate national economic policy. I further believe that any confrontation with the administration over a specific policy will be resolved on the merits of the case; if the Fed is right, it will win; if it is wrong, it will lose.

I hold these and views on the first of the three issues. I suggest that the Fed is appropriately equipped to judge what the optimal size of its portfolio shall be. Not that there is, in my view, any single measure, either from among those mentioned in the subcommittee's inquiry or from other sources, or any combination, which will yield a correct answer on that optimum. But since all the Fed does have the power to alter reserve requirements and since these requirements are an important determinant of the size of the portfolio, it can be maintained that only the Fed can judge the exact optimum, if there is any; others may assume this part of the problem away by assuming unchanged requirements but such an assumption is unrealistic.

Apart from the reserve requirement consideration and the attendant consideration of public preferences as among the types of deposits—demand or time, which carry different reserve requirements—there are others of importance. Among these are the gold stock and other sources and uses of bank reserves. If, for example, the gold stock were to decline further, further purchases of Government securities would probably be required, so as to maintain the existing volume of bank reserve, thus enlarging the Fed's portfolio. If, on the other hand, the gold stock were to rise abruptly, a reduction in the security portfolio might be appropriate.

On the first issue, then, it can be said in sum that no one, including the Fed, can fix a formula for setting the optimal size of the Fed's portfolio of Government securities.

The second issue can be solved on the basis of the first. If no one can determine the optimal size of the portfolio, it follows that determination of the excess cannot be made. This should not be taken to mean, however, that is impossible to determine "excess" or unneeded income accruing to the Federal Reserve. Nor should it be taken to mean that the Fed "needs" its entire portfolio in its present form (marketable securities). On the matter of unneeded income, it should be pointed out that the Fed already returns substantial income to the Treasury. (I would prefer that this capture be made through a franchise tax and I suggest that this tax be enacted.) Alternatively, a part of the Fed's portfolio could be made to consist of non-interest-bearing, nonmarketable securities. Certainly in the sense of having a sufficient volume of securities for open-market sales, some large part of the Fed's portfolio is "excess" and from the standpoint of needed income to the Fed, there is also an "excess." It follows, therefore, that the above alternative is possible, although perhaps meaningless (since the Treasury already receives the excess income).

On the third issue, I again maintain that the Fed should be the judge—not a statute—of the appropriate composition of its portfolio—short maturities versus long, public versus private securities. This is not to say that I have always approved of the Fed's choice; for example, I disagreed with the so-called bills only policy. I must admit, however, that although some harm resulted from the policy, it was not serious, in my view.

As for my advice to the Fed on the matter, I would say that their present choice as to maturities and as to private (banker's acceptances) versus public instruments are the appropriate ones. Should the subcommittee wish to recommend an expansion of the list of instruments eligible for purchase, and the Congress wishes to put into law an

expansion, I see no great harm (or benefit). Further, if the subcommittee wishes to strike from the present list some securities which no longer exist, I see no harm (or real benefit) in that step either.

STATEMENT BY JACOB COHEN, PROFESSOR OF ECONOMICS, UNIVERSITY OF PITTSBURGH, PITTSBURGH, PA.

VIEWS CONCERNING THE STRUCTURE AND MANAGEMENT OF THE PORTFOLIO OF FINANCIAL ASSETS HELD BY THE FEDERAL RESERVE SYSTEM

The Federal Reserve should manage its portfolio of assets primarily for the purpose of influencing the level of aggregate money demand. In pursuing this objective it should of course have an eye both to inflationary possibilities and the monetary requirements of economic growth. (We would give concern with the balance-of-payments problem a low order of priority.)

The mechanism whereby the Federal Reserve affects ultimate economic activity is relevant to evaluating portfolio policy. The open-market operations of the Federal Reserve accomplish several objectives. They have an immediate effect on the money supply insofar as transactions take place with the nonbank public. They increase the reserves of commercial bank. They affect interest rates. As far as the choice of securities are concerned, whether the operations took place in Government obligations or corporate securities, the effects on the money supply and on reserves would be similar. It is with respect to interest rates that the choice of securities exerts a unique effect. Thus the purchase of long-term Government securities can be assumed to have a more immediate effect on the long-term interest rate than would the purchase of short-term Treasury securities. Similarly the purchase of long-term corporate bonds would be assumed to have more of a direct effect on yields than the purchase of long-term Treasuries. One should also make a distinction between the new issues market and the market for outstanding securities. The effect on new borrowings for the purpose of product expenditures should be much more direct and immediate if the open-market transactions take place in the new issues market rather than in the market for outstanding securities. Given the objective of stimulating given sectors of the economy or certain types of spending, transactions in corporate securities (bonds) mortgages, municipal securities, should be a desirable extension of present open-market practices. More hesitation should be exercised about extending operations in foreign exchange beyond their present scope because involved are questions of the relative merits of fixed versus floating exchange rates. We should also hesitate in recommending commodity transactions since this would mark an unnecessarily sharp break with the traditional "financial" scope of monetary policy. Open-market operations as at present constituted are sufficient to influence commercial bank lending in the desired direction, without direct participation of the Fed in this market.

We can see little purpose being served by canceling "Governments" held by the Federal Reserve. Presumably some equivalent certificate—irredeemable and noninterest bearing to be sure—would have to be issued by the Treasury in its place. But if the excess of interest in-

come over expenses are returned to the Treasury as at present, Federal Reserve holdings are already free of interest cost. As far as the principal is concerned, the rolling over of the debt by the Treasury—if it chooses to do so—makes it a perpetual obligation. The existing distribution of the marketable debt among the Fed, commercial banks and the nonbank public together with the “tailoring” features assigned to new issues, furnishes the Federal Reserve and the Treasury (hopefully acting in harmony) with a powerful and flexible weapon for policymaking.

STATEMENT BY WALTER P. CORRIGAN, NORTH MIAMI BEACH, FLA.

In acknowledgement of your inquiry of September 1, 1965 concerning the solicitation of views pertaining to the “structure and management of the rapidly growing portfolio of financial assets held by the Federal Reserve System.” Rather than attempting to answer directly each of your questions, I have decided to comment briefly on the August 24, 1965, progress report addressed to the “citizens interested in returning our monetary system to the people of the United States” from the Honorable Wright Patman, 1136 House Office Building, Washington, D.C. I have decided to acknowledge the letter of September 1 in this way for two reasons: (1) The material contained in the progress report is very closely related to the subject matter covered in the questions; (2) my views on a few of the fundamental points raised in the progress report are a bit less vague than are those pertaining to a few of the specific questions raised in the September 1 letter. I might add that I am somewhat pressed for time, and this, then, enhances the importance of reason No. 2.

The Honorable Patman has distinguished himself for many years for his knowledge of the U.S. money and banking structure and for his courage in pressing for those reforms he has deemed necessary to the welfare of the entire Nation. I could not possibly present a record of experience, by way of a letter of recommendation for my views, that would be even within sight of Congressman Patman’s background of accomplishments. However, for whatever little value this may be to anyone, I should like to record my disagreement with several of Congressman Patman’s views. I believe that these are fundamental points and, therefore, basic to a more advanced analysis required in answering the specific questions listed in the September 1 letter.

Because of the scarcity of time, that which follows will consist simply of very brief comments addressed to various statements appearing in the progress report and which I have selected somewhat at random.

In statement 6 there appear the following words: “Another great privilege enjoyed by the commercial banks is monopoly. All individuals and corporations desiring checking accounts are compelled to patronize commercial banks.”

My comment would include the following question: In a single community why would there be greater competition between a savings and loan association, for example, and a commercial bank (assuming, for the moment, that both institutions have the authority to create

demand deposits (check book money)) than there would be between two commercial banks?

In statement 6 there appear the following words: "The banks get free use of the billions of dollars in Federal deposits that are maintained in the commercial banks. * * *"

My comment would include the following: In part, this is a service to the public. For example, businessmen enjoy the convenience of depositing their withholding taxes with the same commercial banks that they have other business to conduct with. Furthermore, it is, in part, a payment to the commercial banks for services rendered to the Federal Government such as the expense incurred in selling Treasury savings bonds. Furthermore, it is a service to the economy since it is an effective device for maintaining the quantity of money within the private economy at a stable level. Remember that the money within these Federal deposits most likely come from private accounts with the commercial banks. This is not new money for the commercial banks, therefore. One account is debited and another is credited, and the quantity of money has remained at a stable level.

In statement 5 there appear the following words: "* * * the commercial banking system is privileged to manufacture money under the fractional reserve system at a ratio of \$10 for every \$1 of reserves."

My comment would include the following: This is a fallacious statement since it implies that only the commercial banks can create money. Many other private financial institutions can do the same thing. For example, consider the case of a dollar deposited in a savings and loan association. Most of it is then lent out. The likelihood is strong that the loan will be placed into the hands of a building contractor who, in turn, will deposit it in his business account at a commercial bank. Part of this can be lent out by the commercial bank, and I suppose that you are referring to this action as the creation of money. Suppose, now, that the loan finds its way back into a savings and loan association. Now the savings and loan association can do the same thing that the commercial bank did with the exception being that the savings and loan association can lend a greater proportion of what they have. Now you will probably tell me that the deposit with the savings and loan association is not considered to be a part of the money supply whereas the demand deposit with the commercial bank is. This type of definition involves some sleight of hand, but even if I should accept it for the moment, you have overlooked one vital point: The savings and loan association has increased the velocity of money in the same way that the commercial bank does this; they have lent out some of the same money a second time. And any monetary theorist who knows his fundamentals will tell you that an increase in velocity has the same effect on prices, etc., as does an increase in the physical quantity of money—remember the old equation P equals M times V ?

In statement 6 there appear the following words: "* * * the people of the United States are captives of the commercial banks and they must give the commercial banks free use of their money under the law."

My comment would include the following: The type of situation that you are referring to here could be described in another way: The commercial banks, in return for a small deposit from the people, give back to the people a much larger supply of money, and they do this for a

very low fee. Now you have argued that this fee is excessive. But if I pay 15 cents for a check drawn on a Miami bank and use this check to pay a bill incurred in South Bend, Ind. (when considering the service that I receive and the complex structure the check passes through), then I call this inexpensive. However, I do recognize that this particular issue does depend upon cost data (that I do not have and that you probably do have) in order that one might make an intelligent evaluation of it.

In statement 7 there is the following implication: Commercial banks in the United States are relatively free to do as they please.

My comment would include the following: No private industry of comparative size is more tightly controlled by the Government today than is the banking industry. Commercial banks do possess significant advantages, but also are they subject to very rigid controls. If you propose to take away some of these advantages, would you also remove some of these restrictions (such as the restriction on interest rates that may be paid on savings deposits)?

In statement 2 there appear the following words: “* * * these three agencies have succeeded in setting themselves up on an independent basis whereby they are able to get their operating funds directly from the public in the form of interest payments and fees, and bypass the Congress. * * * Moreover, each of these three agencies conducts its own examinations and audits of banks. * * *”

My comment would include the following: This is certainly not the only illustration within the structure of the Federal Government of an independent agency relying upon funds received directly from the public. We both are aware of several successful cases of “independent” and “semi-independent” Government corporations. Furthermore, it is misleading to say that these entities “bypass the Congress.” Congress has the ultimate control over every single one of them. Their structures have been designed in the way that they have in order that the so-called political influence might be as far removed from their business operations as possible. Concerning the duplication of examinations and audits of banks, you have supported one of the principles lying behind this in your words appearing in statement 8. You have said that your bill “would require that the Federal Reserve undergo outside audits. * * * “If one agency examines a bank twice, that is duplication; if two agencies each examine a bank once, that is confirmation—all of which is designed, of course, to achieve the eradication of fabrication (or ought we better say simply the mitigation of conditions that might facilitate the generation of misinformation?).”

In statement 7 there appear the following words: “* * * it is going to take a real fight * * * to get the three supervisory agencies that have escaped from congressional control back into the Government and subject to Presidential and congressional control, where the Members of Congress, elected by the people in accordance with the Constitution, can properly review their activities.”

My comment would include the following: Of course these agencies are subject to Presidential and congressional control. True, they are not subject to the day-by-day operational control that are other Government agencies, but this is desirable. To those who doubt this and who would favor, for example, the proposal to place the central bank under direct control of the Treasury Department, I would suggest a careful reading of the history of the Bank of France.

In statement 6 there appear the following words: The banks “* * * enjoy interest on billions of dollars in Government bonds that were purchased with the credit of the Nation.”

My comment would include the following: The U.S. commercial banking system today is stronger than it has ever been in history. One of several reasons for this is the availability of large blocks of safe U.S. Government securities. As a result, the banks have invested heavily in these securities and, therefore, are highly liquid. Of course, they pay interest; there would be no point in the banks buying these securities if they did not. Concerning the charge that they were purchased “with the credit of the Nation,” for the use of this credit the banks, in turn, supply the Nation with several services, one of which is the availability of checkbook money. In conclusion, if there were no Federal securities for the banks to invest in, where would the banks place these funds? In whatever other direction the banks turned the result would be a decline in liquidity. You might suggest that the banks leave the funds on reserve, but the banks must invest for income if they are to continue supplying the Nation with their various services. In the 1920's the banks placed a good deal of their funds into real estate, and this certainly did not mitigate the evils that were to follow in the early 1930's.

In statement 5 there appear the following words: Speaking of the commercial bank reserves, you say, “* * * the reserves are not actually money set aside, but only a bookkeeping entry in the form of a credit by the Federal Reserve System.”

My comment would include the following: From the point of view of the commercial banks, the money is there for they would use it if their legal reserve requirements were lowered. Furthermore, the reason that there is not the volume of hard cash sitting inside the Federal Reserve that many people think there ought to be is that the Treasury Department is continually borrowing from the Fed and, thus, keeping the cash in circulation. In turn, of course, the Fed finds it has a larger and larger volume of Federal securities on its hands—something that you have expressed concern about in your statement 1.

In statement 3 there appear the following words: The banks charge “usurious interest, excessive service charges * * *.”

My comment would include the following: This statement may be true; I do not have the quantitative data necessary to make a really scientific analysis of this issue, but if it is true, why do you not initiate or support legislation that would permit the banks to pay back to the public some of the fruits of these excessive charges, namely, the freedom to pay higher interest rates on savings deposits?

In statement 6 appear the following words: “In the very depths of the depression, when Congress was struggling to correct some of the misery and poverty that afflicted the whole Nation, the banking lobby slipped through a law that prohibited banks from paying interest on demand deposits * * *. As a result, the people of the United States are captives of the commercial banks and they must give the commercial banks free use of their money under the law.”

My comment would include the following: There may be some truth in the first sentence, but surely you must know that no banking law is violated more than (or, in fact, as often as) by the commercial banks as section 19, statement 13 of the Federal Reserve Act. This would

seem to indicate that many bankers do not look with favor upon this legal prohibition.

In statement 1 there appears the following argument: U.S. bonds held by the Federal Reserve have been paid for once and will "have to be paid again when due. This is similar to a situation where a house-owner paid off his mortgage and was then required to continue paying interest on it, and then pay it off again when the maturity date comes around. It would be illegal and absurd in the case of an individual, but that is exactly what the Government is required to do under our present banking structure."

My comment would include the following: I have saved this argument for the concluding part of my letter for two reasons: (1) Congressman Patman apparently believes that this is his strongest and most important argument—he refers back to it again and again. (2) From my point of view, it is the most erroneous of his arguments. Before presenting my comment, I ought to preface it with the following statement. I strongly suspect that there is something quite basic here that I am confused on. Perhaps my chain of thought here is even less clear than it has been in my wanderings through the previous statements; I say this because Congressman Patman's argument appears so absurd I find it difficult to believe that the words mean what they seem to mean. I would agree that commercial bank ownership of Federal Reserve stock is a sleight-of-hand procedure disguising the fact that the Federal Reserve really represents the U.S. Government, and, therefore, bonds sold to the Fed are paid for by the Government; but, remember that these bonds are sold to the Fed by the Treasury which certainly represents the Federal Government as well. This is like moving a dollar bill from my left pocket to my right. I may certainly want to know that the dollar is now in my right and not my left. But, if later I should move the dollar back to my left, have I lost anything? You may complain of the left paying the right interest while the dollar is in the right pocket. But remember that the right will later on pay back to the left the major portion of all of its profits. Now let us consider the issue in straightforward terms. After the Treasury sells bonds to the Fed, it places these funds into the private economy to pay its bills. Later it will draw money out of the economy in the form of taxes and pay off the bonds. The Treasury and the Fed will then be back where they began. If you should complain that the Treasury is not buying back all of these bonds, then this is a problem of insufficient taxes. Refer the matter to Chairman Mills. The point is that the Federal Reserve is simply a go-between here; the entire operation could be handled in other ways. For example, suppose that the Treasury printed paper money, paid its bills with these funds, later pulled the money back out of the economy through the use of appropriate tax rates, and then burned the money. The ultimate effect would be the same as it is with the Treasury using the more "politically" acceptable method of the Federal Reserve acting in the capacity of a go-between. There might be one difference, however; under the present method the Federal Reserve can act as a restraining force on any impulsive, temporary, and extravagant acts of the Treasury—acts that could more easily occur were the Treasury given greater freedom in the use of its printing press.

STATEMENT BY MARRINER S. ECCLES, CHAIRMAN OF THE BOARD, FIRST SECURITY CORP., SALT LAKE CITY, UTAH

I have read your letter with interest and note you want my comments relative to the growth of the Federal Reserve System Government securities portfolio and also several other issues. I have just read Chairman Martin's statement before your committee and also his letter to you of August 19, 1965, in response to your letter of July 15 in which he answers a number of questions raised by you and other members of the committee. I am in general agreement with the position taken by Chairman Martin so that further comment by me would be superfluous.

STATEMENT BY IRA T. ELLIS, ECONOMIST, E. I. DU PONT DE NEMOURS & CO., INC., WILMINGTON, DEL.

It is a pleasure to give you my views on the questions raised in Mr. Patman's recent letter concerning Federal Reserve management of its portfolio of Federal securities.

It is true that Federal Reserve holdings of Federal securities rose \$15 billion over the past 10 years, to \$39.2 billion, but almost one-half of this rise was related to the decline of \$6.8 billion in our monetary gold stock since 1955.

Another reason for the relatively rapid rise in Federal Reserve holdings of Federal securities to expand bank reserves over the past decade was that loans and investments of commercial and mutual savings banks in mid-1965 were up 85 percent from their total in June 1955. The rise in "real" gross national product over this period was only 38 percent. This situation represents true "inflation"; i.e., expansion of bank credit at a rate faster than the corresponding rise in real output of the economy. A slower rate of expansion of bank credit over the past 4 years would have required a lower rate of purchasing Federal securities by the Federal Reserve System.

I believe the size and composition of the portfolio of Federal securities held by the Federal Reserve System should be determined by the Federal Reserve authorities on the basis of their judgment of the need to provide bank credit in the economy. Federal securities are an appropriate instrument for purchase by the Federal Reserve to expand bank reserves. There is a sufficient supply of Federal securities in existence, and the supply continues to grow by authority of congressional action. There seems to be no need to substitute other kinds of securities in central bank reserves.

Certainly, there should be no suggestion that Federal securities owned by the Federal Reserve should be returned to the Treasury and canceled. This procedure is tantamount to "running the printing presses." Congress should authorize Federal tax rates. Federal spending, and, therefore, the magnitude of the Federal debt. An independent Federal Reserve should determine monetary policy. Certainly, the money-creating power of the central banks or of commercial banks should not be used to provide spending power for the Federal Government in peacetime. The Federal Reserve should remain free to buy and sell Federal securities in the market, to hold appropriate quantities, to draw interest on them, pay its expenses and dividends, and return the unexpended balance to the Treasury.

STATEMENT BY WILLIAM J. FELLNER, STERLING PROFESSOR OF ECONOMICS, YALE UNIVERSITY, NEW HAVEN, CONN.

I am sure all members of the economics profession consider it a privilege to be called upon to try to clarify matters that have become controversial between personalities prominent in the making of economic policy. My views may be expressed in the following three paragraphs:

(1) The Government security holdings of the Federal Reserve System should, in my opinion, give rise to no misgivings whatever, as long as we are satisfied with the allocation of Federal Reserve profits between the shareholders and the Government—as I take it we are. Unless we should want to consider the Federal Reserve banks Government agencies in the sense proper—and I would not suggest so considering them—the Government cannot be said to pay for the securities at the time when the System buys them, but the Government must be regarded as paying for the securities on the one and only occasion when they mature. Even on the interpretation that the Federal Reserve is “essentially part of the Government”—an interpretation which in this context I find inappropriate—the conclusion would still be that the Government pays only once, because on this interpretation the “Government” would have to be considered as paying on the one and only occasion when the Federal Reserve System acquires the securities.

In other words, I am in agreement with Mr. Martin’s statement, and I feel convinced that no useful purpose would be served by imposing on the System rules requiring the transfer of securities to the Treasury for cancellation. I do not even see what assets the Federal Reserve banks could carry on their books under such rules; that is to say, what assets they could carry as against their corresponding liabilities, which after all are not liabilities vis-a-vis the Treasury but are liabilities vis-a-vis the commercial banks.

(2) I feel convinced that it would be unfortunate to let the Federal Reserve System buy corporate bonds, make corporate loans, etc.—that is to say, to let the System enter into a direct relationship with individual users of bank credit—since the Federal Reserve banks should not take it upon themselves to favor or to penalize various users. The function of the allocation of bank credit should be left to the market.

(3) I feel convinced that it would be unfortunate to lay down rules as to the proportions in which the Federal Reserve banks should hold the different kinds of assets they are now holding. This proportion must be allowed to change with business conditions, and the Federal Reserve should be allowed to use its judgment in the appraisal of these conditions. I may add that I hope that as the present expansion continues the money market will be sufficiently tightened to enable the authorities to remove the measures of capital-export control which were introduced this year, and to remove also the earlier interest-equalization tax. These are undesirable discriminatory measures.

These are the views I take the liberty of submitting in response to your inquiry.

STATEMENT OF CHARLES A. FRANKENHOFF, PROFESSOR OF ECONOMICS,
COLLEGE OF SOCIAL SCIENCES, UNIVERSITY OF PUERTO RICO, RIO
PIEDRAS, P.R.

In my doctoral thesis, "The Economic Independence of the United States Monetary System," I came to the unfashionable conclusion that the Federal Reserve monetary authority is not the powerful, independent institution it appears. As a political structure, it certainly has considerable independence, especially when one considers its freedom from congressional budget committees. Economically, however, it is an integral part of the U.S. monetary structure.

The Federal Reserve is not, I believe, an independent variable in the money market. It serves that market to stabilize it, to help it grow solidly, to protect it from sudden changes in exogenous forces. It does not rule the market. You recall very well, I am sure, the Federal Reserve-Treasury accord in March 1951. Prior to that time we had no monetary policy worthy of the name. In other terms, the Federal Reserve monetary authority depends on the continuing existence of a strong open market. If the Federal Reserve foolishly seeks to dominate that market, it will immediately destroy its freedom. The dealers will withdraw their initiative. They will not make a market.

In the last 4 years I have been out of contact with the changes (detailed) which have taken place in the Fed's portfolio. My work has been in connection with the development of an economic housing policy which is to be found on the same spectrum with monetary policy and fiscal policy. For this reason I shall not attempt to answer your provocative questions.

STATEMENT BY THOMAS G. GIES, PROFESSOR OF FINANCE, GRADUATE
SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF MICHIGAN,
ANN ARBOR, MICH.

In brief, my recommendations are as follows:

1. The present system of Federal Reserve bank ownership of Treasury issues should be continued essentially without modification. That is, there should be no upper limit on the portfolio of the Federal Reserve, despite the fact that there is evidence of substantial secular growth in this portfolio. Such accumulation of securities does not represent absorption of economic resources of the Nation and, therefore, while purchase represents effective payment by an agency of the Government for the debt, it constitutes no real burden on the Nation. While present arrangements for financing operations of the Federal Reserve are somewhat unique, they function very satisfactorily and involve neither burden nor special risk to responsible use of public money. There is clear parallel between accumulation of securities by the Fed and accumulation by Federal trust funds.

With respect to payment of interest to the Federal Reserve on these securities, I recommend continuation of the present arrangement under which Federal Reserve income in excess of operating expense be returned to the Treasury in the form of a special tax. My

experience with Federal Reserve budget administration convinces me that the present arrangement has not given rise to excessive or profligate operating budgets by the Reserve banks or the Board of Governors.

2. With respect to the proposal to lay down standards relative to the type of assets to be held (including quality, maturity, public versus private issues), I recommend only general guidelines designed to prevent gross misuse of the monetary authority. I feel that maximum freedom and flexibility of action for the monetary administration in selecting the particular issues should be preserved.

The theoretical issues involved in the area of financial markets and types of securities—government versus private issues, short versus long maturities, etc.—are not at this time well enough established to consider embodying instructions in statutory form. Rather, it is of importance to leave “elbow room” from the monetary authority to explore new methods and modify old methods in the area of open market operations. Circumscription of operations by statute or regulation would be contrary to the long-run interests of good monetary management.

STATEMENT BY J. A. GREENE, JR., DEAN, SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF SOUTHERN MISSISSIPPI, HATTIESBURG, MISS.

I am not concerned with the dollar amount of Government securities the Federal Reserve holds. Why they must continue to build their holdings is of more concern to me for as you know this is the most inflationary method by which the Treasury can finance deficits. You were concerned that in 1958 the commercial banks added \$10 billion of Government securities to their holdings. I was, too, but I would have been more concerned if the Federal Reserve had had to purchase them.

I do not think it was ever intended that the Federal Reserve would reluctantly wind up with more Government securities than it thought feasible to hold. I can see nothing wrong with disposing of these either to the public or to the banks if it can be done without upsetting the economy or Treasury financing. If the Treasury issues a bond and considers it a bona fide debt of the Federal Government, then this bond may be bought and sold freely just as the debt of General Motors. Therefore, I think the Federal Reserve, with full cognizance of its public responsibilities, should have the right to decide on the basis of its knowledge of the economy, the banking system and the money supply whether it should dispose of some of its holdings to the public or to the banks.

Frankly, sir, I would be appalled at the idea of making the Federal Reserve solely a moneymaking tool of the Treasury by removing its independence. This I perceive to be your intention after reading parts of “A Primer on Money.”

Since I have a great deal more confidence in the opinions of the Board of Governors who are dealing with these matters constantly and are less subject to political pressures than Members of Congress, my principal recommendation is that decisions relating to monetary matters be left up to the Federal Reserve by Congress.

I am definitely opposed to transferring the securities back to the Treasury for cancellation. I do not think standards relative to the kinds of assets to be held by the Federal Reserve should be imposed. I do not think the portfolio of the Federal Reserve should be in any proportion to another flexible criterion. In fact, as time brings changes and crises must be met, I merely ask that the Federal Reserve be staffed with competent people and be given the flexibility to meet its responsibilities.

STATEMENT BY WARREN J. GUSTUS, CHAIRMAN, DEPARTMENT OF FINANCE AND STATISTICS, COLLEGE OF BUSINESS ADMINISTRATION, DREXEL INSTITUTE OF TECHNOLOGY, PHILADELPHIA, PA.

HOW LARGE A PORTFOLIO SHOULD THE FEDERAL RESERVE SYSTEM HOLD IN RELATION TO THE MONEY SUPPLY?

Currently, Federal Reserve holdings of U.S. Government securities are in excess of \$39 billion. With present reserve requirements only a fraction of this amount is necessary to insure that the Federal Reserve has the ability to control any undesirable expansion of the money supply. Transfer of some of these securities to the Treasury for cancellation would reduce the administrative costs of transferring tax collections to the Federal Reserve in the form of interest payments, part of which is then returned to the Treasury because they are excess earnings of the Federal Reserve.

Nevertheless, legislation to permit such transfers and cancellations of Government securities held by the Federal Reserve would have to define the portfolio level the Reserve would be allowed to hold. Provisions would have to be made for increases in this ceiling so that as the economy grew, the Federal Reserve potential for controlling undesirable expansions also increased and to permit the Federal Reserve to hold sufficient earning assets to meet secularly increasing expenses. More important such legislation would be foreign to the popular concepts of the economic relations between the Federal Reserve and the Treasury and of the economic significance of the public debt. If the public can be persuaded of the soundness of this legislation, then it is worthwhile considering more deep-seated changes to achieve better fiscal monetary coordination, the principal reasons for past rejection of many of which has been tradition. For example, devise legislation which would make the Federal Reserve fully responsible and fully accountable for debt management.

CAN WE DESIGN OBJECTIVE STANDARDS BY WHICH TO GUIDE FEDERAL RESERVE PORTFOLIO OPERATIONS?

Federal Reserve portfolio operations are enormously complicated, because these are a whole series of Government agencies which are, in effect, dealing in open market operations and whose operations have an impact on the supply of money. Most important of these is the Treasury. The Federal Reserve problem is further complicated by the wide range of Government securities that are now used. One consequence has been lumpy and sporadic refinancing by the Treasury.

The continual erratic shifts in the maturity distribution of Government debt mean that the Federal Reserve must always be engaging in

neutralizing open market operations to bring about shifts in the money supply in order to prevent shifts in the price level. The frequently-claimed money market myopia of the Reserve is in part caused by the policy with respect to types of Government debt instrument used.

One reason given for this policy is the need for countercyclical balances. Issue short-term debt in recessions to increase liquidity, issue long-term debt in booms to decrease liquidity. In practice, however, such counterbalancing has not occurred. Another reason given for the policy is that security tailoring minimizes Government interest costs. Minimization of interest costs, however, cannot be a primary objective. If it was, interest payments could be reduced to zero by monetizing the debt. Nor is it clear that, in fact, tailoring will minimize total Government costs. Thus, what if shortening the maturity of the debt brings about an increase in all prices, including prices of all the goods and services the Government purchases.

One way to reduce the need for devising standards to guide Federal Reserve portfolio operations would be to drastically simplify the Government debt structure. Limiting maturities, for example, to several durations and providing for periodic and substantially equal refinancings would greatly reduce the need for Federal Reserve counterbalancing operations and the criteria for determining what and when these counterbalancing operations should be.

SHOULD THE FEDERAL RESERVE SUPPLEMENT ITS PORTFOLIO OF GOVERNMENT SECURITIES WITH OTHER TYPES OF ASSETS SUCH AS COMMERCIAL LOANS AND CORPORATE BONDS

Government debt privately held is sufficiently large—in excess of \$150 billion currently—to permit the Reserve to finance any desirable increase in high-powered money. To empower the Federal Reserve to acquire other types of earning assets must thus be justified on non-monetary grounds. I see no reason to suppose that the Federal Reserve has any comparative advantage in the banking business; that is, private lending. If there are serious imperfections in the capital markets, then it is better to deal directly with these by focusing on private lending institutions and the legislation regulating them.

STATEMENT BY BURTON C. HALLOWELL, PROFESSOR OF ECONOMICS,
WESLEYAN UNIVERSITY, MIDDLETOWN, CONN.

I view monetary, debt management, and fiscal policies as a package of methods available to implement our national economic objectives of high employment, steady growth, and reasonably stable price levels. I believe that the authorities who have immediate operational responsibility for these policies—the Federal Reserve, Treasury, and executive branch—must not only cooperate in attaining the objectives stated, but be provided wide discretionary powers in the uses of these policy instruments.

The question at hand, therefore, is whether additional restraints should be placed on the portfolio of assets which the Federal Reserve can buy, sell, and hold in its operations. Specifically, the question is whether the volume of Government securities now held by the Federal

Reserve should be limited in some way. To do so, in my judgment, reduces the potential flexibility of the Federal Reserve in attaining our national objectives without any comparable gains.

The argument that the Government would gain by reduction in interest payments on the debt is largely obviated by the arrangement whereby the Federal Reserve turns over to the Treasury an overwhelming share of its net profits in the form of interest on Federal Reserve notes. The argument that fewer Government security holdings by the Federal Reserve would prevent further substantial reductions in reserve requirements, offset in part by sales of Government securities to the private sector, seems to settle this issue by legislation on the assumption that it would not be settled on its own merit. The view that the Treasury pays twice for its debt, once when the Federal Reserve buys it from the public and again when it retires it from the Federal Reserve, I cannot understand, much less evaluate.

I conclude that we should impose no new criteria concerning the volume or type of assets that the Federal Reserve can buy, sell, or hold and that we should not cancel any portion of the Federal debt now held by the Federal Reserve.

STATEMENT BY JOHN J. HARRINGTON, JR., ASSISTANT PROFESSOR OF FINANCE, DEPARTMENT OF FINANCE, SETON HALL UNIVERSITY, SOUTH ORANGE, N.J.

I do not believe that it is possible to use money supply, gross national product, total liquid assets, or any other financial or economic aggregate to measure the adequacy of the size or composition of the assets of the Federal Reserve banks. The appropriate criterion can only be the effectiveness of the Reserve in contributing to our achieving what are generally accepted as our national goals (including maximum employment and purchasing power, an adequate rate of economic growth, and overall stability in our balance of payments) within the specific framework of the Employment Act of 1946 and the Federal Reserve Act.

Whenever there is conclusive evidence that achieving our national goals requires that the Reserve hold different types of assets they should be acquired. Maintaining its traditional asset structure is not a legitimate test of the adequacy of Reserve policy and its officials are almost certainly aware of this. During the next decade it seems likely to me that if certain sectors of the economy have access to less credit than is needed for a balanced achievement of our national goals, the Federal Reserve should acquire and hold an appropriate quantity of municipal securities, Federal agency issues, and other high-quality debt. Clearly, authorizing legislation should be permissive and not mandatory in nature, leaving the amounts, timing of purchases and sales, and maturity distributions within the discretion of the System. An advantageous time to consider legislation modifying and expanding the Reserve's powers in this area will occur when the Congress considers liberalizing the present definition of eligible paper. It makes little economic sense that certain types of commercial bank assets (for example, State-guaranteed bank loans to students) which make substantial long-range contributions to the Nation have a second-class status under the obsolete real-bills doctrine. Here there is a real

danger that tradition may restrain growth. However, eligibility should not be extended to all types of commercial bank assets, but only to those categories which make the maximum contribution to the Nation's goals. At any time, there should be some assets falling outside the definition of eligibility because of their nature, maturity, or both. The same yardstick should be used in the discussion of changes in the types of assets legal for holding by the Federal Reserve System, and changes in the two areas may well be parallel.

In the future the general direction of open market operations will necessarily be to acquire Government securities to expand commercial bank reserves, and it is extremely unlikely that the System will ever sell any substantial part of its present holdings of Treasury securities. Transferring a large portion of this debt to the Treasury would result in a nonrecurring reduction in both the gross and marketable debt outstanding and be equivalent to raising the legal debt ceiling by the same amount. However, the real impact of this legislation would not fall on the Reserve statement of condition but upon its income statement: its gross income would be considerably reduced and it would become dependent upon the Treasury for the funds needed to carry out its responsibilities.

Since the Fed remits annually to the U.S. Treasury its net earnings after current expenditures and certain transfers to surplus, it is tempting to believe that its operations would not be affected in any important way if in exchange for the transfer of the Government securities, it received its operating expenses from the Treasury through the appropriations process just as other agencies do. However, this alternative seems to me to have at least two serious flaws: (1) There can be no guarantee that the Congress will invariably give the System appropriations hearings that are both timely and objective; (2) there is likely to be a serious psychological impact on the thinking of foreign central bankers.

My first objection involves several factors. The System's total expenditures, including capital losses, are difficult to project or forecast, and a tight budget might force it to defer or fail to carry out certain assigned responsibilities or to perform them in a perfunctory way. It is possible that from time to time some operations might be influenced by profit (or minimizing loss) considerations either in conjunction with or instead of their contributions to the goals mentioned above. While it is probable that under most circumstances the Reserve will receive just treatment in the appropriations process, it is possible that at the time of regular or supplementary budget hearings, the Congress might be occupied with legislation on topics even more important than this, and the hearings on the System's budget might be delayed or be too brief. An alternative would be to provide the System with authority to expend as needed substantial sums not earmarked for specific areas, but large unallocated amounts here would tend to defeat the inherent purpose of the budgetary process. And there is also a danger that the System might deliberately and indiscriminately spend up to the annual budget limit so as to prevent cuts in succeeding years. To me, any of these effects, if they occurred, would be an inadequate trade-off for eliminating the few expenditures, questionable in nature and/or in amount, revealed in congressional hearings in the past few years. Finally, under this first objection, there is the possibility that individ-

ual Members of the Congress may be hostile to specific expenditures in a proposed budget even though not to the Fed's broad courses of action, and there may be attempts to influence or cause the Fed to rethink the broad course of monetary policy during budgetary hearings—probably the worst time to make policy. This is not to deny or restrict the value of congressional inquiry into the System's operations, a right and responsibility that is unquestionable, but to suggest that questioning and criticism should be directed to specific areas in a direct manner, not indirectly through congressional control over the pursestrings. Equivalent final results would be better accomplished by revisions of specific portions of the Federal Reserve Act.

Closely related to the possible outcomes briefly described above are the probable reactions of foreign central banks to the transfer of securities to the Treasury for cancellation. Some will regard this as the first step in our nationalizing banking here; others will interpret it as setting the stage for annual public debates of past and future monetary policy, including the most delicate (and up to now, private) international negotiations; others will view this as the first step leading to artificially low interest rates with the implications for inflation which they associate with such rates. At this time when there are so many other strains upon international confidence in the dollar, it is absolutely necessary that there be no questioning of our abandoning any of our national goals. On the other hand, since the basic targets of governmental policy are similar throughout the Western World, a clarification and restatement by the Congress of the Fed's responsibilities, with discretion as to techniques, timing, etc., would be appropriate.

In the discussion above, I am not necessarily stating my personal feelings but my brief analysis of how and why foreign central banks will react. The nature of their probable reactions must not be disregarded, particularly now when revisions of the international monetary mechanism are under active consideration. Since their reactions might include a run on the dollar, the Congress should so act as to preserve the independence of the System within our democratic framework, never hesitating to act to increase the Fed's responsiveness but always avoiding the slightest hint that popularity rather than responsibility may dominate its policymaking.

At this point, I must note my feeling that the proposed transfer of securities is weakest from the viewpoint of its timing. A successful resolution of the international liquidity problem may change the outlook of foreign central bankers enough to minimize their adverse reactions if such legislation were enacted. Just as the change may be premature, it also may be tardy—that is, it might have had only minor psychological effect domestically and internationally had it been enacted some years ago, before the role of the dollar in international finance became such a key issue.

Beyond the comments above, there is one other that seems to me to be important. The internal audit procedures of the System apparently include the same goals as those used by the General Accounting Office in its work: the verification of all expenditures and the preparation of opinions on the appropriateness and legality of some expenditures. GAO audited the Board of Governors' expenditures up to 1933 when the Banking Act of 1933 removed the Board from GAO audit.

(The district banks were never under this audit.) I suggest that there may be no valid reason why the entire System should not be covered by GAO postexpenditure audit, assuming that GAO is directed to concern itself with accuracy and not policy. In such an arrangement policymaking and the preparation of budgets would remain System responsibilities.

STATEMENT BY SEYMOUR E. HARRIS, PROFESSOR OF ECONOMICS,
UNIVERSITY OF CALIFORNIA, SAN DIEGO, LA JOLLA, CALIF.

First, it should be noted that the Government debt held by the country generally in the middle of 1965 was about \$318 billion. Of this amount, \$63 billion was held by Government and trust funds, and \$39 billion by the Federal Reserve banks.

Of course it has been an advantage to have public or semipublic institutions purchase Government securities because it means the Government has to depend on the market considerably less, and to that extent probably gets a better price or lower rate of interest on its securities.

The memo raised the issue of how many or what volume of Government securities the Federal Reserve ought to hold.

I think it is difficult to make any precise estimate here. I think the Federal Reserve banks ought to hold enough Government securities to make sure that we get the monetary expansion we need. Congressman Patman is well aware of the fact that open market operations are very important if not the most important weapon the Federal Reserve has. And if the Federal Reserve had not in the 1920's and early 1930's learned how to use open market operations, we would have had a very restrictive and a much more restrictive monetary policy than we have had so far. The more Government securities held by the Federal Reserve the more money is likely to be created.

I present a brief table below to give some indication of what has happened since 1933 and 1945.

Federal Reserve operations, 1933, 1945, 1965

[In billions of dollars]

	Public securities ¹ held	Member bank reserves (plus currency)
1933-----	1.9	2.2
1945-----	23.7	16.9
1965 (June)-----	39.2	21.7

From 1933 to 1965, for example, the total public securities held by the Federal Reserve banks has increased from about \$2 billion to \$39 billion. It is hard to imagine what would have happened if this increase had not taken place. This made possible, for example, a rise of reserves of member banks from about \$2 billion to \$22 billion.

Somehow or other in these years, the Federal Reserve System had to finance something like an increase of currency outstanding of about \$35 billion. This was partly met by a rise in gold supplies of \$10 billion. But the increase of currency outstanding which had to be fi-

nanced, and also the rise of member bank reserves were primarily of course financed by open market operations, that is, by the purchase of Government securities by the Federal Reserve banks. This is what made possible the great expansion of the supply of money since 1933.

There are, of course, some important problems raised by the holding of Government securities by the Federal Reserve banks, and, particularly, the problem of how much return the Federal Reserve banks and, in turn, the member banks that own the Federal Reserve banks should have.

It is my understanding that the member banks are guaranteed 6 percent return on their investment and the remainder of the return goes to the Treasury. Of course, the major profits and virtually all the profits or interest or income for the Federal Reserve comes out of the government securities that they hold.

I would like to suggest one possible solution to this problem; namely, that the return of member banks on their investments should not be 6 but 4 percent. After all, a member of the Federal Reserve System has many privileges, not the least of which is the privilege of borrowing from the central bank and being guaranteed against any serious financial difficulties by virtue of the help that the Federal Reserve System can give the commercial banks. It seems to me that at the present time 4 percent is a good return on a safe investment, and I would think that the committee might very well suggest that the return on the investments of the member banks might be cut from 6 to 4 percent. I am of course not aware of the legal problems involved here, but if this is legally possible, I think it would be a good move.

Moreover, there is the problem of what should be included as reserves for member banks. I have held to the view, which Senator Douglas and I believe Congressman Patman also presented, namely, that the increase of reserves by counting cash as reserves, a reform of the last few years, was an excessive windfall for the commercial banks. It simply made it possible for them with a given amount of cash to do much more business and increase their profits. Profits are more than satisfactory; this is another argument for reducing the return on their investment from 6 to 4 percent.

STATEMENT BY G. LOWELL HARRISS, DEPARTMENT OF ECONOMICS,
COLUMBIA UNIVERSITY, NEW YORK, N.Y.

Discussion of the questions in your letter of September 1, 1965, can serve the public interest although there may be danger of giving undue attention to matters of little more than surface importance. My own participation must be limited to a few points, expressed in broad terms and without any claim to exploration of some deeper implications.

Your respondents will not agree on which are the relatively superficial issues and which are of more fundamental importance. Yet one question is basic: Who is to control changes in the stock of money—and the availability of credit to the extent that it is affected by the monetary authorities? Then, by whom, and how, are the controllers to be controlled? This latter control can be exercised directly and indirectly, one means being through “the power of the purse.” An agency with its own independent income, however, cannot be subjected to control by this means.

The size of the Federal Reserve portfolio will influence the System's income. Two kinds of issues arise: (1) The amount of its income will influence the System's freedom to operate. No one need tell you that the Federal Reserve has been independent of authority exercised by Congress (or by any other agency) through control of funds to finance operations.

(2) If Federal Reserve income exceeds expenses, who gets the "profit"? For many years, of course, System income has been vastly greater than needed to finance its operations. The excess goes to the Treasury. In effect, therefore, the country pays no (appreciable) net interest on the Federal debt held by the 12 Federal Reserve banks. This arrangement seems to me generally satisfactory. (Some tidying of budgetary classification appears desirable. Why not show interest as a net figure after deduction of the refund by the Federal Reserve?) Cancellation of some or all of the Federal debt held by the Federal Reserve would not significantly alter the realities of interest cost to the Treasury. As regards System profits, therefore, I see no public advantage in change and would rather deplore the prospect of debate on an issue of so little significance.

The first point above, however, does involve a matter of real substance. The cancellation of debt, along with other changes, might reduce System income to the point where the Federal Reserve could be compelled to go to the Congress for appropriations. This possible result is too important to be dealt with by an indirect means. Proposals to subject the Federal Reserve to direct and continuing control by elected authorities call for debate on their own merit and should hardly be thought of as possible byproducts of portfolio change.

The literature with which I am familiar overwhelmingly favors central bank independence of legislative and executive control. I have agreed. Today I am "not so sure." What do we know about how results would differ under other arrangements reasonably possible? Could not the public be better served by prompter and franker discussion of the reasons for, and expected results of, Federal Reserve actions? If so, the congressional hearing process offers an obvious forum for such discussion. Granted. But by what body? The Joint Economic Committee seems to me to be the group—except that under present rules you have no way to require Federal Reserve officials to discuss what they do not wish to discuss.

Would the Appropriations Committee provide more effective bodies? I think not, at least as they are now constituted. The background, interests, focus of staff efforts, and experience of those responsible for the appropriations process do not, I suggest, qualify them for guiding monetary policy. The timing of their hearings and scheduling of their decisions are not now geared to the very different responsibility of "overseeing" the Federal Reserve.

Existing monetary arrangements relate the size of the System's portfolio to the growth in the stock of money; the System's liabilities (member bank deposits—reserves) depend upon its acquisition of assets. As you know, changes in the stock of money (and in credit which results from money creation or destruction) depend primarily upon (a) the amount of reserves held by member banks and (b) the ratios of required reserves. The relative roles of the two can be altered, but (other things being the same) the portfolio holdings

which are appropriate at one time will be too small months or years later.

A high reserve ratio coupled with high reserves will apparently involve less profit opportunity for the commercial banking system than if reserve requirements were lower, assuming that member banks receive no interest on reserves. Over the long run, however, will not the income results depend upon how the Federal Reserve creates deposits for member banks? If it does so without reducing bank earning assets, then within anything like the present range of required reserves, the earning capacity of the banking system can be independent of one or the other element.

The creation of modern money (but not the operation of a banking system which is essential to make this money effective in conducting transactions) is essentially costless. The institution which creates money has at its disposal something which did not exist before. If the institution is Government, the funds can be used to pay for current expenses. If the institution is a commercial bank, the funds are available for lending to produce income—and for the banking system as a whole to do so indefinitely. In essence, it seems to me, our present system deprives the Government of a potential “profit” from money creation (initially). The system also gives the Treasury some of the future income because the Federal Reserve holds U.S. debt corresponding to the required reserves of member banks (subject to qualifications). The remainder of the interest goes to commercial banks, presumably helping to cover operating expenses.

How do these conditions compare with possible alternatives? Might there be some method by which the money created without cost could be used as a substitute for taxes? Time does not permit me to try to explore such questions—including the bookkeeping which might be necessary. And I almost shudder at the thought of public discussion of such a possibility. Therefore, fundamental change of this sort would be low indeed on my agenda for monetary debate and possible legislation.

Three more points warrant brief comment: (1) The volume of assets required by the Federal Reserve for sale if monetary restraint is called for would seem to me very small. Any need for more than minor reduction in bank lending capacity seems highly unlikely. Except perhaps temporarily, the practical problems will involve the rates of increase in lending capacity and timing.

(2) The possibility of wiping out that part of the public debt held by the Federal Reserve seems to me likely to generate debate which would be more diverting than helpful. The time and energy available for public consideration of monetary problems could be spent more wisely on issues of greater significance.

(3) The Federal Reserve's portfolio operations, it seems to me, are best confined to Treasury obligations, with some exceptions. The refund of interest on Treasury debt seems automatic, uncomplicated. Little practical importance attaches (on this score) to the kind of debt acquired or the interest yield. But if the Federal Reserve were to become a holder of State-local debt, or the debt of governmental agencies or businesses, would not complications arise? One can easily imagine pressures for artificially low interest rates for this or that worthy purpose—with implications inviting, at the least, much thought before any move in the direction. The temptations would exist, and the potential difficulties might take more than one form.

Needless to say, other important issues warrant your attention—the possible payment of interest on member bank deposits at the Federal Reserve as part of a broader program of monetary change and 100 percent reserves, to name two.

STATEMENT BY E. C. HARWOOD, DIRECTOR, AMERICAN INSTITUTE FOR ECONOMIC RESEARCH, GREAT BARRINGTON, MASS.

Scientific research on money-credit problems conducted by American Institute for Economic Research for more than three decades has provided the evidence that is the basis for the assertions and recommendations that follow.

The excessively large Federal Reserve bank holdings of U.S. Government securities is one of the consequences of the unsound banking practices that have been followed in the United States during the past few decades. Those practices were the result of a departure from a basic principle of commercial banking included in the original Federal Reserve Act but long since abandoned.

In attempting to deal with the monetary problems associated with financing two great wars and with speculative booms and marked contractions of business activity, many individuals including legislators and other responsible authorities seem to have forgotten the basic principle of sound commercial banking. When followed, that principle confined the creation and lending of purchasing media by banks to the amount necessary for representing gold and things en route to and offered in the markets.

In recognition of that principle, the original Federal Reserve Act authorized the Federal Reserve banks to rediscount only short-term, self-liquidating loans made by the commercial banks to those processing things soon to be offered in the markets. During World War I the act was amended to permit Federal Reserve bank rediscounting of U.S. Government securities in order to finance deficit expenditures for war. Thus, the basic principle of sound commercial banking, which had been rediscovered after years of research by a monetary commission and by the Members of Congress concerned with Federal Reserve legislation, was abandoned.

Monetary theorists and bankers have made many attempts to demonstrate that commercial loans are an inadequate basis for a modern banking and money-credit system. The assertion is unwarranted, but discussion and refutation of the arguments presented in those attempts is not feasible here.

After World War I, Federal Reserve authorities sold and forced the commercial banks to sell much of the U.S. Government securities held, thereby forcing removal from circulation of most of the excess purchasing media that had been created. Subsequently, during most of the 1920's however, those authorities acquiesced in the disregard of sound banking by the commercial banks, which created and loaned purchasing media to private borrowers for purposes other than the short-term financing of processing activity. Both the Federal Reserve and commercial banks bought large amounts of U.S. Government securities during the mid-1930's, when the spend-for-prosperity notion was tried, and they bought unprecedented amounts of such securities during World War II, again to finance deficit expenditures for war.

After the war, commercial banks again began to create a large amount of purchasing media for noncommercial purposes, which they loaned for purchases of real estate, securities, and consumer goods and used for investments in obligations of corporations and State and local governments.

At the end of World War II, Federal Reserve bank holdings of U.S. Government securities totaled about \$24 billion. The total had decreased to about \$19 billion at the end of 1949 but subsequently had increased to nearly \$26 billion at the end of 1953 and to more than \$27 billion at the end of 1960. During the past 5 years such holdings have increased about \$12 billion to a total of about \$39 billion.

The Federal Reserve banks have purchased unusually large amounts of U.S. Government securities during recent years, apparently in order to offset the contraction of total purchasing media in use that resulted from large withdrawals of U.S. gold by foreign claimants, and in order to make available to the commercial banks additional reserves required for the increasing volume of loans necessary for expanding business activity.

During the past several years the large volume of savings made available to the commercial banks has enabled them to make noncommercial loans and to acquire investments without creating inflationary purchasing media. However, Federal Reserve purchases of U.S. Government securities totaling \$12 billion during the past 5 years involved the creation of that amount of purchasing media. These purchasing media were turned over to and spent by the Government without placing on the market things of equivalent value; consequently, such purchasing media are inflationary.

When Federal Reserve purchases of U.S. Government securities are evaluated with reference to the principle of sound commercial banking described above, such purchases clearly are revealed to constitute inflation. Moreover, the practice prevents the stabilizing influences on the amount of purchasing media in use and on prices that ordinarily result from outflows of gold. Consequently, international payments imbalances remain uncorrected and seem to require the imposition of restrictions on economic activity, including a tax on the purchasing of foreign securities and restraints on lending and direct investment abroad.

Federal Reserve authorities attempt to regulate the amount of purchasing media in use by buying and selling U.S. Government securities, thus altering the reserves of the commercial banks and the amounts of purchasing media that these banks can originate for lending. This method of attempting to provide a flow of purchasing media appropriate for representing things being processed and placed on the market evolved after the basic principle of sound commercial banking was overlooked in amendments to the Federal Reserve Act.

In abandoning the practice of rediscounting only short-term, self-liquidating (commercial) loans, Federal Reserve authorities discarded the essential guide for providing an appropriate flow of purchasing media. Thus, the relatively small number of monetary authorities now attempt to make decisions regulating the flow that formerly were made much more effectively by the collective judgment of thousands of commercial bankers.

The money-credit problems of the United States will not be resolved until the practice of sound commercial banking is restored. That restoration can be accomplished by the following steps:

1. Amending pertinent legislation to (a) confine rediscounting by the Federal Reserve banks to short-term, self-liquidating commercial, industrial, and agricultural loans; and (b) prohibit Federal Reserve bank purchases of U.S. Government and other securities in excess of their capital funds available.

2. Separating the commercial banking function from the investment functions of the commercial banks (the latter including lending for installment buying, term loans, and longer term investments in mortgages and real estate and in securities of corporations and of Federal, State, and local governments). Such a separation could be effected by appropriate accounting and examination procedures, rather than by performing each function in separate banks.

3. Requiring each commercial bank to work toward and reach, within a period of 10 to 15 years, a condition such that its investment-type assets did not exceed its savings and capital liabilities. Satisfaction of this requirement would insure that all purchasing media (currency and checking accounts) in use would represent either gold or things being processed and offered in the markets.

4. Reducing the gold content of the dollar to the extent necessary for reestablishing the previous equilibrium between the gold-exchange value of purchasing media and that of commodities. Commodity prices are about 160 percent of their previous equilibrium; therefore, a reduction of a little more than one-third of the gold content of the dollar, to a so-called price of about \$60 per ounce, would appear to be scientifically warranted and would approximately reestablish the equilibrium mentioned above. (Although commodity prices probably have been influenced by disproportionate changes in the human-effort cost of processing gold and other things, the relative magnitudes of such changes and methods of measuring them are not ascertainable. Therefore, the influence of such changes must be ignored.)

5. Requiring the U.S. Treasury to (a) use the so-called profit resulting from reduction of the gold content of the dollar to retire U.S. Government securities held by the Federal Reserve banks; and (b) use any accretion of monetary gold to retire U.S. Government securities held by the Federal Reserve banks. The latter action would involve Treasury provision of gold certificates to those banks in exchange for the securities, and selling of the securities to the public, thus obtaining purchasing media for paying the seller of gold.

6. Requiring the Federal Reserve banks to sell, within a period of 10 to 15 years, all U.S. Government securities in excess of the banks' capital liabilities less real estate.

By implementing the steps outlined above, the United States could reestablish a sound money-credit system and unilaterally lead the way toward the establishment of such a system in and among the leading industrial nations. Those who chose to follow that lead would benefit; those who did not would continue to suffer the consequences of depreciating currencies.

I do not suggest that the foregoing proposals would solve all the Nation's economic problems. However, solution of our money-credit problems is essential for future growth and may even be necessary to

sustain the economy while scientifically warranted solutions for other problems are being developed.

STATEMENT BY GABRIEL HAUGE, PRESIDENT, MANUFACTURERS HANOVER TRUST CO., NEW YORK, N.Y.

Representative Wright Patman has asked me to communicate to you my views on H.R. 7601 which would provide that the 12 Federal Reserve banks shall transfer to the Secretary of the Treasury U.S. Government securities in an aggregate principal amount of \$30 billion for cancellation, and to offset this loss of assets the Treasury would be directed to relieve the Federal Reserve banks of the same amount of liability with respect to Federal Reserve notes outstanding.

I note in the sixth paragraph of Mr. Patman's letter that he is "more interested in the specific recommendations and reasons for them than in elaborate argument or citation of source materials." With this request in mind, I submit the following comments on the questions asked in the letter:

1. There is no clear reason why the size of the Federal Reserve System portfolio of U.S. Government securities should bear any fixed ratio to the money supply, gross national product, or aggregate liquid assets. Its size should be determined by the judgment of the Federal Reserve Open Market Committee on the basis of the credit needs of the national economy. Such needs should be appraised on the basis of economic information available to the committee. Any attempt to fix ratios by legislation would negate the function of the Federal Reserve authorities to "lean against the wind" and prevent excesses in credit expansion and contraction. This policy has generally worked well over the last half century.

2. The expression, "if the portfolio grows too large," is not clear in that no standard or criterion is stated by which one could judge whether it were too large or too small. If the portfolio is to large for the credit needs of the national economy, the proper remedy would seem to be to sell some of the securities in the open market.

3. Transfer of such assets (U.S. Government obligations) to the Treasury for cancellation would not appear to accomplish any constructive purpose. The Treasury would save the interest paid on such obligations but it would lose an equal amount of income by the reduction in Federal Reserve payments to the Treasury. Such payments in the year 1964 exceeded the interest received on its portfolio of Government securities. (Federal Reserve Bulletin, February 1965, at p. 322.)

On the other hand, cancellation of the Government securities which now back the outstanding Federal Reserve notes would mean that the notes would be converted, in effect, into "greenbacks." While the American public may not distinguish between the two kinds of currency, the act of cancellation of some three-fourths of the Government securities held by the Federal Reserve banks could be interpreted abroad as a sign of monetary weakness and could precipitate a run on the dollar; that is, a rush to convert dollar exchange into gold, with consequent needless loss of our specific reserve.

4. In my opinion, the Federal Reserve should continue to hold U.S. Government securities purchased in the open market and return the excess earnings to the Treasury as now provided by law.

5. It would not be practicable to legislate "objective standards" to guide Federal Reserve portfolio operations. Such restrictions would hamper the Federal Reserve authorities in their supremely important task of smoothing out swings of the business cycle.

6. I see no reason to direct the Federal Reserve to purchase private obligations or commodities. The Federal Reserve banks from the very beginning have been authorized to rediscount certain types of commercial loans held by their member banks when such member banks require additional funds. Prior to World War I the rediscount of "eligible paper" held by member banks was the principal, if not the sole, function of the Reserve banks. Acquisition by the Reserve banks of private obligations should be limited to such rediscounting for members. Open market purchases of private obligations could not perform any financial or economic function not already performed by such purchases of U.S. Government securities, and in many cases would mean a sacrifice of liquidity.

7. In the colloquy between Mr. Patman and Mr. Martin I do not understand the reference to "compelling the Government to pay its debts more than once." The Treasury received payment for its obligations when they were issued, and will redeem them at maturity, regardless of whether the owner at that time is the Federal Reserve or some private citizen.

STATEMENT BY ROBERT G. HAWKINS, GRADUATE SCHOOL OF BUSINESS
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THE FEDERAL RESERVE'S PORTFOLIO

The size of the portfolio

1. The size of the Federal Reserve's portfolio of securities should be considered from two basically separate points of view. The first is with respect to the conduct of monetary policy. The Federal Reserve needs a minimum amount of securities which could be sold in the event that renewed inflation or other factors make it necessary to significantly contract money and credit. What this minimum amount should be depends on the contingencies to be met, but certainly \$10 billion in securities would be sufficient for almost any in the present economic environment. Any holdings beyond this minimum, while acquired through past monetary policy operations, would be irrelevant for the satisfactory conduct of future Federal Reserve monetary operations. However, it would be advisable that the minimum absolute amount held by the Fed rises as the economy grows, since the amount of open market sales necessary to obtain a given relative contraction in money and credit will be larger the larger is the money supply. Thus, the minimum amount of security holdings should be based on a relatively fixed ratio between these holdings and other relevant economic variables such as the money supply, GNP, liquid assets or the like. But the other variable in the relationship is largely a matter of indifference, since an appropriate ratio at the outset, regardless of which variable is used, will yield roughly the same growth in the minimum as the economy expands.

2. The second point of view from which the size should be considered is essentially political and administrative. Should the Fed-

eral Reserve be allowed to hold securities in excess of the minimum amount needed for open-market operations? At the outset, the Federal Reserve, even though legally owned by member banks, must be considered an arm of the Federal Government, and with respect to broad matters of economic policy, hopefully subject to its control. As such, the case can be made that under a democratic governing system, all Federal Reserve revenues should accrue to the Treasury and Federal Reserve expenditure should be authorized and appropriated by the Congress. This could be partially achieved by transferring Federal Reserve security holdings in excess of the "minimum amount" to the Treasury so that they could be retired. This would eliminate the funneling of interest payments through the Fed, and back to the Treasury as unexpended income as is now the practice. If the Fed's income from their remaining securities was insufficient to meet operating expenses and various contingency reserves, the remainder would be made up from appropriated funds. This would involve a transfer of potential power over the Fed to the Congress rather than an increase in the extent of the control of the Fed by the executive. The latter is probably the more desirable to facilitate the coordination of economic policies.

A lesser consideration involves the potential loss of an independent source of operating expenses by the Fed which might result should the excess in the portfolio be transferred. Heretofore, the Fed has had highly efficient operations and has accumulated competent staffs of economists who have produced valuable research. To the extent that a loss of independence from Congress in income would impinge on administration and research activities, the result would be unfortunate.

On balance, it seems unlikely that much would be gained while some unfortunate results could occur from a removal of the excess securities of the Fed.

The composition of Federal Reserve assets

1. In general, the composition of the asset portfolio should be determined solely on the grounds of the effectiveness and equity of monetary policy. Open-market operations in a broad range of financial instruments, including Government and private across the maturity spectrum, would provide a number of advantages relating to the effectiveness of monetary policy. Selective operations among various types of securities would provide monetary policy with the potential to alter relative interest rates and credit conditions among various capital and money markets. Since the transmission of the effects of monetary policy is not perfect among capital markets, these imperfections could be used to affect the allocation of credit while the volume would continue to be controlled by the usual means. This would allow (1) more selective control of inflationary pressures by selling debt instruments of the sectors experiencing excess demand while retaining easier credit conditions in sectors where prices are stable; and (2) selective permissiveness of credit expansion to allocate demand and production for specific purposes such as economic growth, State and local expenditures, etc. It is not suggested that a broadening of the Fed open-market powers should be adopted forthwith, but careful examination and discussion of the possibility

is needed. Furthermore, the extent to which individual interest rates and credit supplies could be effected differentially is probably small, due to available alternatives on both the demand and supply sides. While markets are not perfect, neither are there great imperfections.

2. More specifically, open-market operations at all maturities of Federal Government securities should be continued. The relative success of "operation twist" is sufficient testament. Likewise, Fed operations in the foreign exchange market is desirable, and should be accomplished for its own portfolio. The coordination of the monetary impact of such operations with that arising from domestic security operations can best be accomplished from the same portfolio.

As for other portfolio candidates, such as State and local government bonds and private debt instruments, the problems are somewhat more complicated. Although the possibilities here for affecting the distribution of credit exist, the risk of default of such instruments must be contended with. Sufficient contingency reserves and selective purchasing would make the problem manageable but it must be emphasized that the default risk is a difference in kind as between Government and non-Government securities and not a matter of degree. Certainly the contemplation of operations in such instruments would exclude commodities and many kinds of bank and other loans. Perhaps high grade corporate bonds, certain commercial mortgages, and State and local bonds offer sufficient ground to experiment on a small scale with open market operations.

There remains a final aspect of extending open market operations to non-Government securities which should be made explicit. Operations in Federal debt issues do not affect the spending of the ultimate borrower while operations in other types of debt issues would presumably be for that specific purpose. Furthermore, operations would be for the purpose of making it more costly (and harder) for some borrowers to borrow than others. This may be viewed as an indirect means of extending limited subsidies to some and taxing others. Would it not be more rational, within the democratic processes which presumably control our economy, to make these indirect taxes and subsidies the responsibility of the Treasury rather than of the monetary policymakers.

Even if such wider open market operations were introduced, they should not be for the purpose of merely diversifying the Fed portfolio, but only for monetary policy objectives. Thus, objective criteria as to the percentage of the portfolio consisting of each type of assets has no place. Rather, the widest discretion should be available to the account managers to use shifts in the composition to influence the allocation of credit, if indeed such is to occur which it should not without considerable analysis.

STATEMENT BY M. LESLIE INFINGER, MAJOR, ASSOCIATE PROFESSOR OF
BUSINESS ADMINISTRATION, THE CITADEL, CHARLESTON, S.C.

Briefly, my views are as follows :

1. I am somewhat surprised that such a bill has been conceived, since no constructive purpose could be served by retiring the bonds held by the Federal Reserve banks.

2. There may be some minor arguments for broadening portfolio policy to include the other securities listed by Congressman Patman, but the difficulties encountered in such a program would multiply the complexities of the Open Market Committee's operations without really adding any significant advantages.

3. It seems to me that Congressman Patman is spending entirely too much time—and the taxpayers' money—fighting Mr. Martin and “the bankers.”

4. In order to do their job effectively the members of the Board of Governors must be kept relatively free from political pressures; therefore, nothing should be done to further weaken the “independence” of the Board of Governors.

5. In order to attract and retain the high-caliber men needed on the Board of Governors, the Congress should not only protect them from political pressures but also see to it that the salary scale is kept relatively high.

STATEMENT BY DUDLEY W. JOHNSON, ASSOCIATE PROFESSOR OF FINANCE,
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The Structure and Portfolio Management of the Federal Reserve System

I. INTRODUCTORY REMARKS

Mr. Chairman and members of the Joint Economic Committee, I am honored and I greatly appreciate the opportunity to take part in your important study concerning the structure and management of the portfolio of financial assets held by the Federal Reserve System. It will be well worthwhile at the outset to spend a few moments establishing some terminological ground rules. This is needed because in order to discuss alternative approaches to the management of the Federal Reserve's portfolio it is necessary to take a position on two fundamental matters, both of which can be considered “practical” questions, though in different ways. These are the nature of central banking, and what constitutes “sound” monetary policy.

II. THE GENERAL NATURE OF CENTRAL BANKING

As is well known, we can view a commercial bank as attempting to maximize its assets subject to certain constraints. Less elegantly, a bank is in the business to make a profit. This is not true of a central bank (the Federal Reserve System for the United States). A central bank is any banking institution which does not attempt to maximize its assets; i.e., has a credit policy independent of earnings. A central bank acts to influence the financial environment of the country in the national interest. Such was not always the concept of central banking in the United States or elsewhere. One will look in vain in the Federal Reserve Act of 1913 for statements asserting that the major goals of monetary policy are to help promote full employment, economic growth, and price level stability—the generally agreed-on goals of modern monetary policy. It was not until 1923 that the Federal Reserve recognized explicitly the weakness in using reserve ratios as

criteria for monetary policy.¹ Since 1923 the Federal Reserve, as is the case for all central banks, has broadened slowly its functions and goals so that the essential nature of central banking is to conduct monetary policy in a manner which contributes to the attainment of domestic economic objectives. How can a central bank best promote the national interest? In the opinion of the present writer, this can be done by managing properly the money supply; i.e., the business of the Federal Reserve System is not the business of banking, but the management of the money supply. The money supply should be managed in a manner such that it contributes to the attainment of the domestic economic goals of full employment, economic growth, and price level stability.² Therefore, as I point out later, the size and composition of the central bank's portfolio of securities should be governed by considerations related to the money supply. With the exception of certain unique economic circumstances, there exists a close association between changes in the Federal Reserve's portfolio and the money supply. The proper way the latter should be managed is discussed next.

*"Sound" monetary policy*³

Because open market operations are the major instrument through which monetary policy is conducted, any evaluation or recommendations for improvement of the Federal Reserve's portfolio policies is conditioned by what one considers to constitute "sound" monetary policy. It is necessary to take a position not only on what can reasonably be expected of the Federal Reserve, but also on what monetary control can be expected to achieve. This necessitates a general view of how monetary policy affects the economy, as well as what constitutes sound money supply management.

At the risk of saying too much by saying too little, it seems to me that two conflicting views emerge with respect to the shortrun economic stabilizing role of monetary policy that has resulted from recent research and thinking on the role of money in influencing economic activity.

One view is that monetary policy cannot perform a shortrun stabilizing role. Within this view, two variations appear. First, some experts conclude that money is of negligible importance in influencing or determining the course of shortrun economic activity and that what matters for shortrun economic stabilization is not control over interest rates and credit institutions, or even over the volume of particular types of lending, but control over the volume of aggregate spending. Since it is difficult, if not impossible, to establish that monetary policy has a reliable, speedy, and quantitatively significant influence on final aggregate demand—i.e., the links between changes in the money supply and aggregate demand are tenuous and weak—shortrun monetary policy is considered of little importance.

¹ The Federal Reserve Board, Annual Report, 1923, pp. 30-38.

² It should be pointed out that some would disagree with my proposition that the Federal Reserve controls the money supply or its rate of change, except in some irrelevant longrun sense. To analyze the validity of this view would lead us too far astray, but one could substitute for management of the money supply the power of the banking system to carry earning assets as the job of central banking and not change the substance of my analysis, assuming nonliquidity trap situations.

³ In writing this section, I have benefited from reading Harry G. Johnson's *Alternative Guiding Principles for the Use of Monetary Policy* (Essays in International Finance, No. 44, November 1963), pp. 7-8; Eli Shapiro's "Structural Changes in Central Banking" (pp. 7-8), and Franco Modigliani's "Discussion," pp. 25-26, both of which are in the 1964 Annual Report of the Federal Reserve Bank of Boston.

The other negative view toward using discretionary monetary policy as a tool for shortrun economic stabilization is best represented by Prof. Milton Friedman. As is well known, Prof. Friedman argues that variations in the money supply are one of the most important sources of economic instability. But because we know so little about what causes shortrun economic stability, he believes that the use of discretionary monetary policy for shortrun stabilization purposes creates the risk aggravating instability rather than stabilizing economic activity. However, since the money supply is such a powerful determinant of economic activity, a fixed rule calling for a steady rate of growth in the money supply should be substituted for discretionary monetary policy. Thus, it is argued that this rule will provide a stable long-run monetary policy for the economy producing the optimal environment for the attainment of growth, price level stability, and full employment. Moreover, Friedman argues that open market operations should be the sole tool used to conduct monetary policy, and the size of the central bank's portfolio would be that amount needed to produce the sought-after rate of growth in the money supply.

Another view of monetary policy is that it can be usefully employed as a shortrun stabilization tool. Central bank operations through the reserve base have a direct influence on interest rates, the money supply, and changes in these variables produce an effect on the volume of final aggregate demand. In spite of the fact that our knowledge of the magnitude of this effect on final expenditures or the time required to make it effective is imperfect, shortrun stabilization should not be abandoned as a primary objective of monetary policy.

I support the view of using discretionary monetary policy. My criterion of a "sound" monetary policy is one in which the central bank varies the money supply in a way opposite to shortrun movements in the volume of final output and employment. Such a monetary policy should not be affected by disturbances in the banking system. Admitting that there does not exist a scientifically correct answer to the question of how low the unemployment rate should be before an economy can be considered to be fully employed, I will arbitrarily define a fully employed economy as one in which the annual average of unemployment does not exceed 3.5 percent. My values are such that any level of unemployment above this rate is socially undesirable.

When aggregate demand is insufficient as measured by less than a fully employed economy, and if the money supply either contracts or does not increase at an appropriately rapid pace, monetary policy is too tight, no matter how loose it might be as measured by some absolute standard. And if aggregate demand is excessive so that the level of unemployment is so low that inflation develops, then aggregate demand is excessive. A monetary policy which does not restrict the money supply is too loose, irrespective of how tight it might be judged in terms of some absolute standard. Since individuals' value judgments pertaining to what constitutes a fully employed economy differ, by definition of one would not be acceptable to all and, therefore, relative measures of monetary ease or restriction by individuals will differ. But the validity of relative criteria of monetary policy is not changed.

An illustration used by Prof. Franco Modigliani may be useful to illustrate the above distinction between absolute and relative criteria of monetary policy:

“Consider the case of a motorboat in a channel whose task it is to be at all times lined up with some landmark, but where the channel is swept by a current of varying speed. In this case an absolute measure of performance might be the amount of gas given to the motor. The relative and relevant measure would be what is happening to the boat relative to its target, no matter how much (or how little) gas is being supplied, we must still say that it is insufficient (or excessive) if the boat fails to gain ground with respect to its target.”⁴

My views on the importance of money do not stem from any belief that there is a simple and highly predictable relation between the money supply and the level of aggregate spending. This relation is very complex and needs much more studying. But my view of what constitutes “sound” monetary policy is based on the notion that, by and large, containing the money supply will contain aggregate spending, while increasing the money supply will normally—though not in all circumstances—tend to increase aggregate demand.

III. VIEWS ON SPECIFIC QUESTIONS

The size of the Federal Reserve's portfolio in relation to the money supply, GNP, or aggregate liquid assets

It is well known that the Federal Reserve does not directly control the money supply. To attempt to alter the money supply, the Federal Reserve operates on the reserve base through open market operations, changes in reserve requirements, and other policies. This behavior of the central bank influences the decisions of commercial bankers and the public. From an interaction of their decisions, the actual money supply is determined. In consequence, there exists a close association between changes in the reserve base and changes in the money supply. It is, therefore, appropriate to look at Federal Reserve policy in terms of how it affects the money supply.

Basically, the extension of Federal Reserve credit (the reserve base) emerges through open-market purchases of securities, purchases of acceptances in the market, or discounting of paper for member banks. Open-market purchase of government securities is dominant in its effect on the Federal Reserve's portfolio. Moreover, since the central bank determines the size of open-market operations, the amount of reserves created or destroyed is precisely determinable, which is not true with discounting, as the initiative to rediscount or abstain is in the hands of the member banks.

How large a portfolio should the Federal Reserve System hold in relation to the money supply, GNP, or total liquid assets? I know of no economic model (theory) from which we could derive any “ideal” portfolio/variable ratio that should be used as a goal or rule to follow in conducting monetary policy. All that one can say is that the “ideal” portfolio emerges from conducting monetary policy in such a manner that the money supply moves in a way opposite to short-run movements in output and employment. If it is desired to expand the money supply in order to contribute to an expansion of aggregate demand (GNP), the portfolio should be increased (assuming no decrease in the required reserve ratio) until the money supply expands

⁴ *Ibid.*, pp. 25-26.

to the desired level. If aggregate demand is too large, the portfolio should be reduced until the money supply is contained sufficiently to reduce total spending. The extension of Federal Reserve credit is a means to an end.

Therefore, as stated before, the size and, more importantly, the direction of change, plus or minus, of the central bank's portfolio, depends on the volume of total expenditures. If the latter is too low to give us a fully employed economy, Federal Reserve credit should be expanded. If the opposite, the portfolio should be reduced. Any absolute criteria for portfolio or monetary policy are useless; only relative criteria of monetary posture are relevant.

An evaluation of recent Federal Reserve portfolio policy

The above makes it clear that in order to evaluate the recent portfolio policies of the Federal Reserve, data pertaining to the money supply and the real side of the economy are needed—e.g., data on employment and GNP.

Since World War II no major depression has occurred in the United States. We have experienced only minor cycles. This is shown in table 1 below. In the contraction of 1948-49, unemployment rose to 7 percent of the labor force for one quarter; the average rate during the recession was 5 percent. Although unemployment did not exceed 5 percent in the recession of 1953-54, the 1957-58 unemployment was more serious. During 1959, a 5.5 percent unemployment rate prevailed; in 1960, 5.6 percent; in 1961, 6.7 percent; in 1962, 5.6 percent; in 1963, 5.7 percent; in 1964, 5.2 percent; and as of June 1965, 4.7 percent.

TABLE 1.—*Percentage change from peak to trough in gross national product for several selected business cycles in the United States*

Business cycle		Months from peak to trough	Gross national product (percentage change from peak to trough)
Peak	Trough		
November 1948.....	October 1949.....	11	-3.2
July 1953.....	August 1954.....	13	-2.0
July 1957.....	April 1958.....	9	-3.4
May 1960.....	February 1961.....	9	-1.1

Source: Adapted from table 2 in Geoffrey H. Moore's "Measuring Recessions," *Journal of the American Statistical Association*, LIII (June 1958), p. 261. Data on 1960-61 contraction added.

During 1959, the annual percentage change in the money supply was 0.5 percent. From 1960 to December 1963, the money supply increased at an annual average rate of 2.9 percent; for the December 1963 to May 1964 period, the annual rate of change was 2.1 percent. These rates of increase are low by historical standards, although in various periods since May 1964 the money supply has increased more rapidly. This period from 1959 to 1964 has seen a slow rate of growth in income, a high unemployment rate, and relative stability in the price level. But the rate of change in the supply of money has not been uniform throughout the period, and it is useful to observe the changing pattern.

The actual history of the money supply and of postwar recession in output in the United States is shown in figures (1) and (2). It can be seen at once that in every postwar recession the rate of growth of the

money supply—I might add that this also holds true for every recession since the establishment of the Federal Reserve—has slowed down during the declining phase of the recession, sometimes becoming an absolute decline. When economic activity reaches boom proportions, the growth of the money supply typically slows down.

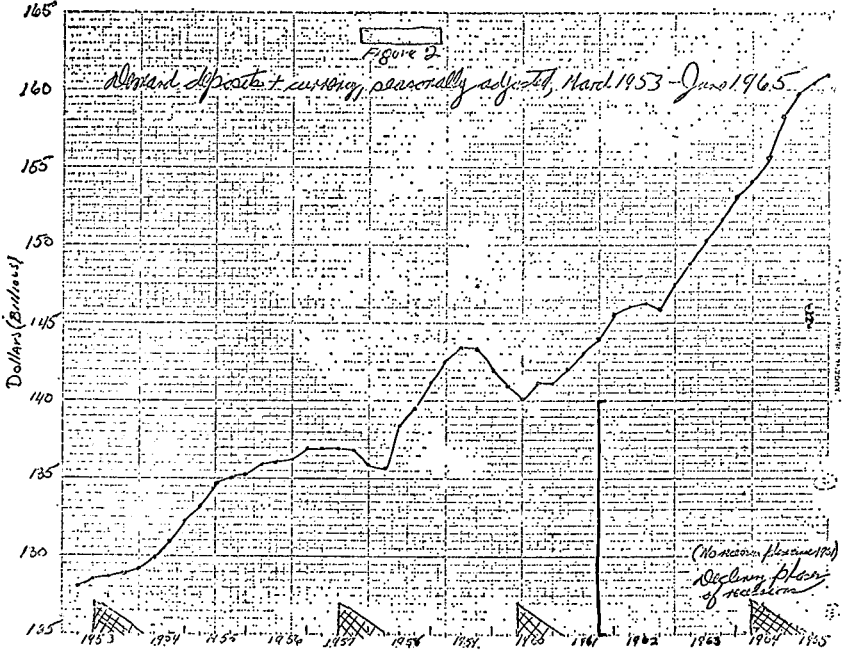
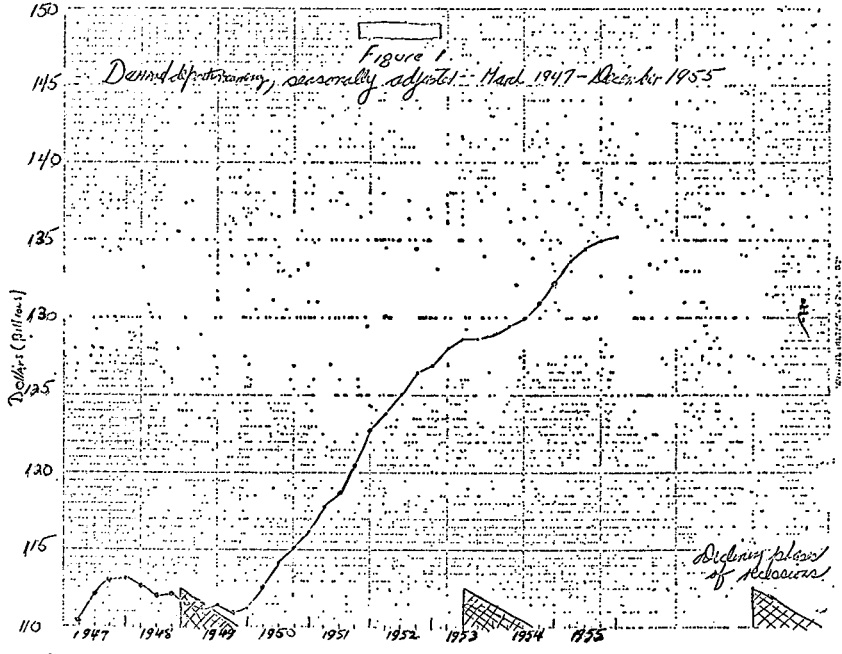


TABLE 2.—*Changes in total holdings of Government securities by the Federal Reserve from peak to trough in postwar business cycles*

Business cycle		Holdings of Government securities (percentage change from peak to trough)
Peak	Trough	
November 1948.....	October 1949.....	-24.33
July 1953.....	August 1954.....	-3.18
July 1957.....	April 1958.....	+1.14
May 1960.....	February 1961.....	+3.92

Source: Computed from various Federal Reserve bulletins.

As the major vehicle for supplying reserves to the commercial banks in order to increase the money supply is the central bank's open market operations, it appears to me that the postwar experience suggests that the portfolio policies conducted by the monetary authorities during recessionary periods have been of little aid in contributing to the elimination of recessions. The data in table 2 show this, especially for the earlier recession periods. Moreover, when the troughs of the cycles have reached their lowest levels and output and employment have failed to expand back to full employment levels, which has been generally the solution since 1959, the portfolio policies of the Federal Reserve have been such that the increase in the money supply has been insufficient to expand aggregate demand so that we achieved full employment. Therefore, given the high levels of unemployment prevailing in the economy from 1959 to shortly after 1965, the portfolio policies followed by the central bank were suboptimum. This phenomenon is not typical only to this period. For example, from January 1953 to January 1961, there occurred only a \$2 billion increase in Federal Reserve credit. Since the creation of reserves by the central bank entails no cost—they are created at zero real social cost—the Federal Reserve System apparently has conducted its open market operations within a constraint imposed by the balance-of-payments situation, or by its fear of inflation, or by both.

What criterion should be used for Federal Reserve portfolio policy?

In effect, my previous observations already answer this question. I think portfolio policy should be determined by how the monetary authorities want to vary the money supply. In the absence of a central bank endowed with the powers of a Santa Claus so that needed increases in the money supply can be injected into the system via "chimneys," the money rein must be implemented primarily through open market operations.

The disposition of "excess" securities

The specific question raised is: If the portfolio grows too large compared to some standard, what should be done with the excess? Then, the following alternatives are mentioned: Should the assets be transferred to the Treasury for cancellation? Should the Federal Reserve continue to hold them, draw the interest, and return the unexpended balance to the Treasury?

Before answering the major issue implied by these questions—viz: Does the holdings of Government securities by the Federal Reserve

System raise substantive issues independent of money supply considerations?—I would like to make the following point: Since my major theme is that there exists no absolute standard by which to measure monetary policy, hence, the size of the central bank's portfolio, an excess amount of securities held by the Federal Reserve can only mean that the money supply is increasing in the face of excess aggregate monetary demand. Under such conditions, the Federal Reserve should not have purchased the securities in the first place; rather it should have sold securities in the market. Increases in earning assets of the Federal Reserve banks cause the money supply to increase and, given an excess volume of total spending, the damage to society of additions to the central bank's portfolio appears when the money supply increases and higher prices result. How the Federal Reserve and the Treasury handle this excess between themselves is absolutely of no significance.

Are there substantive issues, independent of general credit conditions, resulting from the Government debt held by the Federal Reserve System? No. The Government debt held by the Federal Reserve System is a direct consequence of the open market operations undertaken by the System, which are the major tool it employs in implementing monetary policy. The System might be viewed as a depository for fictitious Federal debt. The fictitious nature of this debt is evidenced by the fact that, although interest is paid by the Treasury on its debt, a large portion of Federal Reserve bank earnings are transferred to the Treasury. Moreover, when the Treasury sells securities to the central bank, this is, in an economic sense, no sale at all. This is an internal bookkeeping operation within the Government incidental to the creation of money for the Government's use.

Maturity composition of the Federal Reserve's portfolio

Open-market operations have three distinct, though related, facets: (1) the creation or extinction of member-bank reserves; (2) the influencing of the absolute level of interest rates; and (3) influencing the structure of interest rates—the relationship between various interest rates, like long term and short term. In consequence, when the central bank undertakes open-market operations, it can do so in a variety of ways, each of which will produce a different effect on the structure as well as upon the level of interest rates. If, for example, the central bank decides to trade in Government securities, it can do so by confining its operations to the short-term sector, and long-term sector, or a combination of both. And, of course, the structure of interest rates can be altered without, on balance, creating or destroying member-bank reserves. The central bank can sell a given amount of short-term securities while simultaneously buying an equal amount of intermediate and long-term securities.

Monetary policy analysis draws heavily upon general interest theory in order to define both its function in the economy and its specific implementation. Since monetary policy is largely concerned with the buying or selling of Government securities, the question immediately arises, "Which securities, short-term, long-term, or various combinations?" If any one of these alternatives is chosen, why? And, can we as Chairman Patman asks, lay down any objective standards for the Federal Reserve to follow in managing the maturity composition of its portfolio?

In my view, it is impossible to lay down absolute criteria regarding the maturity composition of the central bank's portfolio. Once again it depends on the prevailing economic environment, although, I do feel that the Federal Reserve often puts too high a value on socially trivial objectives like the technical health of the bond market. Such concern like the bills-only doctrine, a doctrine whose economic rationale I was never able to understand, often limits the size of interventions in the market to amounts less than that current monetary policy needs would justify. But Chairman Patman's question raises a substantive issue, viz., the general economic significance of altering the structure of interest rates via changing the maturity composition of the central bank's portfolio. My direct answer to this question is that how much securities the Federal Reserve buys (or sells) is far and away more important than what issue it chooses to deal in. In what follows I attempt to justify this view. In analyzing this question, we shall focus on two broad effects of manipulating the structure of financial assets held by the Federal Reserve. They are: relative interest rate and liquidity effects.

In order to simplify the analysis, let us assume that the Federal Reserve, in changing the maturity composition of its portfolio, on balance neither creates nor destroys member bank reserves. Admittedly this is highly unrealistic, given stabilization goals, but it enables us to ignore money supply changes and isolate the relative interest rate and liquidity effects.⁵

Interest rate effects.—The traditional view is that various debt-management policies can influence the level of private expenditures. The orthodox theory, as related to Treasury debt management, implies that during periods of prosperity the Treasury should attempt to sell long-term securities and buy short-term securities; that is, lengthen the average maturity of the debt in the hands of the public. Let us assume that the central bank does this, although, as stated above, the central bank in such a possible inflationary situation would probably not offset the reserve loss by buying short-term securities. The reasoning underlying this debt-management system policy is that such sales will reduce the volume of long-term funds available for investment, long-term interest rates will increase and liquidity will be reduced. Presumably, investment spending will be reduced. The counterpart of Treasury debt-management theory (in our discussion, central bank debt management) is that in times of recessions short-term securities should be sold and long-term securities bought, that is, the outstanding debt should be shortened. Liquidity will be increased, and the long-term rate of interest will be lowered and presumably investment spending will be stimulated. But such a stabilization theory of debt management is too simple; the reasoning underlying this orthodox theory is not obvious. Let us explore it further by first examining the interest rate effects of debt-management techniques; we then will look at the impact of these interest rate effects on private spending.

Assume the Federal Reserve or, for that matter, the Treasury undertakes an anti-inflationary debt management policy, that is, sells long-term securities (borrows in the long-term market) and uses the funds

⁵ In writing this section, I have drawn extensively from Warren Smith's "Debt Management in the United States" (Joint Economic Committee Study Paper No. 19), U.S. Printing Office, 1960.

to retire (buy) short-term debt—the average maturity of the outstanding debt is lengthened. Now, simultaneously two things happen: the long-term rate rises, which presumably exercises a restrictive effect on investment undertakings, but the short-term rate falls, which affects certain types of spending decisions in an expansionary manner; there occurs a change in the structure of interest rates. Thus, when funds are drawn from the long-term sector and injected into the short-term sector, we have two forces working simultaneously—one expansionary and one restrictive. The net result of this debt-management technique depends on which one of these two effects is greater. The impact on private expenditures depends on the responsiveness of spending to changes in long-term rates. Not only are the relative interest elasticities of investment demand with respect to long and short-term investment rate charges relevant here, but also the interest elasticities of the supplier of funds in the two sectors.

Obviously, an extremely important (if not the most significant) factor in all this is the investment interest elasticities. Not only is it difficult to form a judgment on the impact of changes in the level of interest rates on investment expenditures, but even more so to evaluate the effects on such expenditures of changes in the structure of interest rates. The whole question of the impact of changes in interest rates on investment expenditures is complex, both at the theoretical and empirical levels. The empirical evidence, such as it is, suggests (does not prove, however) that both long-term and short-term investment are relatively insensitive to alterations in interest rates. It would appear, then, that debt-management techniques that alter the composition of the debt produce negligible effects on investment expenditures as a result of the changes in the interest rates. In all probability, the interest-rate effects on long-term investments are more important than such effects on short-term investments. Thus, there might be some restrictive effects of shifting funds from the long-term sector (selling bonds) to the short-term sector (buying short term)—that is, lengthening the debt, and some stimulating effects from shifting funds from the short-term sector to the long-term sector (that is, shortening the debt). But the order of magnitude is an empirical question, on which the present writer has no evidence.

Of course the effects of various debt-management techniques on private demand depend not only on the elasticities of the investment demand functions in the various markets, but also upon the elasticities of supply in the various markets. Little, if any, evidence exists regarding the elasticities of supply in these markets. One might expect on a priori grounds that the elasticity of supply in the short-term market exceeds that in the long-term market because short-term securities are better substitutes for money than long-term securities.

Regarding then an overall evaluation of relying on relative interest rate effects as a tool for so-called debt-management operations, it would appear that they serve as a weak foundation for stabilization policy.

Liquidity effects.—Alterations in the term structure of interest rates are not the only effects resulting from changes in the composition of the publicly held debt. There is a liquidity effect. Almost a complete theory of debt management has been constructed on the basis of the liquidity argument. The analysis runs somewhat as

follows. Assume the Federal Reserve or Treasury sells long-term securities and with the proceeds purchases short-term debt. Those who bought long-term securities are much less liquid than before, whereas those who sold short-term securities for cash are only a little bit more liquid than before. Those whose liquidity is reduced will substantially decrease their demand for goods and securities, while those whose liquidity increased only slightly will increase their spending only slightly. The net result is deflationary. If the Treasury or central bank were to buy long-term securities and sell short-term securities the result would be just the opposite—that is, expansionary. Please note that we are dealing here with the direct liquidity effect, which is not dependent on interest rate changes.

The argument here is presumably an extension of the idea that the level of aggregate monetary demand is affected by the size of the stock of cash balances or other liquid assets held by households and business firms. As far as the direct liquidity theory of debt management goes, the level of private expenditures is not only influenced by the absolute size of the stock of liquid claims, but on how liquid this stock is.

There is no doubt about the important theoretical role played by the stock of accumulated wealth on influencing the level of expenditures, especially on the part of the consumers. But the empirical evidence is mixed regarding the importance of changes in the stock of liquid assets on spending. Some investigations have shown that liquid assets appreciably affect consumer expenditures, while others have obtained predictive relationships that are quite satisfactory without using liquid assets. Thus, if there exists some doubt on the empirical importance of the size of the stock of liquid assets, it is more doubtful that changing the composition of such a stock exerts any important influence on spending.

In the view of the author it does not seem possible to specify any precise rules to govern debt management, whether it is undertaken by the Treasury or the Federal Reserve—enough is not known about the effects of alternative debt management techniques to be specific. Secondly, it would appear that we should not take too seriously the economic stabilization effects of altering the maturity composition of the Federal Reserve's portfolio, assuming that the total amount of Federal Reserve credit remain the same. All the effects are of secondary importance—when some people are made more liquid, some are made less; when some interest rates rise, some fall. Given the fact that there exists considerable doubt regarding the impacts of changes in the level of interest rates and liquidity on private spending, it is not surprising that changes in the structure of interest rates and liquidity on spending are more difficult to determine. Of course, this does not mean that the composition of the debt is of no significance. If there exists a large stock of highly liquid debt during an inflationary situation the task of the monetary authorities can become more difficult.

The addition of non-Federal Government securities to the Federal Reserve's portfolio

Another question raised is, "Should the Federal Reserve supplement its portfolio of Federal Government securities with other types of assets such as commercial loans, foreign exchange, municipal se-

curities, corporate bonds, mortgages, commodities?" Of course, the Federal Reserve, through the discounting process, does buy commercial paper, acceptances, and foreign exchange, but they constitute a negligible fraction of its portfolio which consists almost exclusively of Federal securities. I see no economic reason for the system to purchase non-Federal Government securities. The reasons are as follows:

Under current arrangements, the ultimate limit to money supply increases that open market operations per se would produce is determined by the amount of Federal Government securities available for the Federal Reserve to purchase, although its gold reserve requirements might set a lower limit. (From an economic view such gold requirements are senseless and should be repudiated.) The total amount of money which the Federal Reserve could destroy exclusively through open market operations is determined by the amount of securities the Federal Reserve could sell. Given the large size of the outstanding marketable Federal debt, the Federal Reserve's open market policies are not restricted in any way. If it were to purchase all this debt, the money supply would increase by an astronomical amount; and if the Federal Reserve sold all the securities in its portfolio, the money supply would more than be cut in half. For these reasons, I see no need for the Federal Reserve to supplement its portfolio with non-U.S. Government securities.

STATEMENT BY CARL P. JORDAN, BETHLEHEM, PA.

In brief, I am absolutely opposed to the bill introduced by Representative Patman, H.R. 7601. To be sure, the portfolio and open-market operations of the Fed were not perfectly conceived, nor have they been perfectly executed. But given our present knowledge of monetary variables and their effects, the existing framework is appropriate. Thus, the crucial problem is the lack of understanding of monetary phenomena: demand and supply variables, asset elasticities, and interaction lags.

The understanding of these problems is not an easy task, and will require a great deal of concentrated professional attention. Perhaps the committee could encourage such research through dissertation grants or through the special residence arrangements which some of the executive departments are now trying.

In short, it is the present state of economic sophistication, not the present institutional arrangements, which has limited the effectiveness of monetary management. Therefore, my opinion is that H.R. 7601 is not only a detrimental piece of proposed legislation, but also serves to badly obscure the real problems.

STATEMENT BY EDWARD J. KANE, DEPARTMENT OF ECONOMICS,
PRINCETON UNIVERSITY, PRINCETON, N.J.

In discussing external regulation of Federal Reserve portfolio policy, one must distinguish between two classes of economic effects: those relating to the aggregate economy and those applying to the

various sectors thereof. Restrictions on the composition (or structure) of the Federal Reserve portfolio have effects mainly of the latter sort. On the other hand, restrictions on the aggregate size of this portfolio, since they tend to dilute the System's fiscal self-sufficiency, may change the very ground rules under which aggregate monetary-policy decisions are made. Because of this possibility, portfolio-policy reform is an inextricable part of the much larger question of the optimal curtailment of Federal Reserve autonomy. This memorandum contends that this is simply too important and many-faceted a question to be treated in so inadvertent and piecemeal a fashion.

1. EFFECT ON MACROECONOMIC POLICY PERFORMANCE

Except in combination with more general revisions in the Federal Reserve's legislative mandate, the restrictions envisaged are, with respect to the level of aggregate economic activity, not critical ones. By themselves, limitations on central bank portfolio activity are apt to influence the tactics—but not the strategy—of future monetary policy.

Under current provisions of the Federal Reserve Act, even a relatively careful specification of the goals of monetary policy and of the state of the economy implies no unique menu of Federal Reserve action. A great many Federal Reserve portfolios, of differing size and composition, are consistent with any overall policy stance. Hence, whatever restrictions Congress might impose on the composition of the open market account, Federal Reserve officials would remain free to vary the pressure on bank reserves so as to determine the money supply. Evidence of this is provided by Federal Reserve performance under such self-imposed constraints as (1) bills only (or preferably), (2) operation nudge (or twist) and (3) governments and bank acceptances only.

Similarly, at least so long as the open market account remains large enough both to cover expenses and to accommodate potential sales, restrictions on the size of this portfolio are equally unimportant. To take an extreme case, if the Federal Reserve were allowed to issue Treasury securities on tap and to cancel (say, for gold certificate credit) its purchases of Treasury debt, it could get along with no portfolio at all.

Getting along without a portfolio need not, however, mean getting along otherwise exactly as before. In particular, such an arrangement would make it impossible for the Fed to continue to finance its own operations. Instead, like most other Government agencies, it would have to rely upon congressional appropriations. Having to push a budget through Congress would drastically modify the environment within which Federal Reserve decisions are made. Each year, Congress would have an opportunity to make its pleasure and displeasure felt and felt strongly. As a result, Federal Reserve policy would fall more closely under the influence of the Congress and, quite likely, become even less responsive to the will of the executive. Because of its overriding importance, we return to this issue in sections 3 and 4.

2. DISTRIBUTIONAL EFFECTS: SECTORAL SHARING OF THE COSTS AND BENEFITS OF POLICY ACTION

While it makes little difference to aggregate economic performance, the particular mix of tactics whereby the Fed chooses to wield monetary control does affect the relative economic welfare of various individuals and firms. Any policy measure is bound to weigh more heavily on certain groups and sectors in the economy than on others. In the perennial choice between lower reserve requirements and open market purchases, for example, the tradeoff is between the interest cost of the national debt and the level of bank profits. Similarly, by dealing in bank acceptances, the Federal Reserve fosters this market. In contrast, issuers of and dealers in instruments like certificates of deposit, commercial paper, and municipal bonds are left quite on their own.

While they need not, on occasion composition-of-portfolio restrictions can influence policy performance in the aggregate as well. Consider, for example, the impact of eligibility and gold cover requirements on the monetary policy of the critical early thirties. This experience suggests that, when they are written into enabling legislation, compositional restrictions are slow to change and provide authorities with too ready a scapegoat. Whereas even today eligibility and gold cover requirements remain somewhat of an embarrassment, in response to emerging pressures on the balance of payments, the Fed has lurched rather easily from bills only to operation nudge.

Unlike their aggregate effects, the distributional effects of compositional requirements operate day in and day out. In a representative democracy, therefore, disadvantaged groups or sectors may be expected to protest their lot, and, via the political process, to bring pressure for change. Ultimately, then, the committee's raising these questions is a reflection of past protests and an attempt to establish whether criteria exist for reconciling such conflicts once and for all.

3. THE BROADER PROBLEM

Viewed in this fashion, the issues raised go far beyond those on which the committee has attempted to focus. The problem is to determine what would constitute the optimal legislative curtailment of Federal Reserve freedom of action. This is a herculean question, one which extends simultaneously both (1) to tactical dimensions other than portfolio policy (for example, to discount policy, to the level and structure of reserve requirements, and to deposit rate regulations) and (2) to lines of authority connecting the Federal Reserve with various agencies of the executive and legislative branches.

To deal with even a part of this problem, one must first introduce extensive assumptions about, and analysis of, these other matters. Since possible alternatives are so diverse (consider, for example, how differently Friedman, Smith, and Tobin would treat the discount rate), one can only list a number of alternative packages of reforms ("programs for monetary stability"), designating one of these as his own personal favorite.

4. A SECOND-BEST APPROACH

Alternatively, one can view the committee's task rather more broadly than we have so far: specifically, as a search for "better" arrangements, whether or not these happen also to be demonstrably the "very best." Along these lines, one can venture this much. Any decision to reduce the size of the Federal Reserve portfolio increases the chance that, sooner or later, the Federal Reserve will lose its fiscal independence. Once this occurs, in and out of season congressional pressures will carry more force. Hence, if something is to be done, the vital question becomes whether or not the newly operative pressures will be better directed, on balance, than those they deflect.

Although it has theoretical overtones, this is essentially an empirical question and one which should be thoroughly researched before new legislation is introduced. Past Federal Reserve policies are a matter of record. Lacking a channel for full and regular expression, contemporaneous congressional pressures are essentially undocumented. Still, by examining such remarks on economic policy as appear in the Congressional Record and various committee hearings and taking into account differences in the individual legislators' probable intent, committee memberships, and general influence, one could construct a rough statistical index of just which modifications in monetary behavior Congress would have supported through time. Comparing discrepancies between this index and actual Federal Reserve policies with actual and potential macroeconomic achievements would allow us to shape an informed judgment about the existence and direction of alleged policymaking biases.

Lacking such a study, I would oppose codifying changes of the variety envisaged here. Even with such a study, I would prefer to see the question of Federal Reserve independence considered on a much broader basis.

STATEMENT OF JOHN E. KANE, PROFESSOR OF BANKING, COLLEGE OF BUSINESS ADMINISTRATION, UNIVERSITY OF ARKANSAS, FAYETTEVILLE, ARK.

This is in response to your recent letter asking for comments relative to Federal Reserve System holdings of U.S. Treasury securities and to certain other matters.

I will comment first on the proposal that a substantial amount of the U.S. Treasury securities presently owned by the Federal Reserve System be transferred to the Treasury for cancellation. There is no compelling objection to cancellation. For example, if \$30 billion of Treasury securities were canceled, Congress could authorize the Federal Reserve System to list on its combined balance sheet, in lieu thereof, an account entitled "Fiduciary Authorization" in the amount of \$30 billion. Thus, the needs of double entry bookkeeping can be met very easily. Furthermore, cancellation would not require any change in the operation of our money and banking system. (I am assuming that the extent of cancellation would not be so great as to eliminate entirely the annual net profit of the Federal Reserve banks.)

It should be recognized, however, that the term, "Fiduciary Authorization," is a pleasant sounding account title which actually means

“deficit.” Thus, the objection may be raised that cancellation would constitute another substantial step toward a completely fiat money system (i.e., a system in which money is without asset backing). It is possible that this would produce a loss of confidence in our money and banking system. But under present conditions it seems doubtful that the public would take any sharp notice of, or feel any concern about the matter. However, if at some future time confidence in our banking system should falter for some other reason, and if liabilities of the Federal Reserve banks were not fully matched by assets, this might have an adverse psychological effect.

There may also be some justification for the belief that a fiat money system lends psychological encouragement to irresponsible monetary management. But the degree of responsibility with which our money system is managed depends primarily upon the dedication of the entrusted members of our legislative and executive governmental branches and agency officials, rather than upon the form of the system. Nevertheless, the principle of full asset backing of Federal Reserve System liabilities may be an important symbol of financial responsibility.

As the above comments suggest, I am not aware of any clearly serious objection to cancellation. On the other hand, neither am I aware of any possible benefit to be derived from cancellation. Cancellation would not, of itself, result in any change in the operation of our money and banking system. And there would be no gain for the Treasury, inasmuch as Federal Reserve System excess profits are paid to the Treasury from time to time.

The question has been raised as to the most appropriate size of the Federal Reserve System portfolio of U.S. Treasury securities “in relation to the money supply, the gross national product, or aggregate liquid assets.” I believe that within broad limits, at least, the size of these three relationships is not important. As suggested above, it is preferable for the total assets of the Federal Reserve System to be at least equal in value to the total liabilities. A substantial part of the assets should be in the form of international reserves of unquestioned international acceptability, or at least of unquestioned usefulness to the Federal Reserve System in its international operations. With respect to the remainder of the assets, it should be noted that lending to member banks is an appropriate activity for Federal Reserve banks; and so it may be assumed that (properly secured) loans to member banks will be found among Federal Reserve assets. However, in recent years, Federal Reserve assets have been acquired largely as a result of open market operations. Thus, the question arises as to the most desirable type of asset for Federal Reserve open market operations.

Under present conditions there is no asset as suitable as U.S. Treasury securities. The advantages which these securities have over other assets, in differing degrees, include the following:

1. There is a relatively broad market for U.S. Treasury securities, with the result that purchases and sales by the Federal Reserve System do not have as great an effect upon market price as would likely be encountered with many other assets. Thus, the possibility that Federal Reserve open market operations will have a disturbing effect on security, real estate, or commodity markets is rather well minimized.

2. The quality of U.S. Treasury securities is above question, with the result that the Federal Reserve System does not need to direct its energies to an analysis of the credit worthiness of such securities. Also, there is a minimum of storage, preservation, etc., problems connected with ownership of U.S. Treasury securities. This leaves a maximum of Federal Reserve energies available for the major function of monetary management.

3. The use of U.S. Treasury securities minimizes the possibility that favoritism and even corruption will become involved in Federal Reserve open market operations. If the Federal Reserve System were to begin buying and selling corporate bonds, for example, there is a possibility that favoritism, or even outright corruption, would be the basis for the purchase of bonds of a particular corporation. It is true that a very high level of integrity that has always characterized the Federal Reserve System suggests that such an unfortunate development is unlikely. But in any case, the motives of Federal Reserve officials would always be subject to suspicion. This, in itself, would be a handicap.

There is some plausibility to the proposition that the economy's liquidity would be increased if the Federal Reserve System were to reduce its holdings of U.S. Treasury securities through open market sales while purchasing a like amount of other assets. Thus, a greater amount of U.S. Treasury securities would be held by other financial institutions or by the general public. However, if a greater amount of U.S. Treasury securities is desirable for holders other than Federal Reserve banks, there is a better method of achieving this goal; and it is unnecessary for Federal Reserve banks to resort to the purchase of less desirable assets.

It might be suggested that the Federal Reserve System should select assets for open market purchase and sale on an *ad hoc* basis, in such a way as to exert a stabilizing effect on various security, real estate, or commodity prices. Such a program should be most earnestly avoided. Aside from the relative disadvantages indicated above, of open market operations in assets other than U.S. Treasury securities, it should be stressed that managing the monetary system is job enough for one agency. If we are to have direct market intervention for the purpose of stabilizing the price of any item (other than the foreign price of the dollar), it is better that such intervention be carried on by some agency that does not also have the responsibility of managing the monetary system. Incidentally, the Federal Reserve System would encounter a special technical problem should it attempt to make its open market operations serve the dual role of influencing the money supply and also influencing the price of some particular item. This problem would arise from the fact that the purchase and sale of assets by the Federal Reserve System normally has a multiple effect on the money supply.

STATEMENT BY JOHN C. KERR, JR., UPPER MONTCLAIR, N.J.

I would like to say that the Congress should not legislate new portfolio requirements for the Federal Reserve System, but should instead seek to maximize the Federal Reserve Board's flexibility over its open market operations. Any points about specific aspects of the

portfolio of Government securities can, I believe, be adequately pointed out at the sessions of your committee to which the FRB Chairman and the other members of the Board are asked to testify.

STATEMENT BY L. F. LOMBARDI, READING, PA.

In response to the kind invitation of Chairman Patman, it is a pleasure for me to submit my views and suggestions for the improvement and the operation of effective monetary and fiscal policy. It is hoped that they will prove useful in discussion of these important topics by the Congress.

It is my personal impression that the supply of money (liquidity) has been markedly tight in the United States for over a decade.

Considering the rate of growth which we are stimulating by fiscal measures, I view the current trend toward restriction of liquidity as quite alarming. I am speaking particularly of tightness in the loan market and that element of the financial market which comprises and influences the stock market.

The fact that the Federal Reserve System is engaged, through its intermediary, the Federal Reserve Bank of New York and other media, in an effort to counteract some undesirable aspects of our gold outflow has required actions to maintain high domestic rates of interest. I am worried about the extension of these responsibilities within the present Federal Reserve System.

It is my view that many policies presently implemented through the Federal Reserve System would be more effectively handled by the Treasury Department. In particular, the use of Government securities as a tool of monetary policy deserves special attention. Would it not be far more effective, and admit of more exact influence and closer regulation, if the money supply were influenced in a direct manner through the issue and recall of suitable currency to all banks on an equitable ratio based on assets? The term "banks" is used here in its broadest possible meaning: commercial banks, national banks, State banks, perhaps some financial intermediaries. Government securities could then resume their rightful place as instruments of national debt. An orderly market in these securities could be maintained by the Treasury.

This program would, of course, require that all banks which are members of the FDIC would have to be members of the Federal Reserve System. The problems of regulating State banks in this manner are beyond the scope of my investigation. I believe in increased inspection, tighter banking regulations, and Government audits on an annual basis for all banks, National and State. This area seems to me the legitimate concern of the Congress which bears the responsibility for the creation of the currency.

The suggestions presented here are based on my belief that the present "dual" system of banking has a definite tendency to bypass the fact that the public or Government sector of our constitutional government has the prerogative of creating the money supply and regulating it. If this prerogative is to be placed in more private than public hands for implementation, it should be done by changing the compact rather than by a gradual erosion of the public sector. These

are the fundamentals which deserve serious consideration and choice. Under the choice already made we require only to give direct control a more firm implementation to assert the public interest and right in a money supply responsive to the will of the majority of our citizens.

STATEMENT BY RAYMOND H. LOUNSBURY, VERGENNES, VT.

In his letter of September 1, 1965, Congressman Wright Patman has raised questions concerning the operations of the Federal Reserve System.

How much of the portfolio of Federal Government securities held by the Federal Reserve System are excess holdings?

The System must add to its holdings if our country is to realize its maximum economic growth. Once the securities are acquired, however, the System does not need to retain ownership of them in order to have them available for sale in the open market at a later date. This is so because the occasion for their sale will not arise if maximum economic growth is to be maintained. Their sale in the open market could stunt our economic growth and, if on a sufficiently large scale, cause recession or even depression. Our goal should be an expanding, not a contracting, economy. However, if, because of a very large growth in the Nation's monetary gold stocks, the excess reserves of member banks should become needlessly large in relation to the legitimate credit requirements of their customers, the System could reduce excess reserves by raising legal reserve requirements instead of selling securities in the open market. Therefore, as far as the performance of the functions of the System is concerned, all Federal Government securities held by the System are excess holdings.

What should be done with excess holdings of Federal Government securities by the Federal Reserve System?

The securities should be transferred to the Treasury for cancellation. As part of the transfer the System should acquire Federal Reserve notes in exchange or the right to demand them from the Treasury at any time in order to meet the public demand for hand to hand currency that will arise from the growth of the economy.

The basis for this recommendation is the fact that it is not the function of the System to make profits. The Congress, of course, should make provision for meeting the legitimate expenses of the System as it does for any other department of Government.

Should the Federal Reserve System supplement its portfolio of Federal Government securities with other types of assets?

The System should rely mainly on the acquisition of Federal Government securities to promote maximum economic growth. This policy and the transfer of the securities to the Treasury for cancellation will reduce the size of the Federal debt and ease the interest burden on taxpayers. However, since the effect of open market operations on member bank reserves may be unevenly distributed, it would seem desirable for the Federal Reserve banks to stand ready at any time to acquire sound private instruments from any member bank whose legal reserves are inadequate to meet the legitimate credit needs of its customers.

STATEMENT BY H. D. MALONEY, PROFESSOR OF ECONOMICS, DEPAUW UNIVERSITY, GREENCASTLE, IND.

Total Federal Reserve holdings of Government securities are the cumulative result of Open Market Committee operations. The absolute level of these holdings does not, as far as present economic research is aware, reflect any particular relationship to economic conditions at any given time. The level of these holdings, as distinguished from changes in this level, has no known or necessary or desirable relationship to such variables as gross national product, national income, or levels of employment and prices. Present holdings of approximately \$40.5 billion are the net result of several decades of buying and selling activities by the Federal Reserve. The growth of these holdings is simply the outcome of an excess of purchases over sales extending over a period of several years. With rare exceptions, the Federal Reserve has not been concerned with the absolute level of these holdings, but rather with the impact of changes in these holdings on bank reserves and other monetary variables, such as interest rates. In a growing economy in which increases in bank reserves are provided principally through such operations, it is obvious that these holdings will rise over time.

As these holdings increase, there necessarily occurs an increase in federally budgeted interest payments to the Federal Reserve. These "payments" are, of course, ultimately in the nature of intragovernmental transfers. Furthermore, the interest income from Government securities accruing to the Federal Reserve is, in effect, largely retransferred to the Treasury in accordance with the longstanding policy and practice regarding the disposition of Federal Reserve System earnings. The essential point is that these transactions do not constitute a real cost or burden to the economy or to taxpayers, aside from their incidental contribution to the operation expenses of the Federal Reserve banks. They have a trivial effect on Federal revenue requirements compared with other Treasury requirements.

In my view, Federal Reserve open market operations should, aside from temporarily and essentially technical daily or other short-term requirements, be guided solely by the bank reserve situation in relation to potential credit expansion, and by considerations of interest rate level and structure. With regard to the level of bank reserves the instruments to be used should be those most immediately available and convenient; e.g., Treasury bills. Other securities with longer maturities should, on occasions, be utilized when it is desirable to influence the term structure of interest rates. The Federal Reserve should continue to be free to use short-, intermediate-, and long-term securities in such operations. Foreign exchange operations are a special case and should be left completely to the discretion of the appropriate Federal Reserve and Treasury officials.

Finally, in my view, the Federal Reserve should not in its operations become involved in the very complicated problem of discriminating among the various types of commercially acceptable assets of a private nature, with the exception of bank acceptances, which occupy a special position of longstanding nature. The view here is that in its open market operations the Federal Reserve should maintain neutrality among liquid assets other than Government securities and, in special cases, foreign exchange and bank acceptances. It should

under no circumstances engage in the most difficult practice of evaluating and trading in municipal or corporate securities or commodities. The central bank must remain essentially aloof from the movements of demand and supply for particular goods, services, and securities of a private nature. Its essential task is to oversee and regulate the reserve base for commercial bank credit expansion.

STATEMENT BY JOHN T. MASTEN, CHAIRMAN, DEPARTMENT OF ECONOMICS, UNIVERSITY OF KENTUCKY, LEXINGTON, KY.

This is written in reply to your letter of September 1, which solicits my views concerning the structure and management of the portfolio of financial assets held by the Federal Reserve System. I give you my views with considerable reservation for I recognize that I may not be fully aware of all of the complex factors which may be involved and that, in the light of a give and take of ideas and facts, I might alter the position which I shall take.

1. I think that much of the additional bank lending power could have been made available by a reduction in required bank reserves and that this avenue should be explored more fully in formulating monetary policy. Bank reserves may provide individual banks with temporary funds but they do not provide liquidity for the total banking system. The liquidity of the banking system depends upon the proper implementation of monetary policy. By reducing bank reserve requirements, the Federal Reserve System would have less of a reason for adding to its portfolio of Government securities.

2. The portfolio holdings of the Federal Reserve System, given the level of required bank reserves, should be large enough to provide an adequate supply of money to accommodate the desired level of gross national product. Since the velocity of money is not subject to control, the exact size of the portfolio, and thus the supply of money, cannot be predetermined. Monetary policy must be flexible, adjustments must be made to changes in velocity and to accommodate economic growth at the desired level. I do not believe that there is any fixed relationship that can exist between the portfolio holdings of the Federal Reserve System and the supply of money, gross national product or aggregate liquid assets. What might be regarded as a satisfactory ratio under one set of conditions might prove to be entirely unsatisfactory under another set of relationships. Flexibility and competent monetary management are necessary, not rigid and static guidelines.

3. The best criterion for monetary policy is whether it accomplishes its objective. Before we can do this, we must agree on our objective or objectives and determine to what extent they are attainable. In a democratic society, objectives should be decided by the will of an informed public; but it is highly important that the public be given all of the facts and that they understand their significance. This could and should be regarded as a plug for more economic education. I would not, however, establish a criterion in terms of the size of the Federal Reserve portfolio but rather in terms of whether it has successfully achieved its objective. If it does not do this, then we are entitled to ask, why; and to take such steps as may be necessary to

remedy the situation. Possibly we may find that we have demanded too much of monetary policy in expecting it to solve all of our economic problems.

4. I fail to see how it is possible to transfer Federal Reserve assets to the Treasury for cancellation without a corresponding reduction in Federal Reserve liabilities. A reduction in required member bank reserves would make a reduction in the size of the Federal Reserve portfolio possible. A reduction in Federal Reserve notes and an increase in Treasury currency (possibly additional U.S. notes) would also make a reduction in the Federal Reserve portfolio possible; but I fail to find any substantial advantage in such a policy at this time. In reality, all forms of currency are a debt of the Federal Government. The Federal Reserve is, in the issuance of notes, merely an instrumentality of the Government.

5. I do not think that it is necessary for the Federal Reserve to draw interest on all of its portfolio holdings. Some portion of the total portfolio could be represented by special noninterest bearing issues. At the same time, the present policy does not seem too unsatisfactory unless it can be shown that the Federal Reserve is imprudent in its expenditures. Even if this can be demonstrated, there are other ways of meeting the problem. The denial of interest income to the Federal Reserve should not be used as a means of penalizing or crippling the System. To repeat, I do not regard it as essential for the hard core of U.S. security holdings of the Federal Reserve to carry interest. It should, however, have a sufficient volume of public issues to conduct normal open market operations. These issues should have the same qualities as all comparable issues available in the open market. In fact, they should be open market issues.

6. The Federal Reserve portfolio of marketable Government issues should be large enough to enable it to engage in open market operations throughout the range of the maturity schedule. Any special non-interest-bearing issues that it might hold should be convertible into marketable issues under predetermined conditions. The important consideration should be the preservation of flexibility in the implementation of monetary policy. I am skeptical of inflexible predetermined standards which serve to inhibit action when it is needed.

7. I do not favor open market operations or purchases by the Federal Reserve of municipal securities, corporate bonds, commercial paper, or commodities. The Federal Reserve should not be subjected to the political and other pressures that would develop as a result of trading in these areas. Foreign exchange dealings are justifiable if they serve to stabilize the flow of funds internationally and thus have a direct impact upon the domestic monetary system.

In summary, I wish to remind the Subcommittee on Economic Progress that nearly all money used internally in the United States is debt. It is not convertible directly into anything of intrinsic value. The real value of money depends upon what it will buy in the way of goods and services. Thus, proper monetary management is of the utmost importance for the welfare of the people.

We need to find a way of coming to an agreement upon the objectives for monetary policy. Then, assuming that the people who must implement policy are honest and competent, we need to give them the tools adequate to the task. Change is inevitable but change for the

sake of change should be avoided. Evolutionary change is also preferable to sudden and disruptive change. I trust that your survey will provide the basis for constructive and considered changes that are undoubtedly needed and I wish to thank you for inviting me to express my views.

STATEMENT BY C. A. MATTHEWS, PROFESSOR OF FINANCE, COLLEGE OF BUSINESS ADMINISTRATION, UNIVERSITY OF FLORIDA, GAINESVILLE, FLA.

SIZE AND MANAGEMENT OF THE FEDERAL RESERVES PORTFOLIO OF GOVERNMENT SECURITIES

Questions related to the size and management of the Federal Reserve's portfolio of Government securities must be considered within the context of the objectives of central policy and of the instruments available to the central bank to accomplish or implement policy decisions. The following comments will be based on the assumption that the objectives of policy will be essentially those set forth in the Report of the Commission on Money and Credit; namely, low levels of unemployment, a relatively stable price level, and adequate rates of economic growth. It will also be assumed that the available policy instruments will be essentially the same as those possessed by the Federal Reserve authorities at present. The question of primary consideration is how to instruct the authorities in the use of open market operations. This leads to further questions concerning the disposition of securities held and of earnings received.

Principles To Be Applied

In formulating instructions concerning the use of any policy instrument, Congress should consider certain basic principles. Obviously, the instrument should be strong enough so that its use will make significant contributions to achieving the objectives of monetary policy. In addition, use of the instrument should be sufficiently flexible to enable it to be adapted to changing needs of the economy and to changing conditions. And finally, the nature of the instrument should be such that its use will interfere as little as possible with the market process and subject the authorities to the minimum pressure from special-interest groups.

If these principles are applied to the instructions which are written into the law concerning open market operations, they would require that the Federal Reserve be given the authority to buy and sell securities in sufficient quantities to achieve its objectives. The framers of the original Federal Reserve Act placed considerable faith in the acquisition and redemption of eligible commercial paper as an automatic guide to monetary policy. While the Federal Reserve banks were permitted to acquire Government securities, they were not permitted to use these as collateral for the issuance of Federal Reserve notes. Consequently, when a shortage of eligible commercial paper coincided with a desire to convert demand deposits into currency, the authorities were limited in their ability to issue Federal Reserve notes in the amounts necessary to maintain liquidity of the financial

system. Considering the size of the Federal debt at the present time, there is little danger that a shortage of this media for open market operations, nor of collateral for Federal Reserve notes will exist in the near future, but the lesson of our past monetary experiences should not be lost.

The principles set forth above would also require that open market operations should be conducted in those securities which have the "deepest and broadest" market. If this principle is followed, open market operations in a volume sufficient to accomplish the System's objectives will have the least impact on the price of securities traded and on the price differentials between these and other securities. Freedom to enter the market to buy and sell securities as necessary without specification as to type or maturity date would result in the least interference with the free market processes and the allocation of resources. Such freedom would also provide the flexibility needed to permit open market operations to adjust to changing economic conditions. It follows that Congress should refrain from specifying too rigidly the types or maturities of securities to be bought and sold in open market operations.

While permission to engage in open market operations should extend to a sufficiently broad definition of securities so as not to limit the authorities' ability to achieve given objectives, the composition of the Federal Reserve's portfolio should not be specified nor should the Federal Reserve be required to buy or sell any particular type of securities. To specify that the Federal Reserve authorities should execute open market operations in State and local securities, would open the gates to pressure from issuing governmental units to buy specific issues or to refrain from the sale of specific issues when impact of such transactions would be beneficial or harmful to the governmental unit concerned. Furthermore, the market for the issues of most of the individual States and localities is probably too narrow to permit open market operations without causing undue fluctuations in the price of the security being bought or sold.

Open market operations in commodities would also subject the monetary authorities to continuous pressure to purchase selected commodities, to refrain from purchase, to dispose of its stocks, or to refrain from sales as the self-interest of different groups might be served by these alternative courses of action. Such pressure would support open market operations designed to influence prices of individual commodities—not the welfare of the economy in general—and would undermine the very foundation of a free-enterprise economy, the marketplace. However imperfect the marketplace is and however limited it may be in scope, to require open market operations in commodities would only serve to limit it further.

Open market operations in commodities are subject to two other objections which should be mentioned. One of these objectives stems from the problem associated with the storage and preservation of commodities. While these problems might not limit the purchase of commodities, if the commodities should be perishable they might not be available for sale when and if the need arose to restrict or contract the money supply. Consequently, open market operations in commodities could result in an inflationary bias as it might provide the basis for an expansion of the money supply without the ability to subsequently force a contraction should the need arise.

Closely related to this is the problem of confidence. Should it be necessary to write off substantial quantities of commodity assets, what capital account would they be charged against? Such a situation could give rise to unlimited rumors which could result in the loss of confidence in the money supply. (If some type of convertibility were maintained, it could also result in runs on the commodity held for conversion.)

OPTIMUM SIZE OF PORTFOLIO DIFFICULT TO DEFINE

It is difficult to define the optimum size of the Federal Reserve System's portfolio of Government securities (or of any other asset or group of assets). Since we are opposed to instructing the Federal Reserve to acquire other types of securities and commodities either separately or collectively, we will direct our comments to the desirability of limiting or defining the size of holdings of Government securities. Here, one must recognize and be ever cognizant of the objective of open-market operations which is to assist in achieving the country's economic objectives through controlling or influencing the money supply. One must also realize that open-market purchases provides the basis for a multiple expansion of the money supply, whereas, sales tend to cause a multiple contraction.

If the money supply is to be varied through open-market operations, then it follows that the size of the portfolio to be accumulated by the Federal Reserve System cannot be defined in relationship with the money supply. To use this means of control would be to assume that the money supply adjusts, in some way, to the needs of the economy and that this adjustment should determine the optimum size of the Reserve System's portfolio. While correlation analysis will show a positive relationship between changes in the money supply and changes in Federal Reserve ownership of Government securities, the change in the former does not cause the change in the latter. It is more logical and accurate to have the causal relationship run from an increase in the Federal Reserve's portfolio to an increase in commercial bank reserves to an increase in the money supply.

Even if the time sequence seems to run for an expansion of the money supply to an increase in Federal Reserve ownership of securities, the significant causal relationship is the reverse. The commercial banking system may be able to effect an expansion of the money supply as a result of continuously increasing discounts at the Federal Reserve banks, or as a result of more efficient utilization of existing reserves.

If the former is the route taken, then a subsequent acquisition of securities is probably necessary for the expansion to be maintained since the banks do not like to remain continually in debt to the Fed. Such is not the case, however, if the banks are able to more efficiently utilize reserves. In the latter case, the past acquisition would have provided the reserves and present innovations enabled the reserves to support a larger money supply. But this case does not need the Federal Reserve to acquire additional securities to provide a base for the larger money supply.

There is a possibility, of course, that in addition to more efficient utilization of reserves, commercial bank reserves may be increased from sources other than increases in Federal Reserve bank credit

outstanding. For example, the public may permanently alter the ratio in which it holds currency and demand deposits so as to decrease the proportion of the former, or the gold supply of the United States may increase. Either of these changes would permit an expansion of the money supply which, if accompanied by an increase in Federal Reserve holdings of Government securities would permit even further increases if the basic objectives required restraint on the expanding money supply.

These relationships and possible effects serve to illustrate the danger inherent in instructing the monetary authorities to maintain any fixed proportion between Federal Reserve holdings of Government securities and other economic series. Fundamental changes may occur in the relationship between the money supply and the level of economic activity, between the selected series and the money supply, and, therefore, between the optimum size of the Federal Reserve's portfolio and the level of economic activity. If the assumed relationships do not exist, then the attempt to maintain a fixed relationship between the Federal Reserve's portfolio and any selected guide may lead to policy which prevents rather than contributes to the achievement of economic objectives; that is, may contribute to instability rather than stability.

WHEN ARE FEDERAL RESERVE HOLDINGS EXCESS?

If it is decided that the optimum size of Federal Reserve holdings of Government securities cannot, or should not, be defined by law, then it follows that it is equally difficult or impossible to define what is meant by "excess holdings." But even if it is possible to arrive at some concept of excess, it would not necessarily follow that those securities in excess should be returned to the Treasury for cancellation. To do so might interfere with the Federal Reserve's ability to contract bank reserves should they experience a substantial growth from other factors such as the tremendous gold inflow during the 1930's and 1940's. It is also conceivable that such action could interfere with the Federal Reserve's ability to issue Federal Reserve notes should the public decide to increase the proportion of assets it desires to hold in the form of currency as opposed to demand deposits or other assets. It is during emergency periods such as these that the monetary authorities find it most difficult to fulfill their responsibilities. Regulations and guides directed toward normal conditions and problems prove inadequate. Only by providing authority and resources sufficient to the exceptional problem can the authorities be expected to meet their responsibilities. It is impossible to determine when or to what extent the periods of crisis may develop in the future. In the meantime, it would be unwise to transfer "excess holdings of Government securities" to the Treasury for cancellation and thus limit the ability of the Federal Reserve to cope with future emergencies.

WHAT SHOULD BE DONE WITH EXCESS EARNINGS?

It does not follow, however, that the excess earnings of the Federal Reserve System should not be transferred to the Treasury. Since the Federal Reserve System has been established as a means of implementing powers granted by the Constitution to Congress, it follows that profits from such operations should accrue to the people as a whole—

or to the Treasury. The only question is how to achieve this transfer as efficiently as possible. The present method is to invoke a clause of the Federal Reserve Act which was originally included for a different purpose. In general, it is undesirable to achieve desirable objectives through illegal means.

It would be preferable to provide for the transfer of excess earnings by statute. Such an objective could be accomplished by requiring the Federal Reserve banks to pay a franchise tax based on their earnings similar to that included in the original Federal Reserve Act. Another possibility would be to have the Treasury issue special securities—at very low rates of interest or noninterest bearing—in exchange for those acquired through open market operations. The securities acquired by the Treasury would be held for reverse exchange should the Federal Reserve need them for open market sales. This procedure, however, would be more cumbersome and the simpler method of a franchise tax is preferred.

The question relating to the disposition of excess earnings implies that some measure of excess exists. It opens a whole series of related questions such as who should be responsible for determining and reviewing expenses of the Federal Reserve System, who owns and should thus receive the “profits” from the operation of the System; and who should own the System. These are questions which were not raised for discussion and to which we have not addressed our remarks. They are, however, germane to any discussion of the disposition of Federal Reserve earnings.

STATEMENT BY THOMAS MAYER, PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA, DAVIS, CALIF.

I feel that the level of the Federal Reserve's portfolio at any one time is not nearly as important a factor as the changes occurring in the portfolio. One can treat the level of the portfolio as a relatively unimportant outcome of these changes. Hence, the problem really becomes one of finding criteria for changes in the Federal Reserve's holdings of Government securities. These changes can be looked at as the resultant of the following factors: (1) the increase in the money stock, (2) the proportion of the increase in the money stock which is brought about by open market operations rather than by other factors, such as currency holdings or changes in reserve requirements, and (3) the distribution of earnings and assets between the Federal Reserve and the Treasury.

The criteria for the optimal growth of the money stock are full employment and price stability, and if we insist on sticking to fixed exchange rates, balance-of-payments equilibrium. (Obviously these criteria need not be consistent.) On a more concrete level I would advocate increasing the money stock at a fairly stable (but not rigid) rate determined by the growth of (full employment) output and major changes in velocity. The second factor, the extent to which the money supply should be increased by open market operations centers around the choice between open market operations versus the lowering of reserve requirements. Your committee has discussed this issue extensively in the past and has done yeoman service in bringing this issue to the public's attention. I lean toward the position that, on the whole, it is better to increase the money supply via open market operations.

This implies that the Federal Reserve's holdings of Government securities are growing over time, unless there is a redistribution of assets between the Federal Reserve and the Treasury. Since the Federal Reserve is a part of the Government such a redistribution has little potential either for good or for evil. I can see only the following three minor advantages in turning over \$30 billion of securities to the Treasury. First, having the Federal Reserve hold public debt exaggerates the size of the national debt, and hence, may cause some unnecessary concern to some people. But this is probably only a minor point since the public appears to be less concerned nowadays with the size of the debt than it was earlier. Moreover, people who are worried about the size of the debt would probably be just as worried about a \$280 billion debt as they are about a \$310 billion debt. A second possible advantage is that a smaller cushion of net earnings may cause the Federal Reserve to work harder at keeping down expenses. But this is only a hypothetical effect, and in case it appears, at least on the basis of my rather casual and quite limited observation, that the Federal Reserve is not spendthrift. Third, turning over Government securities to the Treasury would prevent the possibility that the Federal Reserve at some future time may decide not to surrender its net earnings to the Treasury. But this is a rather unlikely contingency. Moreover, if this were to happen the Treasury could increase its deficit spending by an equivalent amount without being inflationary, so that the failure to receive the Federal Reserve's earnings would really involve no significant cost to the Treasury.

The second point raised in your letter is the composition of the Federal Reserve's portfolio. With regard to the maturity structure, like most economists I was glad to see "bills preferably" abandoned. Since the long rate reacts only sluggishly to changes in the short rate, the Federal Reserve should stand ready to operate in all maturity segments of the market if it wants to bring about a change in interest rates.

The purchase of private securities in place of Government securities raises another issue. It may be worth noting at the outset, that the Federal Reserve through its purchase of banker's acceptance and the provision of business loans is already operating in the private market, and hence, that there is little room for the ideological argument that operating in the private market is against Federal Reserve tradition. Under normal circumstances I see little need for the Federal Reserve to buy or sell private securities. But in a very severe depression, if rising risk premiums prevent rates on corporate securities from falling, Federal Reserve purchases of private securities would be helpful. Admittedly, there is no imminent danger of such a severe depression, but giving the Federal Reserve the power to purchase corporate and municipal securities, (without compelling it to do so) would be a useful safeguard. Support of mortgages in a severe depression could perhaps be handled better by one of our numerous specialized housing agencies. This leaves business loans. I believe that the Federal Reserve should not be in the market for two reasons. First, the granting of business loans requires an intimate knowledge of business, and the Federal Reserve is not equipped with this knowledge, except perhaps in the case of large firms. Second, granting business loans brings the Federal Reserve into competition with the banks it has to super-

wise, and this creates trouble. Apparently, one of the European central banks has been hindered in its monetary policy by the fact that banks are reluctant to rediscount (and thus reveal their customers) for fear that the central bank will attempt to capture these customers for itself.

STATEMENT BY STEPHEN L. McDONALD, PROFESSOR OF ECONOMICS,
UNIVERSITY OF TEXAS, AUSTIN, TEX.

COMMENTS ON ISSUES RELATING TO THE FEDERAL RESERVE SYSTEM'S
PORTFOLIO OF GOVERNMENT SECURITIES

I. General.

Given the tools of monetary management available to the Federal Reserve System and the various factors not subject to System control affecting the availability of reserves to commercial banks, growth of the System's portfolio of Government securities is closely linked with growth of the Nation's money supply. Purchase of securities is the only means by which the System may directly and on its own initiative supply additional reserves to commercial banks and thereby enable an expansion of the money supply. Additions to reserves through discounts and advances, while influenced by the discount rate and System permissiveness, depend on the initiative of member banks. The System may enable an expansion of the money supply by reducing the required reserve ratios of member banks, but the limitations on this tool of monetary management, imposed by law, and the need always to leave some room for emergency reductions, make it an unsuitable means of providing for orderly growth of the money supply over the long run.

Several factors other than Federal Reserve policy actions affect commercial bank reserves: variations in the monetary gold stock, changes in currency in circulation, growth of Treasury currency outstanding and fluctuations in the float, in nonmember deposits with Federal Reserve banks and in other System accounts. Chief among these are variations in the monetary gold stock and changes in currency in circulation. To manage the Nation's money supply appropriately the Federal Reserve System must supplement, offset or passively permit the effects of these other factors influencing commercial bank reserves, depending on the size and direction of their net effect. In recent years a substantial decline in the monetary gold stock and a similar increase in currency in circulation, both tending to reduce commercial bank reserves, have required compensatory expansive actions by the System, principally enlargement of its portfolio of governments through open market purchases.

II. How large should the System portfolio be in relation to other economic variables?

There is no simple rule that can be stated concerning the appropriate or best relationship of the System portfolio to the money supply, the gross national product, aggregate liquid assets or any other such variable. Given the System's powers and depending on the concurrent net effect of the several nonpolicy factors affecting commercial bank reserves, it may be appropriate for the System portfolio to grow at

the same rate, at a higher rate, or at a lower rate than other economic variables; and there are no specifiable critical ratios at which relative growth or decline of the portfolio should cease. The important thing is that the System have adequate and efficient means of increasing the money supply at a rate conducive to sustainable growth, minimal involuntary unemployment and stable prices, regardless of the influence of nonpolicy factors on commercial bank reserves.

It is conceivable that System accumulation of governments over the years might so reduce the supply available to the private sector as to affect adversely the quality of private portfolios, particularly if the Federal debt should grow at a markedly lower rate than private debt. The development of such a problem in the foreseeable future seems most unlikely. In any case, there is no basis in economic theory or experience for specifying some unique ratio between System holdings of governments and total available financial assets (of any degree of liquidity) at which private portfolios would begin to experience significant deterioration. The best way to insure against such problems is to give the System wide latitude in its choice of means to affect the money supply, including the types of assets purchased and sold.

III. What types of assets should be eligible for the System portfolio?

For several reasons, Government securities are the preferred type of asset for that portion of the Federal Reserve System's portfolio acquired through open market purchases. Governments are eligible collateral for Federal Reserve notes; they are traded in well developed, highly active markets in which transactions costs are low and quantity purchases have minimum impact on price; they may be bought and sold without directly influencing the relative borrowing costs of individual businesses or industries.

For the simple purpose of supplying additional reserves to commercial banks, however, the type of asset purchased by the System is immaterial. It may be real or financial, a claim issued by a public or a private entity and, if a debt instrument, of any maturity. Consequently, the System should be free (and willing) to acquire assets other than governments and instruments of any maturity when such action would tend to enhance the effectiveness of monetary management, whether by increasing the selectivity of policy actions or by minimizing such unwanted side effects as private portfolio deterioration. Since the desideratum is sufficient System flexibility to cope with any likely set of circumstances in pursuing the aims of monetary policy, it would be undesirable to try to prescribe the composition of the System portfolio.

IV. What should be done with any "excess" in the portfolio?

The Federal Reserve System's portfolio of governments may be "excessive" in the sense that it contains more securities than the System is likely ever to wish to sell as a matter of policy, or in the sense that it yields more current income than is necessary to finance the legitimate operations of the System. If the portfolio is excessive in both senses, or in the latter sense only, two remedies are readily available. First, the System may be required to exchange the excess portion of its portfolio for non-interest-bearing obligations of the Treasury, the latter being eligible collateral for Federal Reserve notes

and reexchangeable, as required for open market sales, for interest-bearing Treasury obligations. The non-interest-bearing obligations might, indeed, take the form of legal tender notes which could be placed in circulation as demanded by the public in lieu of Federal Reserve notes. Second, the System may be required simply to return any excess earnings on governments to the Treasury, as it now does.

The second remedy is simpler and equally effective in reducing the net cost to the Treasury of debt held by the Federal Reserve System. The variant of the first remedy involving legal tender Treasury notes would reduce the gold certificate reserve requirements of the System (by reducing the issue of Federal Reserve notes); but this reserve requirement, which is domestically functionless and internationally detrimental, should be eliminated in any case.

STATEMENT BY GEORGE W. MCKINNEY, JR., UPPER MONTCLAIR, N.J.

In specific comment on the colloquy between you and Federal Reserve Chairman Martin, enclosed with your letter, I oppose H.R. 7601 or any other measure which would cancel legal obligations of the U.S. Government. I feel Mr. Martin's position is both clear and correct.

The free market principle is an important aspect of effective central banking. To require the Federal Reserve to hold nonmarketable Government securities, or to cancel or otherwise renounce any part of the public debt of the United States, would involve a subversion of the principles of central banking and a debasement of the credit of the Nation which would be intolerable. Cancellation of outstanding obligations of the Federal Government, whether or not they were held by the Federal Reserve, would pose a threat of partisan manipulation of central bank assets or forced acquisition of assets by the central bank. It would be considered by foreign governments and individuals to be a serious threat to those monetary policies necessary to preserve the value of the dollar. The prestige of the U. S. dollar abroad would suffer damage of incalculable significance. The damage to foreign and domestic confidence in the integrity of our Government would be considerable.

The following comments are in specific answer to the questions raised in the body of your letter. The size of the portfolio held by the Federal Reserve should not be determined by the money supply, the gross national product, aggregate liquid assets, or any similar quantitative measure; the appropriate criterion is the well-being of the economy. Under no circumstances should these assets be returned to the Treasury for cancellation. The Federal Reserve should continue to hold them and draw the interest on them as does any other properly constituted owner of Government debt instruments. This interest, as such, should not be returned to Treasury, although the present substantial tax paid by the Federal Reserve is reasonable and appropriate. Standards set by the Congress to guide Federal Reserve portfolio operations generally should not be quantitative. They should be subjective in nature and should relate only to achieving the most effective execution of the responsibilities given to the Federal Reserve by the Congress. In general, additional standards

relative to the kind or maturity of assets held by the Federal Reserve are not now necessary.

These replies to your questions should be considered only in the context of the central banking functions of the Federal Reserve System. The Federal Reserve's total portfolio of assets should be determined in the first instance by the needs of the economy. Because other considerations should be subordinate to this one, the appropriate size of the Federal Reserve's portfolio of Government securities cannot be discussed in isolation. Alternatives must be considered: it is feasible for the Federal Reserve to reduce its average portfolio of Government securities only if the contractionary effects of the related open market operations are offset by some equivalent expansionary influence. To consider whether the Federal Reserve should hold a smaller average portfolio of Government securities, it is essential to simultaneously consider whether reserve requirements should be reduced, or member banks should be encouraged to increase their borrowings from the Federal Reserve, or some other asset should be increased in an amount commensurate with the reduction in the Government securities portfolio.

The Federal Reserve should be attentive to arguments of those who feel the "mix" of these variables should be changed in any specific situation, but the responsibility and authority should be left to the System. The range of discretion the Congress has seen fit to grant to the Federal Reserve in managing its asset holdings should not now be further restricted. It would be appropriate, though, to permit or require the Federal Reserve to reduce reserve requirements, especially against time deposits. Such a reduction, of course, would be accompanied by an offsetting sale of Government securities or other assets from the Federal Reserve's portfolio.

It is important to bear in mind the fact that a relationship between the Federal Reserve's portfolio and any other single economic aggregate which might be appropriate at one time or under one set of circumstances would be inappropriate at another time or set of conditions. The Federal Reserve needs the maximum possible freedom of action to formulate effective credit policies tailored to economic circumstances as they change from day to day. Positive efforts should be made to avoid unnecessary restraints on the mechanics by which these policy objectives are accomplished.

STATEMENT BY FLOYD A. METZLER, PROFESSOR OF ECONOMICS,
UNIVERSITY OF CHICAGO, CHICAGO, ILL.

In answer to Mr. Patman's question, I do not believe there is any hard and fast rule concerning the amount of Government bonds which the Federal Reserve System should hold in its portfolio. Canceling the Government bonds held by the Federal Reserve would indeed reduce the Government debts, but it seems to me that this effect would be small. A much more important consideration than the asset portfolio of the Federal Reserve System is the fiscal policy followed by the Federal Government.

If we want to expand the demands for goods and services, I believe that except for its effect on the balance of payments, it is a matter of

indifference whether we try to manipulate the quality and availability of money or the relation between the Government taxes and its receipts; fiscal policy, in fact, is likely to be more effective and more rapid than monetary policy. Until now, the Government debt has not increased substantially relative to the national income. For this reason, I am not greatly concerned about the asset portfolio of the Federal Reserve System. What is more important, I believe, is an extension of our ideas concerning the Government debt. If the Federal Reserve System were considered a part of the Federal Government, Treasury bonds held by the Federal Reserve would be an asset from the point of view of the banking system and a liability from the point of view of the Treasury. The net effect would be zero so far as the Federal Government as a whole is concerned. Canceling the debt would thus write down the Treasury liability and the Federal Reserve asset to the same degree, leaving the net debtor position unchanged. There is another point, however, which argues in favor of giving the Reserve System more latitude in its portfolio. The balance of payments is not, now, a pressing issue but it may become so in the future. In this situation the Federal Reserve System might have to sell bonds to prevent a capital outflow. If so, it would be important for the Federal Reserve have enough bonds in its portfolio to carry out its responsibilities.

STATEMENT BY ERVIN MILLER, ASSOCIATE PROFESSOR OF FINANCE,
WHARTON SCHOOL OF FINANCE AND COMMERCE, UNIVERSITY OF
PENNSYLVANIA, PHILADELPHIA, PA.

It seems to me that it is not feasible to stipulate just what should be the quantitative relationship of the Federal Reserve portfolio to the money supply, gross national product, or aggregate liquid assets of the economy. Although it is certainly true that the portfolio of Government securities has been growing rapidly, it should be borne in mind that this rise has been in the period 1958 to date, while for the 6 previous years the portfolio was relatively stable. Indeed, one can go back still further and find that at year ends 1945 and 1957 the holdings of Government securities were almost identical. The recent period of rapid growth has coincided with adverse gold movements and with increases of currency in circulation and thus the growth in the Federal Reserve portfolio has been necessary largely to offset them. This serves to demonstrate that in a world of rapid change, freedom of action to move vigorously and decisively is essential to the success of central bank policy. Quantitative restrictions on acquisitions of Government securities in recent years would have hampered Federal Reserve's ability to move vigorously and decisively.

However, there is one relationship of the Government security holdings of the Federal Reserve that should be watched carefully; namely, the ratio of Federal Reserve holdings to the marketable Federal debt by the public and the Federal Reserve combined. Circumstances can be envisioned in which this ratio might impinge on the needs of the rest of the economy for the uniquely riskless asset that Federal debt provides. In such a situation, it might be desirable for the Reserve authorities to consider acquiring other assets. Here it would seem best to avoid private securities in open-market operations owing to possible political

charges that may be made concerning the choices of securities and the impacts of the purchases. It would seem best also to avoid commodities for a variety of reasons; e.g., political complications, the impinging on other governmental programs which deal with price and/or income stabilization in agriculture, etc. The most suitable additional assets for the Reserve authorities to consider would probably be the highest grade of readily marketable municipal and State securities. These are in substantial and growing supply and probably give reasonable insulation from political pressures. Foreign exchange offers the highly desirable quality of being an impersonal medium, and can be used successfully at times. On the other hand, its availability is related to the state of the balance of payments. Thus open-market operations in foreign exchange—especially if large scale—might at times be in conflict with foreign and other economic policies or be hampered by the state of the balance of payments. In short, foreign exchange does not offer the possibility of flexible open-market operations at all times.

If private assets are to be considered, open-market commercial paper is a logical possibility, given its impersonal character and short life-span. Existing operations in bankers' acceptances could be stepped up, with the Reserve authorities taking an active role in acquiring or disposing of such assets.

The fiscal impact of Federal Reserve holdings of Government securities is handled reasonably well at present, since nearly all the interest flows back to the Treasury under current policies. However, improvement is clearly possible, and a strong case can be made for having the Federal Reserve exchange a substantial part of its portfolio for special non-interest-bearing issues of the Treasury. This would make the recorded budget level of interest payments correspond more closely to the facts; i.e., some of the present overstatement of interest charges in the Federal budget could be removed and the overall budget total correspondingly reduced.

STATEMENT BY HAROLD W. MILLER, PROFESSOR OF ECONOMICS, STATE UNIVERSITY COLLEGE AT BROCKPORT, BROCKPORT, N.Y.

It would be very handy to have some formula for arriving at portfolio need of the System, however I fear it might not serve too well. To look back over the years to note portfolio change we may observe a swell from 2.2 billion in December of 1941 to 23.7 billion in 1945 was accompanied by a near comparable change in the money supply from 10.9 to 28.4 billion. Naturally the Fed was playing a central bank's role in financing the war while politicians were content not to levy the necessary tax.

From what I can observe this was the beginning of a large portfolio and the swell is now 39 billion as you point out while money supply is now about 163 billion. To me these relationships are quite interesting.

I would judge the "prime" purpose of having any portfolio at all is for OM operations. They wouldn't need a bundle of stock in order to buy more to expand reserves. However, to tighten up on things they would need something to sell—you must admit we wouldn't want the Fed to be caught without highly salable securities just in case we need to cool off the economy.

Your question—How much do they need? A review of OM sales of the past tells us past needs but the future might require something more. Of course, the needs would have some kind of relationship to GNP, total credit, etc. However, any relationship that might be established would not be constant for any length of time. I appreciate your efforts to simplify monetary theory but I fear it isn't a 1, 2, 3 kind of thing.

It appears your real worry is the level of efficiency of the System. The Fed spends what it needs and turns the rest back to society. Perhaps this is an odd arrangement but I feel it might very well be considered better than to have a central banking system that has to go to Congress for operating funds; regardless of the party in power, politics can become sticky.

Somehow I feel you would agree we want a central bank to have operating funds adequate for the:

- (1) hiring of top flight, well-trained individuals;
- (2) expense of providing for visitors from abroad;
- (3) publication and distribution of education materials;
- (4) servicing of money in general; and
- (5) currency exchange activity

As for the backing of Fed notes with securities one might hesitate to give it too much weight. Actually the true backing of the note is the availability of goods and services in the country at competitive prices. This also applies to the dollar when on foreign soil.

Mr. Patman, I appreciate your concern and even if I thought the system was perfect I would still value your interest in monetary theory. In the past you have worried about the source of new money. With expansion of the stock of money some loyal citizen pays someone else interest on money today that did not exist yesterday. Naturally this usually happens with an expansion of the economy and an increase in loans. Contraction of the economy with fewer loans would contract the money as you know. The real question then centers on the downright efficiency of our commercial banking system.

Perhaps this correspondence does not answer your question to your satisfaction. Let me say the situation is far from simple and does not lend to simple answers.

STATEMENT BY OSCAR MILLER, ASSISTANT PROFESSOR OF ECONOMICS,
COLLEGE OF BUSINESS ADMINISTRATION, UNIVERSITY OF ILLINOIS,
CHICAGO, ILL.

It is my opinion that the only important relevant criteria in regard to size of the Federal Reserve portfolio is the ability of the Open Market Committee to affect the monetary supply and thus affect price-level stability and the volume of employment in our economy. More explicitly, I feel that the size of the portfolio should be large enough so that the reserves of the member banks could be significantly altered to provide price-level stability and full employment. I see no necessity for stating a maximum level of assets to be held by the Federal Reserve, but rather a minimum level, namely, enough to significantly effect changes in the supply of money in the economy. I see no reason for the Federal Reserve transferring assets to the Treasury, inasmuch as the interest payments merely represent a transfer of ownership,

but do not place a greater real burden upon the economy when being held by the Federal Reserve or being held by the Treasury. If the Federal Reserve did not draw the interest and use it to pay their expenses, they would have to obtain their expense money elsewhere (via taxes or other charges) and although a different distribution (as among citizens) of the burden might be achieved, the burden to the whole economy would be the same.

With regard to the types and maturities to be held, I feel that so long as U.S. Government securities are available, they should be held as the major kind of asset in the open market portfolio—with long-term maturities being preferred so that long-term interest rates may be significantly affected by the Federal Reserve (again toward the objective of full employment and price-level stability) so as not to cause the the possibility of undue embarrassment to the Treasury of an overzealous board attempting to reduce a large part of their holdings at inconvenient times (recessions). Commercial and foreign assets should be permitted to be held by the Federal Reserve only if and when the supply of U.S. Government securities is too small for the Federal Reserve to achieve the increase in bank reserves necessary to affect price-level stability and full employment. I do not see the latter condition as a real condition in the near future.

The questions of combining the Treasury and Federal Reserve into a single monetary authority under some form of congressional control and membership on the Board of the Federal Reserve and on the Open Market Committee are left for another time. In general, I find myself sympathetic to Representative Patman's views in these areas.

STATEMENT BY HYMAN P. MINSKY, PROFESSOR OF ECONOMICS,
WASHINGTON UNIVERSITY, ST. LOUIS, MO.

The Federal Reserve System really is a department of the Federal Government that has been granted some independence in policymaking. Within what is normally a small range of variation, the liabilities of the Federal Reserve System determine the reserve base and hence the deposit liabilities of the member banks. I take it that the continued existence of fractional reserve commercial banking is not at issue. What is at issue is whether the "posture" of the Federal Reserve System as a bankers bank is to be maintained.

If we consolidate the books of all the Government agencies, then the Treasury debt held by the Federal Reserve banks would appear as both an asset and a liability of the Government. Such internal financial arrangements are usually ignored—the debt to all practical purposes does disappear once it enters the Federal Reserve System's portfolio.

The present arrangements make the reserve base of the commercial banks reflect either loans or investments by the Federal Reserve or the Treasury's holdings of gold. In principal there is no reason why the Federal Reserve System should be able to cast up a conventional balance sheet. It could like the Treasury have only half a balance sheet. In principal the erasing of some \$30 billion of Federal Reserve holdings of Government debt or equivalently the substitution of some \$30 billion of a special zero interest rate Treasury debt for the standard

debt now held—should have no effect upon the operation of banks or the central bank.

Because something makes no difference in principal it does not follow that it does not in fact matter. The transformation of conventions into matters of principal is not an unknown phenomena, witness the recent controversy over the kind of metal on which coins are to be printed. The convention that the Federal Reserve System have assets equal in value to its liabilities can blunt the willingness and ability of the Federal Reserve System to fulfill its responsibilities as the lender of last resort in a time of crisis. On the other hand, there is no reason to take the myth about the Federal Reserve seriously if the Federal Reserve does not take it seriously. Under these circumstances we might just as well let well enough alone.

A central bank does not need any stock of interest-bearing Government debt in order to engage in contractionary open market operations. It could decrease the reserve base of the commercial banks by borrowing from banks in the Federal funds market. The distinction between Treasury debt management and Federal Reserve open market operations is trivial. In principal the Federal Reserve System could own the entire Federal debt and emit its own interest-bearing debt to keep the reserve base of the commercial banks on target.

Much of what is called the defensive operations of the Federal Reserve System are really unnecessary in the sense that they could be eliminated by some slight changes in usages. Two changes that would help to this are (1) to allow member banks to issue currency on exactly the same terms as they now issue demand deposits; and (2) to open the discount window to money market institutions such as Government bond dealers and consumer credit houses.

The essential function of the Federal Reserve is to act as a lender of last resort to the financial markets of the economy as they are rather than as the Federal Reserve thinks they ought to be. The Federal Reserve—or the Government—by implicitly insuring the nominal price of private liabilities against the possibility of a general pressure to liquidate prevents the development of a cumulative crisis and makes such liabilities more attractive.

When tested the Federal Reserve System failed not only as a lender of last resort to the market but even as a lender of last resort to the commercial banks. As a result of the distrust of the Federal Reserve which followed the central banking function was decentralized. Partial central banks such as FDIC, FHA, HOLC, FNMA, etc. have arisen with responsibility to maintain orderly conditions in particular markets. However, because the Federal Reserve controls the quantity of money, it might be necessary for the Federal Reserve System to back up these specialized institutions. Unless the Treasury intervenes, the Federal Reserve System, using bankers ideas of eligible assets might not find the intruments offered by these specialized institutions to be of high enough quality.

The Federal Reserve's broad responsibility is not to allow tangible asset prices to get far out of line with their costs of production. In order to do this it must stand ready when a deflationary crisis threatens to buy all "assets" at a price that is close to their nominal or book value.

It follows that the view that the Federal Reserve System must maintain a conventional balance sheet, and that the Federal Reserve System

should hold a risk averters portfolio, can get in the way of the Federal Reserve System doing the correct thing. If the aim is to expand the reserve base you buy assets, any assets will do. If you want to peg a price you buy the assets or a closely related asset; you do not depend upon a "perfect" oozing relationship among assets. If you want to abort a deflationary process you acquire the assets under pressure.

The other function of the Federal Reserve System, the maintenance of conditions for economic stability and growth is fulfilled with the proper change in the reserve base. There is no reason why the subsequent substitution of a special Treasury instrument for whatever the Fed acquires in this process need lead to any repercussions.

On the other hand, it may very well be that the public's direct and indirect holdings of Government liabilities is the really relevant determinant of income. If this is so, merely increasing the size of the conventional money supply may not be sufficient to maintain income and employment. Rather what is needed is a correct rise in the public's secure outside asset, the Government debt. Thus a chronic deficit, rather than the substitution of one Government liability for another in private portfolios is what is needed.

STATEMENT BY HOWARD E. MITCHELL, ASSOCIATE PROFESSOR OF ECONOMICS, WESTERN WASHINGTON STATE COLLEGE, BELLINGHAM, WASH.

A review of the questions raised in your letter suggests that there are two general areas for consideration. The first has to do with the amount of Federal Government debt held in the portfolio of the Federal Reserve System; the second raises questions relative to the composition of the portfolio of the Federal Reserve. I shall consider them in this order.

Although the original intent of the legislation creating the Federal Reserve System was to provide for a flexible money supply through the device of discount operations and to improve the regulation of commercial banks, later modifications have delegated to the Federal Reserve System along with other agencies a responsibility for assisting in the establishment of sustained high employment, production, and purchasing power in our economy. The major instrument used by the Fed in pursuing this latter objective is its open market operations. The sizable portfolio of Federal Government debt instruments has accumulated over time as a result of open market sales and purchases. As the gross national product of the Nation has grown, the Federal Reserve has continued to be a net purchaser of Federal debt instruments and thereby has provided the additional supply of money needed to facilitate the exchange transactions. Additional amounts of reserves have been provided since 1960 to assure that inadequate supplies of money would not interfere with a continued growth in output and employment. The portfolio of Federal Government debt accumulated over time by the Federal Reserve System reflects the consequences of its continued action in pursuit of its assigned responsibilities.

In view of these responsibilities, then, it would appear that primary concern should be directed toward whether the operations of the Fed-

eral Reserve have furthered its accomplishment of these responsibilities or have in some way detracted from their accomplishment. The size of the portfolio should be, in this sense, of secondary importance. It would be quite inappropriate to allow the size of the portfolio to in any way affect current operating decisions of the Federal Reserve authorities.

While it may be unnecessary and perhaps undesirable for this portfolio to reach extreme size, there is at least some indication that a minimal level might be desirable. Proper fulfillment of its responsibilities may, from time to time, require that the Fed sell Federal debt instruments. The portfolio should be adequate both in size and in maturity distribution to allow the Open Market Committee optimum latitude in its sales operation. Reference might be made to Federal Reserve operations undertaken in 1960, popularly referred to as "Operation Switch," as an illustration of the need for an adequate and diversified portfolio.

It is difficult to visualize any particular criterion such as money supply, gross national product, or aggregate liquid assets, which might serve as a guide to the proper size of the portfolio of Government debt. While recognizing that for any given gross national product a certain level of money supply might be desirable, changes in the rate of expenditure or the intensity of utilization of the given money supply, changes in the sources, availability, or use of credit, and other circumstances could render different recommendations as to the proper amount of money, and the size of the portfolio itself. In view of the very large near-liquid obligations of the commercial banking system in the form of time and savings deposits, a great degree of latitude would be needed by the Federal Reserve should depositors decide to change the structure of their asset holdings so that it included a smaller proportion of commercial bank time deposits. Statistics indicate that time deposits have risen as a percent of personal financial assets since 1959 and approach the proportion they represented in 1945 and 1952.

The question of the desirable size of the portfolio of Government bonds, interesting as it is, is completely subsidiary to the problems associated with the transfer of a sizable segment of it to the Treasury for cancellation. The proposed transfer fails to deal with both the solvency position and the monetary control responsibility of the Federal Reserve. Since the greater portion of the Federal Reserve's assets are offset by current liabilities in the form of currency and commercial bank reserves—neither of which can be cancelled—the debt instruments would have to be replaced by U.S. notes (as suggested in sec. 2 of H.R. 7601, 89th Cong., 1st sess.). This would be comparable to replacing the debt with non-interest-bearing permanent debt of the Federal Government, or alternatively of rendering permanent that increase in money associated with Federal Government deficits originally financed by interest-bearing debt.

The Federal Reserve does not stand in the same position as the Treasury. Notes issued by the Treasury and declared to be money are acceptable and will circulate without discount. Thus in the event that all or a large part of the present portfolio were to be returned to the Treasury for cancellation, conditions might arise which would present the Federal Reserve System with a dilemma. One might imagine a

condition of high liquidity and inflationary pressure which needed to be counteracted by the Federal Reserve. Lacking an adequate portfolio of Federal Government securities, the Federal Reserve would have to develop a new instrument, probably an instrument of its own which it might sell to the banking community or to the public. It is quite apparent that this instrument would not carry the same rating and status as Federal Government securities and hence would be difficult to sell. Since the Federal Reserve has no taxing authority nor could it always be assured of adequate earnings through the discount window to sustain interest and principal repayment on these obligations, the market acceptance would probably be nil. It is in this sense that there is some necessary minimal portfolio of Government bonds that must be held. There appears to be no evidence that the size of the portfolio of Federal Government securities has affected either the ability or the willingness of the Federal Reserve to pursue its obligations to the society. In view of the difficulties associated with the transfer of the securities to the Treasury and their cancellation I see no reason to recommend any change in present operating procedures.

The second area of discussion has to do primarily with the composition of the asset portfolio of the Federal Reserve System. The constitution of this portfolio should reflect the unique characteristic of central banking, which is the primary function of the Federal Reserve System. The importance of proper conduct of the central banking operation to the total society is so overriding and the management problems involved are so extensive that it would be unwise to further complicate its role and responsibility.

The United States has, through the course of time, developed particular institutions—commercial banks, savings and loan associations, the Small Business Administration, the Federal National Mortgage Association, etc.—to serve various special needs of the society. It would appear that these institutions are adequate at the present time, or if believed to be inadequate to serve special needs, could be modified or supplemented in such fashion as to meet new goals or responsibilities associated with their area of operation. It has been the trend historically to divest central banks of many operations not directly connected with the central banking function rather than to add to their role and responsibility. This would appear to be a very wise policy in the present situation.

In summary, my recommendations would be as follows:

First, that the Federal Reserve System continue to hold in its portfolio those Federal Government debt instruments that it acquires in the normal course of its operations. The present procedure gives a maximum of latitude to its operations and adds little cost except that associated with tax collection and transfer payment. No significant benefit would accrue to the Federal Government by the proposed procedure.

Second, under present circumstances, I would not recommend the extension of the authority of the Federal Reserve to deal in debt or equity instruments of other institutions than those of the Federal Government. It would be more desirable to modify the authority and power of existing institutions to meet special needs. The Federal Reserve can, and presently does, assist these institutions by providing additional reserves or liquidity when this action will assist in maintaining economic stability and growth.

STATEMENT BY O. ERNEST MOORE, INTERNATIONAL ECONOMIC SERVICES,
NEW YORK, N.Y.*

The size of the Federal Reserve System's portfolio of U.S. Government securities should not be related to such factors as the money supply, the gross national product, or aggregate liquid assets. Since the purpose of open market operations is the day-to-day, seasonal, and cyclical control of member bank reserves, the size of the portfolio should be guided by a single criterion: the amount of securities which the System must acquire in order to stabilize or raise the level of member bank reserves, or which it must dispose of in order to lower that level. This is subject to the reservation that the portfolio does not, and need not consist exclusively of U.S. Government securities. Nevertheless, so long as U.S. Government securities make up the overwhelmingly largest part of the money market's instruments, they will necessarily continue to be the backbone of the open market portfolio.

By this reasoning, there should never be an "excess" of U.S. Government securities in the System's open market portfolio, and consequently no need to make the suggested transfers to the Treasury for cancellation. Such transfers would, in any event, have a highly disruptive influence on our monetary system, in at least two ways: (1) They would result in two types of currency; namely, a fiat Government-issued currency without any gold-certificate backing, and a Federal Reserve currency with a gold-certificate reserve. Under present legislation, and as a matter of practical necessity, the Government is obliged to maintain all forms of U.S. currency at a parity with one another. How this could be done if we had two such diametrically different currencies in circulation is far from clear. (2) They would add greatly to existing doubts abroad of the soundness of the U.S. dollar and would probably impel foreign central banks to convert into gold all or most of their existing dollar balances and their future acquisitions of dollars. This would be a serious blow to our present efforts to restore the U.S. balance of payments and might well make the balance-of-payments problem insoluble, with the ultimate danger of a dollar devaluation and world monetary chaos. The Federal Reserve System should therefore be allowed to hold onto all of the U.S. Government securities which it has acquired. Moreover, the time may very well come when a drastic change in overall credit conditions will make it desirable for the System to liquidate a substantial part of this portfolio by sales to the market.

As to the interest which the System now earns on its holdings of U.S. Government securities, for all practical purposes this money is already being returned to the Treasury in the form of so-called interest on Federal Reserve notes in circulation. The procedure, while in general satisfactory, could in my opinion be changed so that, in lieu of paying interest on the note issue, the Federal Reserve would simply pay into the Treasury each year an amount equivalent to the interest received on its holdings of U.S. securities. In this way, it would be clear to everyone that the System derives no pecuniary advantage from such holdings.

*The views expressed by Mr. Moore are his own. This statement does not in any way purport to express the opinions of International Economic Services.

It would be unwise for Congress to lay down standards relative to the kinds of assets to be held by the System, their maturity composition, or the relative proportions of private and public instruments. In the constantly changing conditions of the money market, the System needs flexibility in these matters if it is to do a good open market job—a job which is difficult enough even with the present degree of freedom. Indeed, if a change were to be made, it should be in the direction of somewhat greater flexibility, so that the System could have a wider range of assets to choose from, at least in times of emergency. While I do not think the System should have power to acquire such dubious and possibly illiquid assets as commercial loans and commodities, it might well be authorized to acquire high-grade corporate bonds that are quoted on one or more organized security markets, and perhaps, also, guaranteed and insured mortgages on residential property. Such authorization could be limited to emergency or other unusual circumstances and should, in any event, be a discretionary authorization, not a legal compulsion.

STATEMENT BY F. W. MUELLER, CHAIRMAN, DEPARTMENT OF FINANCE,
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The letter of inquiry, under date of September 1, 1965, from the Joint Economic Committee Subcommittee on Economic Progress poses four principal questions as follows:

- I. How large a portfolio should the Federal Reserve System hold—
 - A. In relation to the money supply?
 - B. In relation to the gross national product?
 - C. In relation to aggregate liquid assets?
- II. If the portfolio grows too large (relative to some standard), what should be done with the excess—
 - A. Transferred to the Treasury for cancellation?
 - B. Continue holding by the System, with unexpended interest income returned to the Treasury?
- III. Should different criteria be designed for the System's portfolio operations such as—
 - A. Different kinds of assets.
 - B. Maturity composition.
 - C. Public and/or private obligations.
- IV. Should the System's Government portfolio be supplemented by other types of assets such as—
 - A. Commercial loans.
 - B. Private capital paper.
 - C. Foreign exchange.
 - D. Commodities.

The common problem running through all of these questions is: How can central bank credit be appropriately administered? It is to this larger question that the following comments are directed.

Central banks like their counterparts in the private sector, commercial banks, operate on the principle of fractional reserves. This provides the central bank with the opportunity to increase or decrease the volume of its bank credit outstanding, in relation to its ultimate reserve (however defined). Such increases or decreases have far-

reaching effects, directly upon the monetary structure, and indirectly upon the economy.

The two principal instruments through which changes in the volume of central bank credit are effected are rediscounts and open-market operations. (The variable reserve ratio does not change the volume of central bank credit, but rather the effectiveness of the existing amount. It is therefore not considered a policy instrument, especially in the short run.) While repurchase agreements and float alter the volume of central bank credit, any change in either is more the result of policy rather than a determinant.

Rediscounts, by member banks at their Reserve banks at some rate, are a means of varying the volume of commercial bank credit through its cost. The lower the rate the lower the cost; the higher the rate, the higher the cost for an equivalent volume of funds. Presumably over a period of time and under normal circumstances, the lower the rate the more deliberate will be the borrower's adjustment, while the higher the rate the more rapid will the adjustment be, since at a low rate the cost is small, while at a high rate the cost can be substantial. The adjustment, of course, will be in the borrowing bank's portfolio and lending rates, the speed of adjustment being determined by the cost of the borrowed reserves, and the cost being determined by the amount of the debt and the rate.

Three circumstances surround the mechanism of rediscounting. First, recourse to central bank credit can be had only on the initiative of the prospective borrower. Secondly, the cost of borrowing is borne by the borrowing bank. Finally, the rediscounting operation is highly selective, since only those institutions "out of step" with the System will be required to react to such a means of adjustment. While such circumstances may not be entirely persuasive to many, they are of sufficient significance to have their day in court. At any rate, rediscounting on the terms of the central bank is a means of varying the volume (at differing speeds) of commercial bank credit through its cost.

Open-market operations, on the other hand, are a means of influencing the cost of commercial bank credit through its volume. For reasons not necessary to detail here, the expansion of central bank credit eventuates in part as an addition to the existing legal reserves of the commercial banking system. Assuming existing full expansion in the latter, any net addition generates "excess reserves," upon which additional commercial bank credit may be expanded by some multiple (depending upon the existing required reserve ratio). Under "normal" circumstances, were interest rates tending to rise they would, at least temporarily, be restrained; if they were stable there would be a tendency for them to fall. A reduction in the central bank open-market portfolio will have reverse effects since, for reasons not detailed here, the elimination of such assets will in fact reduce the aggregate reserves of the commercial banks and, in the process, if commercial bank rates were rising they would tend to rise further, as if falling they would tend to level off. This assumes that there is a sufficient number of interest-sensitive borrowers, either to absorb the additional expansion made possible in case of central bank increases in its holdings, or in case holdings are reduced, enough borrowers can be induced to curb their request for accommodation or actually discharge an existing loan

without the benefit of renewal. Such sensitivity is not as acute as was once supposed. Under any circumstances, operations on the part of the central bank in the open market are able to affect significantly the terms upon which commercial bank credit is made available.

It is essential to observe certain qualifications surrounding open-market operations. First, unlike rediscounting, the initiative in open-market operations lies principally with the central bank. (An exception is currency in circulation.) In the second place, open-market operations provide reserves without any explicit cost to the commercial banking system. Third, because of this latter aspect, and if the commercial banks are in debt to the central bank under expansion, the debtor banks will first retire their debt at the central bank before any further expansion of commercial bank credit eventuates. Conversely, a reduction of the central bank portfolio may force the commercial banks into the debt of the central bank, thus imposing a cost upon the former, which if persisted in will result in a rise in rates and a contraction in commercial bank credit. Fourth, a final qualification of the effectiveness of open-market operations involves the fact that a reduction in the central bank's portfolio can force a reduction in aggregate available reserves and thus ultimately in the volume of commercial bank credit, whereas an increase in holdings can in no way force expansion; the additional reserves may merely eventuate as "excess." In open-market operations, therefore, the cost of commercial bank credit may be varied by making differing amounts of commercial bank credit available through changes in the aggregate reserve base.

It is important to emphasize the functioning of the evidences of central bank credit, which for present purposes may be defined principally as central bank deposits and central bank currency. From shortly after the beginning of the Federal Reserve System until late 1959, all legal reserves of member banks were required to be held in the form of deposits at their respective Reserve banks. These deposits had their origin principally (but not exclusively) as a result of open-market operations of the Reserve banks. Being defined as good legal reserve, they formed the basis for subsequent expansion on the part of the member banks. In this process borrowers of all types—personal and corporate, public and private—are enabled to exchange their own unacceptable debt for the more convenient and acceptable debt (deposits) of the commercial banking system. In this manner, commercial bank debt (deposits) permeate the economy, the latter having access to this process by virtue of the reserves made available by the central bank in conjunction with the commercial bank's expansion coefficient. Thus every facet of economic activity has come to be dependent upon the clearance provided for the economic structure, through the banking system. Any shifts in the terms (interest rates) or availability of bank credit thus have far reaching and frequently an unpredictable impact.

The other principal evidence of central bank credit is Federal Reserve currency. Such currency—as in the case of all currency—has the same object as deposits; namely, as a means to accommodate the indirect exchange of values. The subject matter of exchange accomplished by currency may be, and frequently is, the same types of values as are subject to exchange by bank deposits. However, for reasons not detailed here, currency is used principally to effect exchanges of

values for which currency is the preferred means compared to deposits. But this great difference exists between the two evidences, that the volume of deposits may be unilaterally modified by the central bank, whereas the volume of currency is determined by the requirements (real or supposed) of the public. Since currency in any amount is now eligible to be counted as legal reserve, variations in the amounts dishoarded or hoarded by the public may change the aggregate reserves of the banking system requiring offsetting action by the central bank if it desires no change in its existing monetary policy.

The upward trend in the holding of currency in relation to bank deposits could pose a difficult problem for monetary management if disgorged in significant amounts, either in terms of commercial bank reserves or the value of money, or both. As a matter of fact it is surprising that currency in circulation continues its relative increase as reflected in the past decade in spite of the increased dependence of the economy on the commercial banking system and the proliferation of other financial institutions whose objects are to substitute for much exchange previously accomplished by the use of currency. This leads to the conclusion that hoarding may be involved to an extent not suspected.

Since the central bank is the point of origin for our exchange media in the form of central bank deposits and currency, a major question arises as to the criteria which may be used to vary the accessibility to central bank credit in terms of both amount and cost. Historically, three main criteria evolved which served as tolerable guides, i.e., foreign exchange rates, currency convertibility, and changes in the value of money. Each of these criteria were oriented to particular problems. The criterion evidenced by the appreciation or depreciation of the defined rate of exchange vis-a-vis other countries was used as a device to determine any imbalance in the balance of payments, and the "Transmission of the Precious Metals" occupied a leading place in early monetary policy. Currency convertibility into the standard also was an early criterion relating to excessive note issues with a distinct domestic orientation. Changes in the value of money had both a domestic as well as an international impact. With all of the implicit limitations, these objective criteria provided a means to measure both the need for and the effects of monetary policy. In addition, such objective criteria possessed the quality of nonmanipulability, which provided an anchor against which the need for and effects of changes in monetary policy could be measured.

Recent years have witnessed either a disavowal or modification of each of these criteria. Pressures on exchange rates have commonly come to be relieved by devaluation or exchange rationing, merely masking in effect the causes, in an effort to avoid the consequences. Internal currency convertibility has nearly everywhere been abandoned, thus relieving most monetary authorities from previously imposed disciplines. The "protection" or security for currency in circulation by the pledging of government securities in no way provides any dependable objective criterion for such issues, since not only is the availability of collateral ever present, but it can be expanded unilaterally ad libitum.

Especially since World War II, one historical criterion, the value of money, has been linked with two other relatively new criteria, economic

growth and employment, to form the new standards for monetary policy. While our own central banking authorities have never, to this writer's knowledge, explicitly avowed growth and/or employment to be unqualified criteria, there is no reason to suppose that they are against either, and every reason to assume that they are in favor of both, as is everybody else. The real problem lies in the orderliness with which either or both could be accomplished and the contributions which monetary policy may be expected to make.

The criterion of the value of money has itself undergone modification. Without detailing the adverse effects implicit in designed windfall gains and losses, shifting of real burdens and the misdirection of resource allocation resulting from changes in the value of money a conviction on the part of many assumes that a designed annual fall in the value of money anywhere from 2 to 5 percent annually, is not only tolerable but also essential to provide "incentive" for industry. These intentional resulting inequities are largely justified on the basis that "growth" will not occur in the absence of such a policy. Doubtless some growth will be stimulated, but the grave risk is that resource allocation may take on unsustainable patterns, and above all only the sum of windfall gains will be counted, windfall losses being conveniently overlooked. Much of this growth therefore is illusory.

There have been three major factors contributing to the growth of the economy, since World War II. The first of these was the accumulated deficiencies of the economy during the years 1930 to 1946. The second has been the nearly 40-percent increase in population since 1942. The third factor has been the fall in the value of money, especially since 1946. The "raw" national income figures show a substantially different rate of growth than the deflated figures; and the per capita figure reflects a lower growth rate than either of the former. As a matter of fact the deflated growth rate from 1900 to 1930 is not much different than the growth rate from 1930 to 1960. Monetary policy in each period was vastly different, which raises the question as to whether or not growth occurs from the needs of the economy accompanied by an accommodating monetary policy, or whether a monetary policy itself can induce or force a sustainable accommodation on the part of the economy. The latter assumes that through some conditioning process, and with great reliance on an environmental philosophy, that the economy can be made to respond in a predetermined manner. Such consequence does not always follow however and the "ease" in monetary policy may find an outlet in directions other than expected. One such current area, in the writer's opinion, is reflected in the stock market. The "yield" criterion has long since been replaced almost exclusively by the "capital gains" criterion. But capital gains depends upon favorable price changes. Emphasis upon favorable price changes is itself the essence of speculation. Witness the price of many stocks selling on a yield basis below the yield basis upon which the same corporation's senior debt may be had. Such a reversal of criteria makes no appeal to reason, and has been aided by the fear of a continued fall in the value of money.

Growth does not have to be at the expense of a fall in the value of money. At some relatively high level of production, say 85 percent, further output will tend to be at the expense of a fall in the value of

money. Such pressures on the value of money may be relieved by absorbing such costs through an easing of monetary policy and thus spreading its impact by diffusion, or by maintaining some modest restraint and thus providing an incentive for innovation and technology. Only from the latter can permanent growth occur. Even if monetary policy could assure "real" growth, the "leapfrog" nature of its impact makes growth an unreliable guide. The impact of an easy money policy takes time to permeate the economy. After its effects have gradually appeared, successive industries are "squeezed" as the value of money declines, which calls for additional infusions. Thus each new infusion is apt to be the basis for subsequent infusions in leapfrog manner. Monetary policy to be equitable should be an "accommodating factor" in preference to a motivating factor.

A second modern criterion is employment—or its converse, unemployment. Unfortunately either term lacks precision. Unemployment shows up in various guises—technological or functional, structural, frictional, and seasonal, all complicated by under- or over-employment. In addition actual employment will be the result of a consideration of all of these factors and this latter in varying degrees. Exactly how structural unemployment for instance can be used as a guide for monetary policy leaves more to be desired than gained, since an exhausted ore mine can never be revived by such a measure. Any new industry will not develop there if there is a more favorable "least-cost combination" location; and if the latter is not true, alternative activities would already have made this deprived location its first choice and the area would not be "depressed" in the first instance. Likewise with "frictional unemployment" which is always with us. No monetary policy is able to eradicate the changing of jobs—nor should it. If, as it is frequently argued, some minimum percentage is allowable, say 2 percent, this is a function mainly of definition. If a period of 1 week is defined as the point beyond which frictional unemployment is measured, the rate could presumably be higher than 2 percent. If the period is lengthened to 6 months we could doubtless eliminate frictional unemployment altogether. In either case monetary policy is largely irrelevant, and the size of the figure is determined by definition. The imprecision of such figures therefore as an objective criteria for monetary policy makes unemployment a slender reed upon which to lean, the other types being different only in degree.

Other fixations of a different character have also in the past been used as criteria for monetary policy. Thus operations by the central bank to correct "disorderly markets" were carried on principally to stabilize the market for Federal Government securities. While central bank authorities are correctly concerned with the state of Government credit, it is doubtful if the latter should be used as a criterion for monetary policy. If the Government debt is as "riskless" as is frequently assumed, it should be able to hold its own in the open capital market without resort to leaning on central bank credit. Even clearer is the case of the "pegged market" from 1942 to 1951. Policy implementation was carried on solely for the benefit of the Government, rather than for the economy as a whole. Nor is it surprising to find the most rapid postwar decline in the value of money to occur within this period.

Since a leading tool of monetary policy is its ability to unilaterally influence the value of money through changes in the rate of interest, the question arises as to what considerations are dependable. Interest rate levels have long been used to protect a country's international currency value. Changes in the rate(s) have long been used to dampen or encourage the flow of current production into capital formation. Such changes have long been used in an attempt to preserve parity between the circulating media and the standard. These changes in monetary policy have largely paralleled or followed changes in the value of money in the open market, being more "corrective" than motivating in nature.

In recent years many have embraced the notion of an "engineered" rate(s) of interest, on the basis that a "low" rate will stimulate growth and reduce unemployment. Both of these criteria have been commented upon earlier. It is admitted that if expectations anticipate \$1 million from an undertaking to become available to support the necessary capital formulation, the latter, in a 5-percent market would amount to \$20 million. If on the same expectations, the rate was forced down to 4 percent, the same anticipated revenue would support \$25 million of capital formation. Further the recapitalization of existing assets would result in a 25-percent increase in their value. But it is this shift in rates which may well induce a misapplication of resources in the hope—not so much to increase production for the social income stream but principally for windfall gains. In addition, if such general rate changes permit, as they have (although not exclusively) a fall in the value of money, new problems arise. If prices should double, as they have since 1941, the required capital formation would amount to \$40 million which at 4 percent would require \$1,600,000 to justify the expansion, which corrected for price distortion would amount to only \$800,000 to the undertakers of the enterprise. This raises therefore the question as to how "cheap" the rate actually is.

Since most of the earlier criteria, i.e., foreign exchange rates, parity between the circulating media and the standard and a relative stability in the value of money, have either been abandoned, modified or administered in a fashion to avoid any unwelcome restraint, the question arises as to which major goals central bank policy should be oriented.

A stable society requires order, and order requires self-discipline, and self-discipline requires individual responsibility. Within the framework of our cultural and philosophical heritage, this assumes that each individual will discharge his current as well as his future responsibilities. The latter however cannot even be measured, let alone attained, unless the future needs can be at least presently approximated. In order for the current approximation to reflect the measure of these future responsibilities, wide fluctuations in the value of money must be ruled out. What remains therefore is a relatively stable value of money, irrespective of growth (which will occur anyway), or unemployment (which is not responsive to monetary policy). Such a relatively stable value of money could do considerable by containing speculation and bring continuing order to the economy through the proper allocation of resources.

Within the framework of the problems discussed in the preceding pages, it is now possible to answer the questions posed.

I

There is no way of determining any absolute measure of portfolio size. It should be "adequate," but adequacy will result in varying amounts at different times and under differing circumstances.

Attempts to measure this adequacy in terms of the "money supply," gross national product or "liquid assets" will themselves fail because these concepts are themselves imprecise and also because emphasis upon such measure could readily compound the problem from which an escape is sought. Thus a continual fall in the value of money may indeed be due to previous infusion on too large a scale. But the maintenance of some proportion between the portfolio and the "money supply" would presumably require an increase in the portfolio. This would of course only tend to magnify the original problem. But in addition, how is the "money supply" to be defined? Only formal exchange media, i.e. Treasury and central bank deposits and currency? or are time deposits of commercial banks to be added?, and if so why not other "available" claims to exchange media? And what is to be done with what many refer to as "near money?" Furthermore, what is to happen to changes in "cash-balances," and the hoarding and dishoarding which are known to occur? Are "idle" balances to be abstracted from the money supply, and only "active" balances included, which would change the measure considerably? There are as a matter of fact a whole host of factors which influence the behavior of money, which rank far ahead of any quantification of the money supply. The latter would thus be a most inappropriate measure for the objectives sought.

The gross national product is equally devoid of merit. In the first place this is an unstable estimate. According to some, it has an error of ± 15 percent. Secondly, even those who compile this measure recognize its limitations, hence the need to "deflate" the measure, and this correction by admission is only minimal. Since the availability of and the terms upon which "funds" may be acquired at different times may be the permissive factors which tend to augment or diminish this magnitude, increases (or decreases) in the portfolio could conceivably be the principal basis for increasing (or decreasing) the standard by which policy was determined. With its many pitfalls the GNP would be an inadequate guide.

Aggregate liquid assets are not defined, but presumably this means such assets as are reversible in the market. Since all assets are reversible in the market at some price, given the proper time, all assets thus become "liquid." This is surely not what the questioner had in mind, and it is assumed that reference was made to those assets which can be shifted "without too much loss," in accordance with common parlance. But what is "too much" for one holder may be acceptable to another, which if true makes "liquidity" a function of who holds the asset. Further, an asset which is "illiquid" one day may turn out to be "liquid" at a later day. "Liquidity" in the economic system (not discussed here), is something quite different than the naivete implicit in the question. For these, and many other reasons, such a measure as "aggregate liquid assets" holds no promise as a means to measure the appropriate size of the central bank portfolio.

II

If some absolute measure of optimum portfolio size could be devised (which is doubtful), there would be no troublesome "excess." Since the question assumes that there can be an excess, with which this writer agrees, and on the supposition that the excess can be identified, the first question arises as to how the "excess" came into existence in the first place. It must have been due either to a previously faulty monetary policy, unilaterally imposed, or externally imposed, most probably by fiscal policy. Given the modern intellectual syndrome of growth, employment, and low interest rates, many would account for the "excess" portfolio, as being an accommodation to forces that did not understand the consequences of their actions; and which differs practically not at all from the same forces which dictated similar monetary actions in the thirties, and particularly from 1942 to 1951, during the era of "pegged markets." Central bank authorities being forced into these compromises, are now criticized for having too large a portfolio. Regardless of the equities in the matter, if the portfolio is now too large, what should happen to the "excess," supposing it can be measured?

Access to the central bank portfolio shows up principally in two types of liabilities: currency and central bank deposits. Since the beginning of World War II when central bank currency amounted to approximately \$5½ billion, it has grown in volume to about \$40½ billion, an increase approaching eight times. This growth has been in the face of increasingly widespread use of bank credit for exchange, and the mushrooming of financial intermediaries. Some of the growth has been due to population changes, much to a fall in the value of money. Such need has been moderated, however, by easy access to credit facilities and continued industrial integration. This tremendous growth would tend to support the conclusion, as has earlier been stressed, that there exists widespread hoarding. Currency and demand deposits being nonearning debts, it can be presumed that such holdings on the part of the uninitiated, may be induced by increasing suspicion of the future. Such an outpouring of currency could not occur, except that the monetary authorities have been relieved of the discipline of limiting its issue. But since this currency has found its way into our system, attempts to reduce it, as a consequence of portfolio reduction is possibly only by inviting catastrophe.

So far as central bank deposits are concerned, they have increased from about \$7½ billion required as reserves in 1941, to about \$22 billion today, or an increase of about three times. It is quite clear from this that currency has expanded nearly three times as much as deposits. In the latter case however, such central bank deposits represent the principal reserves upon which the commercial banks have expanded. But this latter has precluded any large reduction in the central bank portfolio, unless a proportionate reduction in required reserve accompanies such action. This in turn would tend to increase the expansion coefficient which could ultimately augment instability in the commercial banking system.

It has been suggested in some quarters that a removal of the reserve requirement against commercial bank time deposits could free a portion of the reserves and thus permit a reduction in the portfolio. This writer has the same objection as expressed in the previous paragraph;

namely, that this is in effect a reduction in the effective ratio which would simultaneously increase the expansion coefficient.

To the argument that these securities have already been paid for (it is presumed by the expansion of central bank credit in the form of deposits and/or currency), it is claimed there would be no harm in their cancellation. This, however, would be no different than fiat money. Instead of acquiring Government securities, the central bank might as well credit the Treasury's account in the first place. At this juncture only the "needs of the Treasury" would restrain expansion. As it now stands, since no reserve is required against central bank deposits, expansion in this manner could theoretically be infinity. And this author ventures a hazardous prediction, that unless our balance-of-payments position is brought into equilibrium, as our gold position deteriorates, the gold requirement against our notes will be reduced and/or ultimately eliminated. We would be then on a pure fiat basis.

The trouble invited by considering central bank holdings "paid for," stems from a failure to recognize the difference between a legal discharge and an economic extinguishment—of vital importance. The debt originated because the public sector withdrew from the private sector at particular periods more values than it contributed, the difference amounting to the debt. Equilibrium can only be reestablished by correcting this imbalance, by developing a surplus, a hardly likely prospect at this juncture. Elimination of any "excess" portfolio, however, hinges on this vital distinction.

This writer can see no solution to the problem of "excess," supposing it can be measured. Central bank credit has become so closely entwined in the economy, that its reduction in the amounts proposed (\$20 billion) would be unthinkable in terms of the readjustments required. To merely "charge off" such amount would be a gargantuan step toward fiat money. Since we have erected this behemoth (against the advice of many), a good, solid first step would be to at least stabilize the holdings.

The revenues of the Reserve System in the form of interest on its holdings is enormous. This could be avoided by the issuance of special non-interest-bearing paper, in order to reduce such earnings. This, however, raises again the specter of fiat money. Furthermore, if all such holdings were in this category, open-market operations would be impossible, since the tie with the money and capital markets, which deal only in interest-bearing obligations, would be destroyed. Open-market operations as we now understand them would cease to exist. The present method of "recapture," does not pose a problem, since it is only a paper transfer payment, and well adapted to the system as it now stands. It should therefore be retained.

III

It is not clear from the question whether the different criteria for the System's portfolio operations as outlined, refers to additions to present Government holdings or as a substitute for them. If it refers to additions, the question of the present "excess" becomes moot, since it is the alleged current excess which is supposed to be the object of reduction.

If the question refers to substitutions for present holdings, this introduces a whole new set of problems. If different kinds of assets refers to real assets, i.e., office buildings, farmland, etc., while this would gladden the heart of such owners, the type of assets involving entrepreneurial risk and lack of any continuous market, makes such assets flatly ineligible, even for consideration. Nor does maturity composition in money and capital market instruments bear much weight. In open-market operations there is an initial impact on the price of the security in which shifts are carried out which either tend to raise the particular yield through depressing the price, or tend to lower the yield by increasing the price, depending upon the operation. In the long run however this is not significant, for except during changes in policy, holdings are customarily "rolled over," thus leaving the maturity distributions as before. And there is added danger, that if maturity becomes a major criterion, stabilizing at some preconceived yield level may take precedence over monetary policy, as it has in the past. The burden of substituting or mixing holdings between public and private paper on the unilateral decision of the central bank would pose more problems than it would solve. Since the span of operating in all private obligations is entirely too broad, even for the central bank, the problem as to what private obligations should be eligible arises. Even if such a choice could be made equitably, particular segments would be prejudiced, either favorably or unfavorably, depending upon policy, in relation to the segments whose paper was not eligible. This would surely skew the flow of capital and could well induce a misallocation of our resources. Furthermore, even if it could be accomplished without prejudice, it could make no contribution to the problem of the "excess" portfolio. To the latter problem a redefinition of the kinds of eligible assets, the maturity distribution or the substitution or additions of private obligations contributes nothing.

IV

The acquisition of commercial loans on the part of the central bank, on the initiative of member banks, was of course—together with the original currency provisions—one of the leading functions of the Reserve System. The desuetude into which rediscounting fell, beginning in the early thirties and lasting until its renaissance in 1951, is well known. This power of supplementing the portfolio has been continuous however, but has largely been replaced by the "availability" theory. The function of controlling the volume of commercial bank credit expansion through its cost, with all its limitations, still has much merit, which has been previously discussed. Because of its selectivity, pressures due to imbalance can be imposed at their point of origin. To the extent that the emission of central bank credit takes this form, just by so much is the size of the portfolio reduced, and by so much would the "excess" portfolio be reduced. Regulation A could well be revised, cutting out the minuscule criteria, and admitting all paper with a maturity of, say a year or less, without resort to the test of "having been" or "to be used" for "working capital purposes." There is no reason why a particular bank, having expanded beyond the current limits of monetary policy, should not be expected to bear the costs of its action. Such action would place the burden where it originated, reduce the

need for expanding open-market holdings, and bring a selective discipline to those banks responsible for the costs involved.

(Private capital paper has been discussed in the preceding section.)

The use of foreign exchange as a supplemental device does not appear promising. Such a device is used chiefly by smaller countries where international trade forms a large proportion of their GNP. In this country such proportion is modest. In addition, because of the volatility in acceptances in this country, to maintain order in monetary policy, the influx and efflux would of necessity have to be offset with compensating actions, doubtless through the portfolio. As a consequence, as an aid in solving the portfolio problem, its inclusion has little to offer.

The use of "commodities" as a supplementary device is no clearer than the different "kinds of assets" discussed above. This writer shudders at what might have happened to monetary policy, if since 1933, corn, wheat, and cotton had been used as a supplement, or an alternative, to the portfolio. The inclusion of commodities is in-supportable.

Frankly, the question is not whether the portfolio is too large. It obviously is the right size for what we have been attempting to accomplish. The real question is: have we aimed at the right objective(s)?

During periods of relatively full utilization of the factors of production, as at present, the interest rate and a fall in the value of money are largely alternatives. The unadministered interest rate acts as a means to determine the amount of current production which social choice makes available for capital formation. At any rate below this level, the magnified demands for current production can only be met by augmenting the "funds" through which diversion will be accomplished by expanding credit. This will require, once excess reserves have been used up, an increase in central bank credit through increasing the latter's portfolio. This must inevitably bring on a fall in the value of money, which in turn not only requires more central bank credit to suppress any rise in the interest rate, but also to finance an increased volume of production. This latter, due chiefly to a lag in costs, sets up increasingly refined processes, which require both time and a more roundabout process. This latter also requires more credit, and in order to keep rates from rising, new infusion of central bank credit are necessary. In addition, continued fiscal deficits require financing, thus making further drafts on credit availability. It is this imbalance that has given rise to the enormous portfolio carried by the Reserve system. So long as this policy continues, the portfolio will continue to grow. But in these holdings, there is no "excess," since the amount has been necessary in view of the policy followed. It is therefore, not the size of the holdings which are to be criticized but rather the policies which required the accumulation for their effectuation. Thus it isn't the holdings which should be changed, but the policy.

STATEMENT BY RICHARD A. MUSGRAVE, PROFESSOR OF ECONOMICS IN THE FACULTY OF ARTS AND SCIENCES AND IN THE LAW SCHOOL, HARVARD UNIVERSITY, CAMBRIDGE, MASS.

If one starts with the proposition that the Federal Reserve System after all is a public organization responsible to Government (be it

Congress or Executive) rather than to the shareholders, it really makes little difference how large the System portfolio is. If receipts from the portfolio exceed the requirements of the System, they will merely be returned to the Treasury. Thus the cost to the taxpayers is the same as it would be if the System did not hold earning assets, and its cost was covered through the budget.

At the same time I recognize that this is an oversimplified view. More likely than not the independence of the System is increased by having a larger volume of earnings. Similarly, the smaller the income of the System, the closer one comes to a situation where the finances of the System are subject to budgetary control. As far as these considerations are concerned, I think it makes more sense to keep System earnings more or less within the limits of what is required to sustain the cost of operating the System. Since in an expanding economy the System portfolio grows over time, it may well be that the built-in increase in earnings exceeds the required needs for funds, which might then suggest that there should be a periodic turning back of securities to the Treasury in exchange against paper bearing no interest.

While these considerations are of some importance, they should not be exaggerated. Certainly they should not be permitted to influence the way in which monetary expansion is to be provided for. Thus the Fed could provide for monetary expansion through reduction in reserve requirements rather than open market purchases, which would decrease the acquisition of earning assets. At the same time it would mean that commercial banks hold more earning assets. Since the latter involves a true cost to the Treasury, to the extent that these assets take the form of Treasury paper, this would of course be a bad bargain for the taxpayer. In other words, the acquisition of commercial bank earning assets is a much more important factor than that of Federal Reserve bank earning assets.

One other aspect of the matter might be mentioned, although it may not be very important in the current setting. During a period when the Federal Reserve wishes to engage in open market sales and combine these with an active policy of debt management, it may not hold the particular issues which it would like to offer for sale in order to push up a particular part of the rate structure. This might make a case for having the Fed portfolio large enough so that a wide variety of issues will be on hand when needed. At the same time this would be a rather silly solution arising from the unnatural separation between debt management and monetary functions. It would make more sense to let the Fed hold Treasury debt "in general," say special issues furnished to the Fed by the Treasury, with or without interest, depending on how Fed finances are to be handled. Whenever the Fed wishes to engage in open market sales, it would then trade in these special issues, and the Treasury would give it whatever specific type of debt instrument the Fed wants to sell in the market. Thus the qualitative purpose of debt operation on the part of the Fed would not be subject to any arbitrary limitations imposed by the particular issues that it happens to have on hand.

From a theoretical point of view, the proper solution to this problem thus lies in letting the Fed hold special issues with or without interest, issues which could be exchanged with the Treasury against

the specific public issues desired for open market sale. At the same time I would not advocate that the earning portfolio of the Fed be sharply limited in the absence of such an exchange arrangement, because then the Fed might be limited in its ability to influence the rate structure through open market sales.

STATEMENT BY DAVID J. OTT, ASSOCIATE PROFESSOR, DEPARTMENT OF ECONOMICS, SOUTHERN METHODIST UNIVERSITY, DALLAS, TEX.

In its purchases and sales of financial assets the Federal Reserve System basically operates to affect (1) the structure of assets in the combined balance sheet of the private sector; and (2) the amount of gross assets and liabilities in the combined balance sheet of the private sector. When the Fed purchases Government securities, it causes a substitution of a highly liquid asset (claims on the Fed-member bank deposits or currency) for a less liquid asset (Government bonds, notes, or bills) in the balance sheets of private sector. To induce the private sector to hold more "demand debt" (to use Tobin's phrase) and less Government securities, yields on Government must be reduced. There ensues a general reshuffling of private portfolios with prices of earning assets (including tangibles) being bid up until the private sector has achieved portfolio equilibrium with less Government securities and more Government "demand debt." Part of this process will be an expansion of deposit money and bank lending made possible by the increased reserves. From both the wealth effects (increase in the value of claims on Government) and the price effects (excess of capital goods demand prices over supply prices) will come a stimulus to aggregate private demand. Federal Reserve sales of Government securities will cause a rise in yields on assets, a decrease in the value of Government securities outstanding, and a capital goods supply price exceeding the demand price. The effects will reduce aggregate private demand.

The size of the System's portfolio is relevant only to the amount of sales the Federal could make, i.e., to the magnitude of inflationary pressures or balance-of-payments surplus it could be called upon to offset.

It can always buy assets regardless of the size of its existing portfolio (ignoring any gold reserve requirements). And in theory it could conduct open market sales by issuing its own security if it had no stocks of assets to sell. In practice, however, limiting the size of the Fed's portfolio by canceling inter-Government debt would restrict the ability of the System to substitute debt for money in private balance sheets—when everything was sold there would be no more to sell since (to my knowledge) the System cannot sell its own debt.

This seems an unwise restriction on the open market operations of the central bank. We may, in fact, someday need drastic open market sales, and unless the bank has assets to sell, it would be forced to turn to changing reserve requirements or perhaps selective controls, both of which have disadvantages when compared to open market operations. I would not favor canceling a large proportion of the System's portfolio without giving it the power to sell its own debt.

In my view, the proper size and composition of the System's portfolio cannot at present be simply related to GNP, the money supply, or total liquid assets. We simply do not know enough about the impacts of open market operations at this point to formulate any firm rules of thumb. From period to period, the amount of Government demand debt required to produce the levels of asset prices consistent with full employment, a modicum of price stability, and international equilibrium will vary.

If the central issue is really whether the Fed should finance its expenses out of interest earned on its portfolio and remain outside the normal budgetary process, it would seem to me that this could be handled separately. The operation of a central bank is a governmental function and there is no reason why any governmental activity should not have its operating expenditures controlled by Congress. Congress could require the Fed to return all interest income to the Treasury and submit its own budget for congressional action. This would keep the System outside the executive branch in drawing up its budget but would submit its expenses to congressional control.

STATEMENT BY BRAXTON I. PATTERSON, ASSISTANT PROFESSOR OF ECONOMICS, UNIVERSITY OF WISCONSIN, MILWAUKEE, WIS.

*Comments on Questions Raised by Representative Patman by
Braxton I. Patterson, University of Wisconsin*

In a letter dated September 1, Representative Patman raises several questions about the Federal Reserve portfolio. Simplifying somewhat, he raises three fundamental questions: How large should the portfolio be? What should be done about (or with) the excess of Federal Reserve revenue over expenses and dividends? Should the composition of the portfolio be changed? I will comment on each of these, and on the related question of reserve requirements.

SIZE OF THE PORTFOLIO

The main objective of the portfolio must be to provide sufficient room for flexibility in open market operations. To provide downward flexibility, the portfolio must be large enough to cover all expenses even if substantial sales are made. A situation similar to that following our devaluation in 1934, when a heavy inflow of gold created more bank reserves than the Federal Reserve could offset through open market sales, could occur again. If it does, it would not necessarily be during a serious depression or during a period when banks want to hold substantial excess reserves. The resulting expansion of bank loans and our money supply could be seriously inflationary. The present portfolio is probably larger than will ever be needed for this purpose, but even a remote possibility that substantial sales would be required in the future suggests that the portfolio should not be reduced unless other reasons for this are quite important.

In the other direction, it is extremely important that the Federal Reserve be free to acquire whatever additional securities may be needed to provide an orderly expansion of money and credit. On a

few occasions in the past, the gold reserve requirement or the collateral requirement against Federal Reserve notes has imposed restraint on the Federal Reserve System's actions. On two occasions, the result was more monetary contraction than could be justified on the basis of prevailing economic conditions. Any ceiling on the Federal Reserve's portfolio, even one tied to capacity gross national product, could be equally dangerous under some conditions.

I do not anticipate that we will soon experience conditions that would require either substantial open market sales or open market purchases at a rate much faster than the growth in gross national product. However, both are possible. It would be better not to force the Federal Reserve to wait for congressional action if they do occur. Although Congress can act quickly under emergency conditions, a few days could make a substantial difference. Also, a request for emergency legislation could have an adverse effect on business confidence.

FEDERAL RESERVE EARNINGS

The present practice of having the Federal Reserve collect full interest on its portfolio, and then return about three-fourths of the money to the Treasury, is unnecessary but creates no serious problems. Simply canceling some of these securities would create some accounting and legal difficulties, which have been amply discussed by Chairman Martin. After the recent transfer achieved through a reduction in the Federal Reserve banks' surplus, there is not enough left to achieve any important changes in this manner. It would be necessary to transfer some of the liabilities also, and so no substantive change would occur. More important, cancellation would also reduce the ability of the Federal Reserve to prevent an excessive monetary expansion. There might be one psychological benefit. By reducing the nominal Federal debt, such action might leave some Congressmen less reluctant to vote for deficit spending at times when that would be beneficial. This hardly justifies any action that might be taken.

The one liability that could be shifted to the Treasury would be the Federal Reserve notes. The Government would still be obligated to pay, by redeeming these notes, just as much as it is now obligated to pay for the debt. The Treasury would not pay interest, but the payment from the Federal Reserve banks would be reduced by essentially the same amount, so that the budget would not be affected. A transfer of the obligation to redeem Federal Reserve notes, except for those issued so long ago that they may be presumed to have been destroyed, also involves a conceptual difficulty. A note issued by a Federal Reserve bank should remain an obligation of the issuer. Of course, the same result could be achieved more slowly by a new issue of Treasury notes to replace wornout Federal Reserve notes. Conceptually, there would be no problem as long as the Treasury limits the issue to the amount needed in circulation. It would be grossly inappropriate to permit the Treasury to use the note issue as a substitute for borrowing. Our money supply should be adjusted to the needs of our economy, and not the Treasury's need to raise funds. Indeed, the larger the deficit, the smaller the increase in the money supply that is consistent with stability.

One possible change would create no serious technical difficulties while reducing the amount of money making the round trip between

the Treasury and the Federal Reserve banks. About half of the Federal Reserve's portfolio could be exchanged for nonmarketable, non-interest-bearing-perpetual bonds. At any time that substantial open market sales become necessary, these could again be exchanged for marketable issues. The securities provided at that time would be determined by the Treasury, after consultation with the Federal Reserve. Provision could be made for further exchanges of this type as the Federal Reserve's portfolio and income grow in the future. There would be some side benefits from this arrangement. Both the Federal Reserve and the Treasury would avoid the costs of redeeming maturing securities and replacing them with new issues. In addition, the reduction of the excess of Federal Reserve earnings over needed income might create some additional discipline over expenditures. However, the net gain would probably be negligible.

RESERVE REQUIREMENTS

While Representative Patman did not raise the question of reserve requirements, I would like to comment on this subject for three reasons: First, I believe that the present system involves serious weaknesses. Second, E. Sherman Adams has raised this question, particularly for time deposits, in a reply which was distributed by the Support Group for Progressive Banking. Finally, the Federal Reserve's earnings will depend on the extent to which bank lending power is created by reducing reserve requirements instead of by open market purchases.

There are several factors that should be considered in setting reserve requirements. In order to provide effective and predictable monetary control, the requirements should remain above the level that banks would ordinarily want to hold. For flexibility, the requirement should be near the middle of the range permitted by law. Aside from changes needed to achieve these two objectives, or to achieve greater equity, I believe that changes in reserve requirements should be made only in extreme circumstances. Since conditions that would require drastic action are possible but not probable, I would prefer to see the present power to change requirements retained, but very seldom exercised.

Another consideration is the benefit from the interest on the public debt. The taxpayers benefit by having the interest paid to the Federal Reserve, and then returned to the Treasury. Banks, and indirectly their customers, would benefit from having lower reserve requirements. With the same money supply, lower reserve requirements would mean less in the Federal Reserve portfolio, but a larger portion of commercial bank assets would earn interest. Competition can be relied upon to force the banks to pass part of this on to their customers in the form of lower interest charges, lower service charges, and higher interest on time deposits. I do not believe that present conditions are such that any substantial net benefit to our society would be achieved by changes in the present reserve requirements in either direction.

Finally, as Dr. Adams quite properly emphasizes in his reply, equity requires that the same requirement should apply to the same type of account, regardless of the class of financial institution involved. The 1959 amendment to the Federal Reserve Act was a step in this direction, since it permits vault cash to be counted as part of a bank's re-

serves. Some banks need to keep much more currency on hand than others, and I know of no real difference in the type of banking involved that would justify a difference in the reserve requirements. However, both equity and the degree of effectiveness of monetary controls require three further adjustments. First, the requirements imposed on members of the Federal Reserve System should be extended to all commercial banks. Secondly, the present classification of banks for purposes of reserve requirements should be abandoned in favor of a system that will more adequately differentiate between different types of banking. Finally, the requirement now in effect for time deposits at member banks should be extended to mutual savings banks, savings and loan associations, and credit unions.

At present, less than half of our commercial banks are members of the Federal Reserve System. The remaining banks are subject to State requirements which vary widely. Equity requires that the same reserves should be held by competing banks unless there is a clear difference in the type of business. Furthermore, since most States permit banks to count some Government securities and correspondent balances, a shift of deposits from member to nonmember banks will increase the lending power of the banking system. These two weaknesses can be corrected fully only by extending reserve requirements to all commercial banks.

Subjecting nonmember banks to the same reserve requirements as member banks would also make it easier to eliminate the notion that the member banks own the Federal Reserve banks by retiring the stock. The stockholding is now the major tie between member banks and the Federal Reserve, and, in contrast to 40 or 50 years ago, is probably an attraction. Retiring the stock would necessitate finding another guide for the level of Federal Reserve bank capital and surplus. The volume of deposits would probably be the best one. All present services for member banks should be available for all commercial banks. Membership in the system might be retained by counting as members those banks that indicate that they intend to take advantage of the privilege of borrowing from the Federal Reserve, however rarely they do so. I believe that the banks should continue to have some voice in the Federal Reserve System, both through the Federal Advisory Council and by continuing to elect the class A directors of the district banks. The class B directors should be appointed rather than elected, providing a majority of directors are appointed by the Board of Governors.

Because there are important differences in the type of business done by commercial banks, some differences in reserve requirements can be justified. The present two-way classification of member banks does not seem to be the best way of accomplishing this. Since those banks that can justifiably be required to hold larger reserves than other banks generally have a substantial volume of funds deposited by other banks and thrift institutions, the logical differentiation would be to impose higher reserve requirements on interbank deposits than on individual, partnership, and corporate accounts. So long as nonmember banks and thrift institutions can count these balances as part of their reserves, monetary policy is not likely to be fully effective unless the reserve requirement against such deposits is 100 percent. This would make it more difficult for smaller

banks and thrift institutions to obtain the services now provided by the larger banks, so it would be better to require them to hold reserves in forms equivalent to deposits at the Federal Reserve banks. If this is accomplished, a differential of from 5 to 20 percent for interbank deposits would seem appropriate on the basis of the existing difference between the requirements for Reserve city banks and country banks. For flexibility, a third class of deposits, those of the U.S. Government, could be subject to a requirement between the other two. While I feel that the classification by depositor provides the best method of distinguishing between banks, a supplementary requirement on the total of all demand deposits above a certain level may also be useful, particularly if the differential for interbank deposits is small. If this is done, I would suggest no more than an additional 1 percent on deposits between \$10 million and \$100 million, 2 percent on deposits between \$100 million and \$1 billion, and 3 percent on deposits above \$1 billion. Time deposits should not be included in this computation.

I am in general agreement with Dr. Adams that the present treatment of commercial bank time deposits and accounts at other thrift institutions is not equitable, but do not agree with his remedy. There are two reasons for preferring to impose cash reserve requirements on mutual savings banks, savings and loan associations, and credit unions. One reason is that any financial institution with accounts subject to withdrawal will hold some cash in the absence of any requirement. A study I did a few years ago for savings and loan associations in the Midwest indicates that these associations generally maintain a ratio of cash to share accounts that is quite close to the cash requirement imposed on member banks for savings deposits. Thus, the existing requirement is not as inequitable as it might appear. Furthermore, the present reserve requirements for demand deposits are higher than the banks would choose to hold, and should remain so. Thus, in the absence of a reserve requirement for time deposits, commercial banks would probably hold little additional cash to cover time deposits. Eliminating the requirement might create an inequity that reverses the present one. My second reason for preferring to apply the same requirement to the other institutions is that it would give the Federal Reserve a somewhat greater degree of control over the availability of credit. Currently, when funds flow into the thrift institutions, most of the money is lent or invested, with the same effect as bank lending. Most of the rest, retained as reserves, is placed in demand deposits at nearby banks. Thus the increase in lending by the thrift institutions is not offset by a decrease in bank lending. The potential for shifts of this sort is large enough that I would favor requiring all financial institutions of a depository nature to hold cash reserves of the same type required for member banks—currency and deposits at the Federal Reserve banks. Federal home loan bank deposits could be counted if revisions were made to insure that any increase in these accounts would automatically be offset by a reduction in deposits at the Federal Reserve banks. Imposing a 100-percent requirement on the deposits at commercial banks that are counted as reserves would be an acceptable, but inferior, alternative.

COMPOSITION OF THE PORTFOLIO

I do not believe that any change in the present law concerning the composition of the Federal Reserve's portfolio would be helpful. Most of the influence of open market transactions is felt indirectly, via the impact on bank reserves. Essentially, the same results can be achieved by buying (or selling) anything—Government securities, corporate stocks and bonds, real estate, or commodities. Under some conditions, purchase of certain securities may be more effective than the purchase of others. The Federal Reserve should be free to shift its portfolio if these conditions arise, but should not be forced to do so in the absence of these conditions. The system should also be free to return to a greater reliance on corporate securities (mainly commercial paper) if the ratios of Government debt to total debt and to gross national product continue to decline.

There are two considerations that make the present concentration of open market operations in the Government security market particularly appropriate at the present time. First, it is desirable for the Federal Reserve to affect bank reserves with a minimum of disturbance to the market. The relatively broad market for Government securities, particularly Treasury bills, enables the Federal Reserve to make substantial purchases or sales with less disturbance than would be created in most other markets. Any shift in commercial bank secondary reserves and residual investments toward municipal and corporate securities could call for a similar shift for open market operations.

The second consideration is the amount of risk involved. Figures in the August 1965 Federal Reserve Bulletin show that the Federal Reserve banks have a very narrow capital margin. For the System as a whole, capital accounts amount to less than 2 percent of total liabilities, ranging from below 1.4 percent for the Federal Reserve Bank of Atlanta to nearly 2.7 percent for the Federal Reserve Bank of Dallas. The ratio of capital accounts to U.S. Government securities owned outright (the one portfolio component that could readily be shifted elsewhere) is over 3 percent for the System as a whole, ranging from 2.3 to 4.2 percent. With any substantial portion of these holdings in common stocks, recent stock market declines would have wiped out any equity. With the Treasury having the residual claim against both income and assets, the loss would ultimately be borne by the taxpayers. The present level of capital is quite adequate with the existing asset structure of the Federal Reserve banks. It might not be adequate if any appreciable portion of the portfolio were shifted to corporate bonds, and certainly would not be adequate if common stocks became important. The risk factor should not be permitted to deter the Federal Reserve from acquiring corporate issues if substantially greater effect could be obtained. I do not believe that these conditions exist now, so the risk factor should be considered.

SUMMARY

With respect to most of the questions raised by Representative Patman, no change is required. If anything, changes should be in the direction of providing more flexibility. One change influencing Federal Reserve earnings is suggested, although it would make little dif-

ference in actual operations. About half of the Federal Reserve portfolio could be replaced by a special issue that would not earn interest, and would be retained by the Federal Reserve banks unless and until future conditions require that they be exchanged for marketable issues.

For reserve requirements, I am proposing substantial changes. All demand deposits of the same type should be subject to the same reserve requirement, regardless of the location of the bank or whether it chooses to be a member of the Federal Reserve System. Differentiation between banks should be achieved by classifying depositors, rather than banks, with interbank deposits subject to higher reserve requirements than other deposits. All thrift accounts should be subject to the same reserve requirements, whether they are deposits at commercial banks or accounts at other thrift institutions, and only items that are equivalent to currency and deposits at the Federal Reserve banks should be counted as satisfying the requirement.

STATEMENT BY GEORGE POLAK, ASSOCIATE PROFESSOR OF ECONOMICS,
WEST LIBERTY STATE COLLEGE, WEST LIBERTY, W. VA.

The growth in the portfolio of financial assets held by the Federal Reserve System, as stated in your letter, "is a natural consequence of the need to expand money supply to meet the growth needs of our economy." Despite the fact that the portfolio of "Governments" had increased by about \$1.5 billion per year over the 10-year period from 1955 to 1965, the ratio of the Federal Reserve portfolio of Government securities to gross national product remained at approximately 6 percent in 1965 and 1955.

While it is true that only a small fraction of this portfolio is needed for the current day-to-day conduct of Federal Reserve open market operations, the letter fails to mention that the Federal Reserve Act provides that before a Reserve bank may obtain Federal Reserve notes for issuance it must tender "collateral in an amount equal to the sum of the Federal Reserve notes thus applied for." Consequently, at the end of July 1965, about \$33 billion of the Federal Reserve banks' portfolio of Government securities was pledged in the collateral account.

What is even more important is the fact that any attempt on the part of the Congress to set a criterion for the disposition or management of the Federal Reserve financial assets could be construed as a serious interference with the independence of the Federal Reserve System. Such action, in my opinion, could have serious repercussions both at home and abroad. Cancellation of the \$30 billion of the Government securities held by the Federal Reserve System would, in effect, raise the debt ceiling by an equivalent amount. This fact in itself would bring about suspicion and speculation as to the intent of the Congress and revive the doubts that have been expressed concerning the fiscal responsibility of the Government. It cannot be too often emphasized that lack of confidence in the dollar could do a serious damage to our financial position.

As long as we like to think that we have an independent Federal Reserve System, and that such a System is quite capable of protecting

the dollar, rather than one dominated by political interests, the Federal Reserve System should be allowed to manage its own portfolio. After all, interest on Government securities paid to the Federal Reserve is repaid to the Treasury as interest on Federal Reserve notes, and the cancellation of the Government securities held by the Federal Reserve System would serve no useful purpose.

STATEMENT BY RICHARD C. PORTER, ASSOCIATE PROFESSOR OF ECONOMICS, CENTER FOR RESEARCH ON ECONOMIC DEVELOPMENT, UNIVERSITY OF MICHIGAN, ANN ARBOR, MICH.

RECOMMENDATIONS CONCERNING THE FEDERAL RESERVE SYSTEM'S ASSET PORTFOLIO

I believe that monetary policy is, along with other Government policies, an important means by which more stable economic conditions can be maintained. Traditionally, especially recently, monetary policy has meant in this country open-market operations; therefore, I believe that some responsible Government agency should have the power to conduct open-market operations with stabilization and growth as its objective. In order to do this, the agency must either own a sufficient quantity of Government securities or have the power to create such securities when the economic situation requires open-market sales. Once such an agency has a sufficiency of Government securities and is responsibly concerned with open-market operations, whether it has too many and what to do with the surplus are not very important questions.

What may be important is the fact that by holding such a large asset portfolio of Government securities, the Federal Reserve System is able to determine its annual budget without recourse to Congress. To the extent that it is disturbing for Government agencies to become independent of Congress, something should be done to alter this situation. The obvious solution would be to introduce some non-interest-bearing securities into the Federal Reserve System's asset portfolio or require it by law to present its budget to Congress (and return its excess interest earnings to the Treasury). While I am, in general, favorable to the idea that Congress should review agency budgets each year, in this case I feel somewhat ambivalent since I would not like to see the many useful research functions which the Federal Reserve System conducts, and is currently expanding, be cut apart by the overly pragmatic scissors of a congressional committee.

As to the composition of the Federal Reserve asset portfolio, I see no reason why the maturity structure of its Government securities should be determined by law. There are too many potential advantages to "twist" operations to justify removing the possibility of their being used in the future. But I do think that for the remainder of this century at least, the Federal Reserve can manage its open-market operations by dealing only with various maturities of Government securities. I do not think that the Federal Reserve System, the Congress, the public, or even the economics profession is quite ready to watch the Federal Reserve operate in corporate bonds, mortgages, or commodities.

I am very much in favor of any action which would make the Federal Reserve System more responsive to national needs, more responsible to our stated policy goals and more daring in its conduct of monetary policy, but I do not feel that the size or composition of its Government security holdings are a key to any of these changes. Certainly insistence that the Federal Reserve gain approval from Congress of its annual expenditures would make the System more responsive to the Congress, but it is not clear that this in itself would mean an improvement in the quality of our monetary policy.

STATEMENT BY JONAS PRAGER, VISITING LECTURER, DEPARTMENT OF ECONOMICS, BAR ILAN UNIVERSITY (ISRAEL) AND VISITING ECONOMIST, BANK OF ISRAEL (ASSISTANT PROFESSOR OF ECONOMICS, NEW YORK UNIVERSITY, ON LEAVE)*

A. THE SIZE OF THE FEDERAL RESERVE PORTFOLIO OF SECURITIES

Changes in Federal Reserve asset holdings accomplished through purchases and sales of Government securities on the open market affect the economy in a number of ways. Open market operations exert an expansionary on contractionary influence on commercial bank reserves, bank deposits, and ultimately national income flows. Such operations also influence the revenues of the Federal Reserve System and the commercial banking community as well as the actual interest cost of the Federal debt. Both sets of influences are explored in this section. The reply to the question concerning the relationship between Federal Reserve portfolio holdings and money supply, GNP, and liquid assets (No. 1) deals primarily with the macroeconomic impact of changes in the central bank's portfolio. Other policy objectives, on the microeconomic level, which might be achieved by legislating regulations concerning the size of the portfolio of the Reserve System are examined in the answer to question No. 2.

1. Question: How large a portfolio should the Federal Reserve System hold in relation to the money supply, the gross national product, or aggregate liquid assets?

Answer: The Federal Reserve System should not be forced to comply with any mechanical limitation of its discretionary powers. Its ability to act flexibly should not be compromised.

Some economists believe that the only tool necessary and proper for the implementation of monetary policy is open market operations. Moreover, they see a clear-cut pattern and a casual relation between changes in the supply of money and economic activity. As a result, they believe that through changes in the Federal Reserve's portfolio of marketable assets, the economy's progress can be controlled easily and effortlessly. A "rule" can be devised, and if the monetary authorities but heed its prescriptions, the economy will achieve, as Voltaire's Dr. Pangloss never tired of repeating, "the best of all possible worlds."

A second group of economists greets this view with considerable skepticism. To be sure, this second school agrees that the supply of

*Mr. Meir Chait, of the Bank of Israel, read an earlier draft of this paper and made some valuable suggestions for which I am indebted.

money influences economic activity and that through the control of money supply the authorities can help shape the economy's growth. However, these economists believe that the relationship between money and economic activity is not simple, nor is it direct, and neither is it stable. At times changes in money supply can exert strong pressures on economic activity and do so speedily. At other times the influence will be weak and will work slowly. An inflexible rule cannot cope effectively with changing circumstances; active intervention based on a sound prognosis of economic conditions and a sure understanding of the nature and consequences of action must be permitted. When the road is hilly and curvy, the topography constantly changing, an automatic driving mechanism could prove fatal to the occupants of the vehicle. A sure hand backed by a knowledgeable mind is demanded.

Moreover, even if one agrees with the "rule" theory of monetary policy, it does not follow that open market operations provide the only method for achieving its goals. A decrease in reserve requirements by "X" percent per year can give the same impetus to growth in money supply as some "Y" percent per year increase in open market purchases.¹ To be sure, if the objective of the rule is to sterilize totally the discretion of Federal Reserve officials, then the fewer the tools, the smaller is the area of discretion. If, however, the objective of the rule is simply to assure adequate noninflationary growth of the money supply, and if other criteria of monetary policy are admitted as well, disarming the monetary authorities of all weapons but one would hinder the authorities from performing their duties. An example may not be improper here. In order to hold down the interest cost of the wartime debt during the Second World War, interest rates were pegged and open market operations of the Reserve System were but passive responses to the demands of the public. Had the Federal Reserve not been provided with the right to increase reserve requirement ratios, that little control over money supply which was achieved would have been absent. If the rule had required a decrease in the rate of growth of money supply, as we suspect it would have, and if open market operations were devoted to other goals, the rule could not have been made effective without alternative weapons.

Thus, it may be concluded, first, that discretionary monetary authority is not only desirable, but necessary for assuring a stable, yet growing economy. An inflexible, mechanistic relationship between money supply or liquid assets and GNP cannot be acceptable. Consequently, it makes little sense to tie open market operations to money supply, GNP, or liquid assets. Furthermore, even if a rule concerning money supply is thought acceptable, a rule relating open market operations and money supply, GNP, or liquid assets does not follow. In both cases, a flexible response to changing conditions is desired. Discretion is needed.

¹ The well-known equation of multiple expansion of money supply reads:

$$\text{Total deposits} = \text{Initial deposits} \times \frac{1}{\text{reserve requirement ratio}}$$

Thus, if initial deposits=\$100 and the reserve ratio is 20 percent of deposits, the total createable money supply is \$500. To expand total deposits to \$1,000, the central bank can buy \$100 worth of outstanding securities, thereby increasing initial deposits to \$200. The identical amount of total deposits, \$1,000, can be realized by lowering the reserve requirement ratio to 10 percent of deposits. While this example is very simple, the principle applies to more sophisticated cases as well.

2. Question: Is any other criterion more appropriate?

Answer: There is no compelling reason why Congress should limit the Federal Reserve's portfolio of Government securities. Such a limitation would impose an unnecessary restraint on the System's ability to react to changing conditions. Other policy objectives can be handled best through specific measures directed at these goals.

Justification for limiting the quantity of Government securities in the Federal Reserve's portfolio may come from a direction quite different from that discussed in answer to the first question. Since the monetary authorities possess a variety of weapons—open markets operations, reserve requirement changes, discount rates—would it really matter if the Reserve System is limited to some maximum portfolio of securities? After all, cannot the same impact on say, money supply, be achieved via reserve requirement changes as through operations in the open market? The answer is "Yes,² but * * *"

One reason for hesitating to suggest such a policy—a policy which implies that Federal Reserve holdings of securities should be limited to \$700 million or less³—has been mentioned already. Any loss or even the partial destruction of its weaponry would entail a reduction in flexibility. One does not discard a rifle even though another identical to the first is available, for the two weapons can cover two fronts. So, too, is it with changes in reserve requirements and open market operations.

A second objection to limiting the Reserve's portfolio involves the magnitude of the ceiling. Federal Reserve holdings of less than \$700 million would be inadequate for Federal Reserve operations of a "defensive" nature. Such actions occur when some exogenous cause changes the reserves of the commercial banking system. For example, when the public increases its demand for cash, banks lose reserves and if money is not to become tighter, the Reserve System will offset this currency drain by open market purchases. Federal Reserve actions of this sort are aimed at preventing the external cause from upsetting the status quo; they are not implemented in order to modify the existing degree of ease or restraint. It is difficult empirically to differentiate between "defensive" and "dynamic" actions of the Open Market Committee, for the authorities often combine the two goals in a single action. Data on open market operations in December, the seasonal peak for currency demand, and January, when a sharp drop in

² This has been shown in footnote 1.

³ This number is derived as follows. During the years 1953-59 (unfortunately, data for later years was not available to me), four "policy periods" can be distinguished. ("Policy period" is defined as the time between a change in the directive to the manager of the open market account from the Open Market Committee signifying tightening or loosening and its discontinuation.) The four are identified below and the change in the Federal Reserve portfolio during the period is added.

	<i>Billions</i>
1. June 1953 to May 1955, loose.....	-\$1.08
2. August 1955 to August 1957, tight.....	-0.72
3. September 1957 to July 1958, loose.....	+1.89
4. January 1959 to July 1959, tight.....	+0.65

During both periods of ease, reserve requirements were reduced. In period 3, the reductions were aided by net purchases on the open market, while during period 1, open market operations prevented excessive ease resulting from decreases in the required reserve ratio. During periods of tightness legal reserve ratios were not increased; the +\$0.65 in period 4 represents purchases to prevent undue tightness resulting from exogenous factors. The only years of tightness in which open market operations actually restrained the growth of money supply occurred in period 2. In this period the authorities could have chosen to raise reserve requirement ratios. Consequently one may infer that had the System's security holdings been less than \$720 million, Reserve officials would have been forced to increase the legal reserve ratio.

currency demand occurs, are illuminating, however, for operations in these months are primarily of a defensive nature. While not all portfolio changes in December and January reach \$700 million, some do and some exceed this limit.⁴

A policy which would force upon the Reserve System more active use of the reserve ratio has still additional consequences. These stem from the requirement that, in the long haul, there must be a sufficiently large stock of money to grease the wheels of the growing American economy. If the portfolio of the System is to be limited, then new money must result from continuous reduction in the legal reserve ratios of the banking system. First of all, this action would tend to increase the profits of commercial banks, as a smaller share of their assets would be kept idle. Secondly, actual interest payments on the Federal debt would increase. Creating new money via open market purchases brings Government securities held by private holders into the hands of a Government agency, viz., the Federal Reserve System. For all practical purposes, securities held by the Reserve System cost the Government little, the bulk of the payment being merely an intra-governmental transfer. Reducing reserve requirements instead means that the outstanding securities remain with the public, and they receive the interest. Thirdly, substituting reductions in reserve requirements for open market purchases reduces the income of the Federal Reserve System.

All these consequences, if desired, can be achieved by direct action rather than by limiting the powers of the Federal Reserve. If Congress wishes to increase the profitability of commercial banking—and without going into the merits of such action, let it be stated that profit rates of commercial banks have not been significantly different from those of industrial firms⁵—it can do so, for example, through subsidies or tax reductions. If the objective of the limitation proposal is to increase the actual cost of the Federal debt—why Congress should want to act in this manner is difficult to comprehend—this result could be achieved by reducing Federal taxes and issuing additional Government securities to cover the increased budgetary deficit. Finally, if Congress wishes to control Federal Reserve income, let it accept the proposals of Mr. Patman embodied in H.R. 9685 (88th Congress), that the Federal Reserve System be deprived of independent sources of income.

⁴ The changes in the portfolio for the period from December 1953 to January 1959 for Decembers and Januaries are as follows:

	<i>Millions</i>
1953: December-----	+\$467
1954:	
January-----	-376
December-----	+244
1955:	
January-----	-717
December-----	+605
1956:	
January-----	-705
December-----	+741
1957:	
January-----	-673
December-----	+656
1958:	
January-----	-374
December-----	+662
1959: January-----	-536

⁵ According to Fortune's annual survey of the 500 largest industrial firms and 50 largest commercial banks, median returns as a percentage of invested capital were roughly 9.3 percent for the former and 10.3 percent for the latter (1960-64).

Actually, limiting Federal Reserve income is not an objective per se, but a means of obtaining control over Federal Reserve expenditures. For without an independent income, the System would have to turn to Congress for appropriations. Of course, this aim could be achieved without forcing the System to disband open market operations. All that would be necessary is a limitation on its portfolio such that the income therefrom (and from other sources such as rediscounting) would not exceed a specified amount. Even such a proposal is inferior to that of submitting the Federal Reserve's budget to the Congressional budgetary mechanism which would result from Mr. Patman's H.R. 9685. Whether the Patman proposal itself is desirable is a question which has been explored by the Subcommittee on Domestic Finance of the House Committee on Banking and Currency and published in its "The Federal Reserve System After 50 Years: Hearings" (1964). Congress surely has the right of allocating appropriations among the various branches of Government—including the Federal Reserve—as well as the right to order that revenues of the various governmental bodies should be turned over to the general fund of the Treasury.

Two sources of difficulty which might result from Congressional supervision of the Reserve System's budget should be mentioned. First, Congress might use the power of the purse as a means of interfering with the day-to-day execution of Federal Reserve policy. While there is no convincing reason for preserving the independence of the Federal Reserve System and there is some reason for believing that Congress ought to assert itself in the determination of general monetary policy, Congress should not intervene in its execution. Congress is not institutionally equipped for daily supervision. Secondly, the possibility exists that the level of staff excellence might be lowered should Congress be niggardly in its appropriations to the System.

In any case, these various objectives could be obtained by direct legislation aimed at the specific goal. To attain them circuitously through limitation of the Reserve System's portfolio involves imposing an unnecessary and unwarranted rigidity into the choice of the Federal Reserve weapon-mix.

3-5. Questions: If the portfolio grows too large compared to this standard, what should be done with the excess? Should the assets be transferred to the Treasury for cancellation? Should the Federal Reserve continue to hold them, draw the interest and return the unexpended balance to the Treasury?

Answer: While discretion over the size of the portfolio should remain with Reserve System officials, no strong objections can be raised if all income therefrom is transferred directly to the Treasury. The assets, however, should remain with the System.

It was emphasized previously that the freedom of the Federal Reserve System in manipulating its holdings of securities ought not be impaired. Changes in the portfolio provide the System with a tool for influencing aggregate economic activity, and such operations should remain undisturbed. To be sure, some undesired side effects may occur from the open market policies pursued by the authorities, but these evils may be remedied by appropriate legislation.

The disposition of the earnings from the Reserve System's portfolio, however, does not affect the general economy. The question

of the System's income is not an economic problem but a political one. In the American system of democracy, Congress controls the purse strings of the Government. There is no strong reason for exempting the Federal Reserve from this requirement. In order to accomplish this end, the System's independent sources of income must be removed. Mr. Patman's H.R. 9685 would accomplish this, and would force the System to come to Congress for appropriations. However, the assets of the System's portfolio should not be transferred to the Treasury, since such a move could limit the ability of the monetary authorities to operate in the open market. Similarly, it must be emphasized that Congress should not interfere with the Reserve System's freedom of operation.

B. THE COMPOSITION OF THE FEDERAL RESERVE PORTFOLIO OF SECURITIES

6-8. Questions: Can we design other objective standards by which to guide Federal Reserve portfolio operations? Should we lay down standards relative to the kind of assets to be held, maturity composition, private versus public instruments? Should the Federal Reserve supplement its portfolio of Federal Government securities with other types of assets such as commercial loans, foreign exchange, municipal securities, corporate bonds, mortgages, commodities?

Answer: The Federal Reserve System should be permitted, indeed, urged to include all sorts of financial assets in its portfolio but should be prevented from purchasing commodities. Further study is required to determine a nondiscriminatory method of enlarging its portfolio.

The channels through which a change in monetary policy finally brings about a modification of the spending flow are numerous. Open-market purchases by the authorities affect the availability of and charges on credit and market interest rates in general. Commercial bank free reserves will be increased (or negative free reserves decreased) as the securities bought by the Federal Reserve are paid for by the creation of reserves. With this increase in bank reserves, borrowers who were previously turned away can now be accommodated. As this source of lending has begun to dry up, and perhaps even before, banks will seek to make additional loans, borrowing will have to be made more attractive, and consequently rates on loans, short- and long-term, will be reduced. And those would-be borrowers who were deterred by the high cost of credit can now borrow more cheaply. In both cases, namely, the increased availability of credit and its reduced cost, new borrowing will be undertaken and new spending will result. A looser monetary policy accomplished by Federal Reserve open market purchases will raise aggregate demand and gross national product. Needless to say, the opposite reactions may be expected from a tightened monetary policy, through open market sales.

Open market purchases can bring about an increase in spending in another manner as well. The increased demand for Government securities by the Reserve System will raise their prices and lower their yields. Portfolio holdings of all sorts of securities by financial and nonfinancial institutions and individuals, based upon the previous

level and structure of yields, will now be reexamined and modified in accordance with the new market information. Security holders will tend to reduce their demands for the lower yielding Government and increase their demands for a somewhat more risky but more remunerative private security, say AAA corporate bonds. Naturally, this action will drive up the prices of AAA bonds, and thus the profit seekers will switch to the next best security, and so on. Ultimately, the new issue market will become looser and issuers of debt instruments will find improved opportunities and lower charges on their obligations. Simply stated, open market purchases by the Federal Reserve have opened a gap in the market which private borrowers can now fill by supplying their own securities. Again, borrowing will increase, spending will rise, and so will GNP.

Now, insofar as the Federal Reserve's impact on commercial bank reserves is concerned, it matters little what type of asset the central bank purchases or what its maturity is. Reserves are created by payments to the seller whose check ultimately finds its way into the commercial banking system and from there to the Reserve banks. However, insofar as specific interest rates and the availability of funds in the new issue market is concerned, the type of security does matter. The location of the gap is important, for interest rates do not fall quickly and portfolio adjustment takes time. There is at least a 6-month lag from the time that the Federal Reserve changes its policy until the impact is felt on aggregate spending. And the lag may be even longer. Needless to say, this lag hinders the ability of the monetary authorities to achieve their objectives, and renders monetary policy less effective than it could be. This lag ought to be reduced.

On the basis of this reasoning, it follows that the Reserve System should be applauded for abandoning its "bills only" policy. If interest rates are to be reduced speedily, the System ought to operate throughout the yield spectrum.

Moreover, since the objective of the loose monetary policy is to increase private spending, the relevant interest rates are the ones the reduction of which will lead to the strongest and fastest increase in spending. It follows that the Federal Reserve ought to purchase evidences of debt issued by others than the Federal Government and equities as well. This emphasis on opening a gap in the market leads one still further. The Federal Reserve ought to underwrite securities. And carrying out the implications of this "open gap" theory to the logical end, the System ought to buy commodities, too; even go so far as place orders for new goods. In this final instance, the Federal Reserve will be pushing purchasing power directly into the spending stream. GNP will be increased immediately.

Intuitively, one feels something is wrong here. Is not the purchase of commodities properly called fiscal policy? Have we not left the financial sphere and moved into that of Government purchases of goods and services for purposes of stabilization and growth? It seems to me that if Congress does not deem it wise to place responsibility for fiscal and monetary policy under one roof by giving the President discretionary monetary and fiscal powers—a plan of great merit—then it ought to divide these powers completely. The

Federal Reserve should have only monetary powers, and thus should not be given the option of purchasing commodities. (As a corollary, the Federal Reserve and not the Treasury should determine the type of securities sold by the Federal Government, although not the quantity issued.)

Different problems arise with respect to permitting the Federal Reserve to intervene in private security markets. Whose securities ought the Federal Reserve buy? Those of the giants or those issued by small businesses? Those of rapidly growing firms, who have shown promise, or those of slowly growing ones, who need aid? Those of firms engaged in export activities or those concerned primarily with the domestic market? Industrial companies or agricultural ones? California, Kansas, or Massachusetts firms? Is not discrimination inherent in such a proposal? The critics of monetary policy have claimed that even open-market operations in Government securities have a discriminatory impact. Federal Reserve operations in specific private securities will strengthen and perhaps justify this criticism. If shares of stock are purchased, the question of Government infiltration into private enterprise surely will be raised.

To some extent, the choice of securities from a specific category might be made at random. For example, should the Reserve officials decide to intervene by \$6 million in the AAA bond market, a random choice from existing AAA securities might be made. Alternatively, some sort of proportional allocation might be suggested. Thus, if 1,000 securities appeared on the AAA list, 0.001 of the total allocation would be purchased of each listing. Some combination of these two methods might also be adopted.

Another objection that could be raised is that the broadening of the Reserve System's portfolio to include non-Federal Government securities would change the nature of the Federal Reserve System from that of controller of money supply and lender of last resort to that of a plain and simple lending institution. Thus, the Federal Reserve would supplement and perhaps take over some of the functions of the SBA, FHA, FNMA, not to mention those of private financial agencies. This would not be too serious an objection if the random procedure suggested above is adopted, for then no consistent bias would occur. It could be justifiable criticism, however, if the Federal Reserve, consciously or not, favored a specific type of borrowing.

As for the implications of stockownership, the Federal Reserve could be prohibited from voting or otherwise interfering in the affairs of the corporations in which it owns equities.

To conclude, then, it makes good sense to permit the expansion of the Federal Reserve's portfolio to include non-Federal evidence of indebtedness and ownership. Some practical problems remain, however, as to the proper method of implementation. I would suggest, therefore, that Congress request Federal Reserve officials, representatives of the academic and financial communities, and other interested parties to investigate the most practicable manner of implementing an expanded open-market policy. The Joint Economic Committee itself might wish to commission detailed studies. The Joint Economic Committee then should act in the light of the results of these studies.

Alternatively, the Joint Economic Committee might recommend the amendment of the Federal Reserve Act to give the Federal Reserve

System the right to intervene in State, local, and private security markets at the System's option. It is to be expected that the Federal Reserve will not exercise this option without careful investigation and serious consideration of the consequences of such action.

STATEMENT BY CHARLES L. PRATHER, PROFESSOR OF FINANCE, GRADUATE SCHOOL OF BUSINESS, UNIVERSITY OF TEXAS, AUSTIN, TEX.

Instead of cancellation of \$30 billion of U.S. Government obligation, as proposed in H.R. 7601, it seems to me there are better ways of handling this problem. There is no reason why the securities should not be retained for accounting and psychological reasons but they may be made noninterest bearing. The public seems to want backing for their currency and the withdrawal of \$30 billion in assets from the Federal Reserve System could be disturbing.

At numerous times, it has been suggested that all legal reserve requirements against savings and time deposits be eliminated, which would reduce the need of the Federal Reserve System's liabilities and its holding of assets. As a depositor, I object to this change until the assets and liabilities of the time and savings departments of commercial banks are segregated. Not before banks protect their time and savings banks are they entitled to have their legal reserve requirements against them eliminated. Under present banking policies, the effect would be about the same as lowering the percentage reserve requirement for demand deposits.

STATEMENT BY LELAND J. PRITCHARD, PROFESSOR OF FINANCE, DEPARTMENT OF ECONOMICS, THE UNIVERSITY OF KANSAS, LAWRENCE, KANS.

PORTFOLIO HOLDINGS OF THE FEDERAL RESERVE BANKS

The proper volume should be entirely determined by the decisions of the monetary authorities, for it is only through adding to or subtracting from this portfolio that the Reserve authorities can supplement or offset the many other factors affecting commercial bank reserves so as to bring about a net effect in keeping with credit management objectives. This is the only way in which nonmember as well as member bank reserves and excess and free reserves can be properly determined.

Now whether or not this determination should be made by the Open Market Committee and executed through the decisions of the Manager of the Trading Desk at the Federal Reserve Bank of New York is another matter. I am inclined to the opinion that this decisionmaking process should lie entirely with the Board of Governors, and that the Board should be reconstituted to include the Secretary of the Treasury, the Comptroller of the Currency, the Chairman of the Federal Home Loan Bank Board and perhaps the Director of the Federal Deposit Insurance Corporation.

I believe your objections to allowing the Reserve System to utilize excess earnings on their Government portfolio could be met by: (1)

eliminating stock ownership (and dividends) of the Reserve banks; and (2) having the books of the Feds audited by the General Accounting Office and all funds in excess of current expenses returned to the Treasury, and not just approximately 90 percent as at the present time. The latter should be accomplished by the reenactment of the old franchise tax and not accomplished in the devious manner now employed.

As you know the Reserve banks do not need to issue common stock or have this stock held by the commercial banks, or any other party or group. The Reserve banks are central banks. They do not need an owners' equity to protect depositors. Furthermore they do not need capital in any form in order to finance their operations. The Reserve banks, as you know, acquire all earning assets through the creation of deposits, and these deposits are the reserves of the banking system. Incidentally, the legal reserves of all commercial banks should consist of deposits in the Federal Reserve banks, that and nothing more. If this were so the job of controlling the size and expansibility of the banking system would be made easier and more responsive to the monetary authorities.

STATEMENT BY L. S. PRUSSIA, JR.

With regard to your direct questions regarding the appropriate size of Federal Reserve System portfolio of Government securities in relation to money supply, gross national product, and liquid assets, I do not believe that any firm measure or rule of thumb can be applied. The relationship depends upon many considerations that are constantly changing. Institutional relationships, the interplay of fiscal and monetary policies, developments in the private sector, and international considerations all have a bearing on this important question.

Generally speaking, I believe that overall monetary policies should provide our Nation with a growing supply of money and credit at the lowest possible level of interest rates to promote continuous, maximum, long-term economic growth. Monetary policies always should seek to be promotive but, equally important, they should encourage stable growth. This means that the monetary authorities should avoid policies that would promote excessive general price level movements that might jeopardize continuous maximum growth. Consequently, this means that the authorities might have to take steps, when the occasion warrants, to make adjustments in policy consistent with fiscal policies and developments in the private sector that will either restrict or enlarge the availability of money and credit. In sum, the monetary authorities should remain continuously cognizant of the overall economic needs of the Nation and adjust policy accordingly. Moreover, I believe they should have a reasonably wide degree of freedom to set policies with these objectives in mind.

The most important consideration is the ultimate objectives of monetary policy. The means of achieving these ends seem less important in relation to these primary objectives. The basic aim of policy should be to provide an optimum flow of credit resources and the Federal Reserve has several alternative means of achieving these objectives. However, the particular policy mix chosen to achieve these ends can have an important influence on the banks and financial relationships generally.

As you noted in your letter, the Fed has chosen to provide bank reserves in recent years through open market acquisitions of Governments. Although this may have been appropriate in the early sixties, the continued pursuance of this policy orientation has raised serious questions more recently. To understand this it is necessary to review briefly the history of the sixties to make my point.

As you well know, our Nation has been involved in a serious balance-of-payments problem for a number of years. The grave importance of this problem became painfully apparent in the early sixties in the midst of a domestic recession. Because of this recession, domestic monetary policy obviously required a promotive orientation, lower interest rates, and rapid credit expansion to encourage domestic growth. On the other hand, this policy orientation was not consistent with our international financial relationships which required a monetary policy that would hold domestic interest rates at levels high enough to prevent excessive outflows of dollars and gold.

Given this dilemma of policy objectives, our Government selected a mix of monetary and fiscal policies that would promote internal growth but that would simultaneously protect our international payments position. In the financial area the Federal Reserve and Treasury cooperated in a policy mix that has come to be known as Operation Twist. The objective of these policies was to sustain or raise domestic short-term rates that were sensitive to international money flows and simultaneously maintain or lower domestic long-term rates to stimulate domestic investment and internal growth.

The Treasury took part in Operation Twist by adopting debt management policies which saw outstanding marketable issues due within 1 year rise from \$70 billion in mid-1960 to \$95 billion at the present time. The rising supply of short-term issues tended to sustain or raise short rates. Simultaneously, the Fed adopted promotive credit policies in 1960 by enlarging available free reserves. During the last 5 years the Fed has supplied reserves largely through open market acquisitions of U.S. Government securities, as you point out. Equally important, the Fed abandoned its bills-only policy in the early sixties, and acquired intermediate and long-term Government securities to support their prices and to hold down long-term rates.

The Fed also has pursued Operation Twist objectives by raising the discount rate and liberalizing regulation Q which governs the rates member banks can pay on savings and time deposits. These moves have raised short-term rates and bank expenses. As a consequence, these moves have helped to sustain short rates at levels consistent with the foreign rate structure and have also forced the banks to move funds into longer-term commitments such as term loans, mortgages, and long-term investment to justify the rapidly rising interest expense. This latter move has been effective in helping to hold down long-term rates.

It seems to me that the authorities employed an imaginative new approach to monetary control under difficult circumstances during this period. The Fed operated on bank balance sheets to increase the flow of credit, but the authorities also successfully influenced the yield curve of maturities by open market purchases and by operating on bank costs. The resulting impact of Operation Twist proved to be successful.

In line with this policy orientation, it appears that it was necessary to offset gold outflows by means of open-market acquisitions of government securities rather than by reductions in reserve requirements. Open-market purchases, particularly long-term issues, helped to sustain the overall effect of Operation Twist. This approach simultaneously reduced long-term rates and provided banks with increased reserves to expand credit. It provided easy money without necessarily reducing short-term rates. The cost impact of higher regulation Q limits did the rest by forcing the banks into longer term commitments. On the other hand, provision of reserves by reduced reserve requirements in the early sixties would have worked against this policy objective because it would have allowed the banks to offset rising costs more easily by greater investment in earning assets.

Although you cautioned against elaborate argument in your letter, I believe this review of history is essential to an understanding of the Fed's rapid accumulation of U.S. Government securities in the last few years. This was a necessary adjunct of this policy orientation; however, this approach has had other important effects on our financial system. Moreover, the economic environment has changed markedly and it is now doubtful whether this same policy orientation is appropriate.

The huge acquisitions of government securities by the Fed have substantially changed the role of the monetary authorities in recent years. Where the Fed held 14.1 percent of the marketable Federal debt in 1959, it now holds 18.7 percent. Because of these acquisitions, the authorities have absorbed 45 percent of the increase in total Federal debt in this period. As a consequence, the Fed has become an important engine for financing Federal deficits. This naturally raises a question as to whether it is appropriate to have an arm of the Government finance so large a part of its indebtedness. This type of internal financing becomes relatively cheap because the Fed regularly remits about 90 percent of its net earnings to the Treasury.

Heavy acquisition of Federal debt by the Fed also has changed the market environment. Continuous market support operations lulled investors into a false sense of security. The breadth, depth, and resiliency of the market narrowed as it came to rely on Fed support, particularly at the long end. Investors assumed that the Fed would continue to support prices in a narrow range with the result that trading tended to decline and investors became complacent. Consequently, the market received a severe shock when the Fed recently withdrew its support. Hence, this whole episode of Fed operations has tended to discourage a broadened ownership of Federal debt which presumably is a prime objective of debt management policy.

Large-scale operations on the cost structure of commercial banks have raised other questions. As indicated, efforts to increase expenses have forced the banks to seek new ways to justify these higher costs to continue to earn an adequate return on capital. This has forced the banks to seek higher yielding, long-term commitments, but it also has required the acceptance of greater risk and reduction of liquidity. Therefore, the safety of depositors has been affected by the Fed's policy orientation. Although the policy has encouraged a rapid growth of credit, it also has affected the quality of credit and the nature of financial relationships. So far, this policy orientation has

worked to achieve the desired ends, but it also has increased the vulnerability of the banking system to economic reversals and raises important questions regarding the future health of our whole financial mechanism.

The policy orientation of the Fed during the recession-dominated period and during the earlier stages of acceleration appears to have been desirable. However, the character of the challenge facing the Nation now has changed. We have passed through this difficult recession stage and the economy is now operating close to full employment. The expansion has lasted nearly 5 years, and without the recent stimulation of the escalation of the Vietnam action, there would be questions about sustaining the advance. Given the increased vulnerability of the banking system, it now seems appropriate to consider a basic change in policy orientation to insure continued sustainable growth.

It no longer seems acceptable for the Fed to support credit growth entirely through open market acquisitions of governments. Increased demand for credit accompanying economic growth has raised interest rates to levels that are consistent with our balance of payments requirements. Moreover, the interest equalization tax and the recently instituted voluntary restraint program have limited the outflow of dollars. It might also be observed that the banks have been required to assume a large share of this burden, again with the result that bank earnings will be squeezed by reduced opportunities for attractive foreign lending. Then, too, bank earnings have been held down this year because the Fed increased regulation Q limits in late 1964 for the third time in 3 years.

Overall, the Fed's policy orientation in recent years has had an important impact on bank earnings. Between 1960 and 1964 member-bank revenues increased \$3.5 billion (38.7 percent), but expenses increased \$3.2 billion (57.3 percent) largely because of increased interest expense. After other adjustments, net income before taxes, at \$2.9 billion, has shown no growth whatsoever during this 4-year period. Net after-tax income has risen \$200 million or by only 13.9 percent during the period, but this was aided by the 1964 tax cut. During this same period, by comparison, total U.S. corporate profits increased 30.4 percent, and after-tax profits of the U.S. corporations increased 39.2 percent—three times the percentage increase in member-bank profits. As a result of this poor bank profit showing, the return on capital declined from 10.1 percent in 1960 to 8.8 percent last year. However, during the same period, the return on equity of U.S. manufacturing corporations increased from 9.2 percent in 1960 to 11.6 percent last year. Clearly, although earning assets of banks have grown sharply in recent years, this has not been translated into profits because of Fed policies which have substantially increased bank costs.

Given this situation, I agree with you that the Fed should change its policy orientation. It is no longer necessary or desirable for the authorities to support credit expansion entirely by open-market acquisition of governments. Indeed, the present policy orientation, if pursued, could have undesirable effects on our economy.

However, it is necessary for the Fed to continue to support credit growth. Therefore, it would seem desirable for the Fed to shift its expansionary policy emphasis from open-market acquisitions to reduc-

tions in bank reserve requirements. At present member banks are required to hold over \$21 billion in cash reserves against their deposit liabilities. As in the case of the Fed's U.S. Government security holdings, this amount of reserves seems to be altogether too large.

Responsible scholars have repeatedly advocated a thoroughgoing revision of these requirements because they are inequitable and perpetuate an anachronism of another period. They no longer serve the necessary ends of monetary policy and are positively damaging with regard to competitive relationships. The most serious deficiency of present reserve regulations is the 4-percent cash requirement against savings and time deposits. Commercial banks are the only type of financial institution that is required to meet such a rigid requirement.

At present member banks must hold \$4.6 billion in required cash reserves against savings and time deposits. Orderly elimination of this requirement would serve to support necessary credit growth and could also serve to reduce Fed holdings of governments if it is deemed inappropriate to provide the banks with this amount of free reserves over a short period. With the consent of Congress, gradually reduced requirements could be offset by sales of governments out of the Fed's portfolio to maintain the overall policy posture desired.

Furthermore, a reduction in requirements against demand deposits also appears appropriate. The present high level of required reserves is a holdover from the inflation-dominated war period. They presently appear to be unnecessary and should also be reduced. Each 1-percent reduction here would, if fully offset by sale of governments, reduce the Fed's portfolio by an additional \$1.3 billion.

A carefully designed program of reduced reserve requirements would achieve your objective and simultaneously improve the overall operation of our financial mechanism. Such a program would provide for the necessary growth in credit, improve the equity of competition between financial intermediaries, and also reduce the Fed's holdings of U.S. Government securities in line with your views.

This approach to the problem appears to be eminently more desirable than your proposal to turn Fed-held securities back to the Treasury for cancellation. This proposal appears to be unworkable and perhaps dangerous. If the Fed were to turn \$30 billion in governments back to the Treasury for cancellation, how would its books be balanced? Reported Federal Reserve capital amounts to only slightly more than \$1 billion. Clearly, an asset cancellation of the proposed magnitude could not be written off against this. The contraction in other liabilities necessary to offset such a massive decline in Federal Reserve assets would be catastrophic because it would mean a sharp decline in credit availability.

But perhaps more important, cancellation of Federal debt suggests repudiation. No matter how adroitly this might be accomplished, and surely it would require an act of Congress, it would have serious repercussions on confidence in the dollar. Wholesale cancellation of Federal debt would cast serious doubts on the Government's sense of responsibility to meet its obligations. Therefore, confidence in the dollar would be seriously damaged around the world.

I share your concern with the present orientation of monetary policy. Ingeniously devised methods to cope with serious problems worked well when they were needed; however, we live in a dynamic

and ever-changing environment. We must constantly be aware of this and adapt our policies to this changing environment if we are to insure the continued health of our Nation. The time for change appears to be overdue and, hopefully, steps will be taken shortly to improve the vital influence of our money and credit policies for the benefit of all.

STATEMENT BY ROLAND I. ROBINSON, GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, MICHIGAN STATE UNIVERSITY, EAST LANSING, MICH.

I believe the present laws governing this portfolio and recent Federal Reserve administrative policies in managing it have been entirely satisfactory; I see no excuse for any change in this regard. As long as the Treasury recaptures the excess of Federal Reserve earnings over operating costs (which seem eminently reasonable to me) the public interest is being served.

May I respectfully suggest, however, that by focusing your attention on this matter, you are losing an opportunity to press forward on more important matters. For example, Federal banking regulation has become increasingly splintered with the Justice Department and the SEC more involved. Regulatory policies of the various agencies have frequently been at odds with one another. On a point closer to your own long-run interests, the organization for decisionmaking within the Federal Reserve System often seems to become bogged down by its own weight. These matters are important; far more important than the channel through which the Federal Reserve—one branch of the Government—funnels its earnings back into the Treasury. In these areas there is a great opportunity for you to serve not only present public policy but the future; structural organization does not have the glamour that is found in current economic policy but in the end it may be more important.

STATEMENT BY ROBERT ROCKAFELLOW, PROFESSOR OF ECONOMICS, COLLEGE OF BUSINESS ADMINISTRATION, UNIVERSITY OF RHODE ISLAND, KINGSTON, R.I.

How large a portfolio of "Governments" should the Federal Reserve System hold in relation to the money supply, the gross national product or aggregate liquid assets? Is any other criterion more appropriate?

The \$39.2 billion of Government bonds have mostly been acquired by the Federal Reserve System as a result of open market operations with buying predominating over selling and only secondarily have Government bonds been bought with the purpose of securing earning assets. Since the Federal Reserve System pays back to the Treasury most of its income and at the same time keeps a surplus twice that of its capital account and assuming that its expenses are reasonable, I see no great harm in the present policy and can suggest no objective criterion or rule, such as a GNP-Government securities holdings ratio, for example. Such a criterion would not be especially significant in my opinion. I am more concerned with the broader problems: have

the "money managers" allowed the Nation's money supply to expand sufficiently "so as to assume an adequate rate of economic growth and sustained high levels of production and employment." We still have unused resources of labor and capital and I believe that the policy followed since World War II by the Federal Reserve has been too conservative. But I think the Federal Reserve should continue to hold its "Governments." I see no immediate crisis like that of the 1929-33 deflation necessitating sharp changes in our central banking structure and practice. Legislation to compel cancellations of some \$25 billion of "Governments" might upset confidence at this time in the conservative world of financial institutions.

Should we lay down standards relative to the kinds of assets to be held, maturity composition, private versus public instruments?

I certainly am not in favor of a "bills only" policy such as characterized the period 1951-60 with its three recessions, preceded in each case by a deliberate "tight money" policy with net deficit reserves. (I do not like the present prolonged "net deficit reserves" position as it is currently maintained.)

Bankers acceptances supplement the Federal Reserve's portfolio now, but since they are limited in supply in our commercial practice, they are not very important.

STATEMENT BY RAYMOND J. SAULNIER, PROFESSOR OF ECONOMICS,
BARNARD COLLEGE, COLUMBIA UNIVERSITY, NEW YORK, N.Y.

Responding to your request for comments on H.R. 7601, I would advise strongly against its enactment. My reasons are as follows:

(1) Unless a non-interest-bearing security were substituted for the income-earning securities now held by the 12 Federal Reserve banks, it would be impossible to cancel \$30 billion of Federal Reserve holdings of securities without either (a) wiping out the capital of the Federal Reserve banks (which would be an expropriation of member bank property); (b) wiping out the reserve balances of member banks (which would be not only an expropriation of property but would create havoc in the banking system); and (c) greatly reducing Federal Reserve note circulation (which would be a disaster for the economy).

(2) To substitute non-interest-bearing securities for those the 12 Federal Reserve banks now hold, not at the option of the banks but at the option of the Congress and against the wishes and better judgment of the banks, would set a precedent for arbitrary debt cancellation that would destroy confidence in the U.S. dollar and the word of the U.S. Government.

STATEMENT BY WILLIAM O. SHROPSHIRE, ASSOCIATE PROFESSOR OF
ECONOMICS, SCHOOL OF BUSINESS ADMINISTRATION, EMORY UNI-
VERSITY, ATLANTA, GA.

Assuming that the Federal Reserve is only responsible for monetary policy, i.e., measures designed to effect changes in the money supply, the only reason the System has for owning any Government securities at all is to have something to sell when it wants to reduce the money supply through open-market operations.

The answer, then, to the question of how large the bond portfolio should be hinges upon the possible size of future security sales by the Federal Reserve. This amount is, of course, uncertain, but a review of the data on security sales for the last 15 years suggests the order of magnitude of open-market operations. Since 1950, the largest reduction in security holdings during a 12-month period occurred between 1956 and 1957. During this interval of credit restraint the Federal Reserve reduced its holdings by \$783 million. It is possible that this net figure for the year fails to reveal very large sales in 1 week that were offset by purchases in the following week. Therefore, it is useful to look at the data for periods shorter than 1 year. The largest net reductions for monthly intervals appear to have been in the neighborhood of \$0.5 billion to \$1 billion; the largest net reductions during 1 week appear to have been in the same range. One further observation is suggestive of the possible magnitude of open-market sales. During the interval that has been described by one critic as "viciously restrictive," the largest net reduction in the System's holdings of securities amounted to about \$2 billion. This reduction occurred between December 9, 1959 and March 2, 1960. These data suggest that the present Federal Reserve holdings of U.S. securities are far greater than the amount necessary to carry out monetary policy.

This does not necessarily mean, however, that the debt should be canceled. From an economic point of view, it is a matter of indifference whether the debt is canceled or held in the Federal Reserve portfolio. That is, neither taxpayers, consumers, nor businessmen would detect the difference if the debt were canceled tomorrow. The choice between cancellation and continuance of the present arrangement seems to me to be a political one. Because of its large holdings of Government securities, the Federal Reserve is not dependent upon congressional appropriations for its operating income. If the debt were canceled, its earnings might be reduced to the extent that tax money would have to be appropriated to finance the System. Under present arrangements, Congress levies taxes to cover debt service, part of which accrues to the Federal Reserve to cover its expenses. If the debt were canceled, Congress would probably have to provide tax money to finance the Federal Reserve. This latter method of finance would mean, of course, that the Federal Reserve would be directly dependent upon Congress for operating funds. Whether this increased control by Congress is desirable is another question, which cannot be answered on economic grounds.

STATEMENT BY BARRY N. SIEGEL, ASSOCIATE PROFESSOR OF ECONOMICS,
UNIVERSITY OF OREGON, EUGENE, OREG.

This is in response to your letter of September 1, 1965, requesting my opinions on the subject of Federal Reserve portfolio policy. As stated in your letter, the Federal Reserve holdings of governments have grown to almost \$40 billion, partly in response to the need for growth in the money supply. I might also add that the external gold drain plus the internal drain of a rapid increase in currency in circulation since 1960 together more than account for the increase in Federal Reserve holdings of U.S. securities. Both the defense of the existing money supply and the need for monetary growth appear to

have influenced Federal Reserve portfolio policy. The growth in the deposits during this period could have been met by relatively small reductions in reserve requirements. The external and internal drains upon bank reserves, however, would have required an approximate 50-percent reduction in reserve requirements if the Federal Reserve had chosen this particular route to offset the two drains.

Should the internal and external drains upon bank reserves continue unabated in the future, they will probably be met by further increases in Federal Reserve holdings of U.S. securities. Under existing arrangements, the only other way of offsetting the impact of such drains upon the money supply is to lower continuously member bank reserve requirements. The effect of this would be to substitute member bank holdings of United States and perhaps privately issued securities for Federal Reserve holdings of U.S. securities. While continuous reductions in reserve requirements are technically feasible, within the lowest legal limit of reserve requirements, I would prefer meeting member bank reserve drains by the method of Federal Reserve open-market purchases. This method at least has the virtue of reducing the net interest cost of the Federal debt to the public. Moreover, the second method would open the Federal Reserve to the charge of feathering the nest of the banking system, since member banks, not the Federal Reserve System, would be receiving the interest earnings on the debt purchased to meet the reserve drains.

The above remarks should indicate that I know of no mechanical rule or criterion which should dictate the size of the Federal Reserve's portfolio. The size of that portfolio is dictated by the rate of desired growth in the money stock and, more importantly, by the direction and size of gold and currency movements. How these influences are met is as much a political and ethical problem as it is an economic problem. The same is partly true of the question of what should be done with the enlarged portfolio of the Federal Reserve. Technically, the Federal Reserve could continue to hold its additional stocks of U.S. securities until maturity, turning over to the Treasury the interest it earns in excess of its expenses and dividend payments. Alternatively, the excess portfolio could be sold to the Treasury in exchange for non-interest bearing certificates issued by the Treasury. The only technical advantage I can see in this latter alternative is a possible negligible reduction in bookkeeping costs.

I do not wish to comment upon the standards which guide the maturity composition of the Federal Reserve's holdings of governments, except to say that such composition ought to be guided by the principles imposed by the theory of debt management. These principles should be exercised to meet the Federal Reserve System's responsibilities in the area of economic stabilization and in defense of the dollar.

I would, however, like to comment upon the standards by which the Federal Reserve System distributes its assets among public and private instruments. In recent years the marketable portion of the Federal debt has been declining. In the meantime, the volume of marketable Federal debt available to the public as liquid and/or default free assets has been declining even more rapidly. Since December 1962, the decline in the Federal marketable debt held by the public has been over \$5 billion. Moreover, there is a strong possibility either that this trend will continue or that, at best, the amount of debt

available to the public will increase only very slowly. This is because of the rapid potential growth in the social security trust funds resulting from schedules increases in social security taxes and because of the possibility (mentioned above) of continued increases in the Federal Reserve's holdings of Federal debt.

The public's demand for Federal debt is not likely to grow as slowly as the supply available to it. Commercial banks are the principal holders of marketable Federal debt. Since 1962 their holdings have dropped from \$58 billion to about \$48 billion. In the meantime their earning assets as a whole have continued to increase, so that the ratio of Governments to total earning assets in their portfolios has fallen from 0.29 in December of 1962 to below 0.20, a postwar low. It is doubtful that banks will continue to allow the ratio to fall as rapidly in the future. In the same period, State and local governments increased their holdings of Federal marketable securities by over \$5 billion. The prospects for a continued rapid increase in demand from this, the second most important source of "public demand" for Federal debt, is quite good. Indeed, corporations are the only important "public sector" institutions to reduce their holdings of Federal marketable debt. They have sold off about \$3 billion of their holdings since 1962. (Most of these data come from the August 1965 Federal Reserve Bulletin, p. 1141.)

In general, then, I expect a continued strong growth in the demand for Federal debt relative to the growth in supply available to the public. If a recession occurs in the near future, this gap between demand and supply may even widen, since both banks and non-financial corporations may hasten to put their assets into Government securities as other investment opportunities fall off. I might also add that there is some evidence in the behavior of the structure of interest rates in recent years which is at least consistent with the view I have been expressing. The yield differential upon U.S. Government's versus State and local securities has been narrowing, indicating that investors may be substituting such securities in their portfolios for the relatively scarce governments. The recent upsurge in popularity of negotiable certificates of time deposits may also be an indication that investors are substituting such instruments for relatively short supplies of short term Treasury instruments.

What does all this have to do with Federal Reserve portfolio policy? Perhaps nothing at the moment. However, for the future, the Federal Reserve may have to widen its portfolio to include all sorts of private instruments. As the economy grows, so also will its wealth. Wealth holders will wish to balance their portfolios with both liquid and low-risk securities. A failure of growth in the marketable Federal debt available to the public will cause the public to substitute private for Federal instruments. The Federal Reserve System is a guarantor of the liquidity only of the Federal debt and a limited class of private paper. If, in the future, the public comes to hold a large volume of privately issued securities as liquid assets, the Federal Reserve may be well advised to think now of changing its procedures in order to buttress the liquidity of those assets.

Let me stress that the above is only a very tentative suggestion, based upon a tentative analysis. At present, I see the liquidity problem as only a small cloud in the sky. The political and ethical ramifications

of Federal Reserve support for private instruments are such that I would want to be sure of myself before recommending that the Federal Reserve provide a supplementary market for privately issued securities. I do think, however, that the situation bears further analysis and, perhaps, some planning.

STATEMENT BY FRANCES P. SING, BROOKLYN, N.Y.

The following are my comments on the topic you raised in your letter:

(1) The current holdings of about \$39.8 billion of U.S. Government obligations by Federal Reserve banks are large in relation to that is required for open market operations. However, they are not large with regard to money supply, especially in view of future need of money as our economy keeps expanding. Money supply is here defined as currency outside banks plus demand deposits adjusted. The ratio of Federal Reserve banks' holdings of U.S. Government securities to money supply ranged from the low of 70.7 percent in June of 1950 to the high of 113 percent currently. (My calculation is based upon quarterly figures of selected years 1946, 1950, 1955, 1960, 1965.) However, if we include time deposits in the money supply concept, then the ratio would be 10.5 percent in June 1950 to 14.9 percent in March 1946 (and currently 11.2 percent). The relatively rapid growth of time deposits in the postwar period and the ease of converting them into cash and demand deposits warrant a close study of the behavior of this item while considering the relationship of the Federal Reserve's holdings of governments to money supply. In fact, the conversion of time deposits into demand deposits would be encouraged when and if H.R. 9687 is passed.

Since increase in gross national product is closely related to increase in money supply, enlarged holdings of U.S. Government securities by the Federal Reserve are essential to economic growth, unless the Federal Reserve authorities choose to lower member banks' reserve requirements to achieve the same goal. From March 1946 to March 1965, gross national product rose by 233.5 percent, while money supply increased only by 55.1 percent. (One compensatory factor here is the rate of turnover of demand deposits which, during the period, went up about four times in New York City and slightly more than twice in other major cities across the country.) However, if we use the broader concept of money supply; that is, money in circulation plus time deposits, then the rate of increase would be 266 percent within the same period. Therefore, the current holdings of U.S. Government obligations by the Federal Reserve are not large in view of the increasing need for money supply in years to come.

(2) With respect to the problem of paying interest on those governments held by the Reserve banks, I do not consider the cancellation of a major portion of those securities a good solution to the problem of saving taxpayers' money. As mentioned above, a growing economy needs a rising money supply. So if those securities are canceled, the Federal Reserve authorities should be permitted, by enacting new law, to purchase other types of obligations, say municipal and/or corporate bonds to back up Federal Reserve notes in circulation and

member banks' deposits at the Reserve banks, unless the Federal Reserve Act is amended to eliminate the requirement of putting up any collaterals, except gold, to secure notes in circulation and deposit liabilities. According to the latest figures I have gathered, on October 6, 1965, Federal Reserve banks' holdings of U.S. Government obligations amounted to \$39,791 million, and \$26,879 million of which had to be used to back up Federal Reserve notes outstanding, leaving \$12,912 million to secure total deposit liabilities of \$19,548 million. Even though there was an excess of \$4,900 million in gold reserve which could be used to replace the same amount of governments held against Federal Reserve notes in circulation, total Federal obligations held by the Reserve banks cannot be considered excessive unless the Congress is willing to abolish the reserve requirements which Federal Reserve banks have to keep against both note issuance and deposit liabilities. Accordingly, I am not in favor of canceling a major part of the U.S. Government obligations held in the Federal Reserve's portfolio. If the Congress considers interest payments on the governments held by the Reserve banks are not in the public interest, one of the two remedies may be adopted: (a) to require the Reserve banks to turn over all interest received on the governments to the Treasury; or (b) to convert the present holdings of U.S. securities by the Reserve banks into non-interest-bearing debt. I believe any one of the two methods is far better than that of canceling governments held in the Federal Reserve's portfolio for the sake of saving interest cost.

(3) It may be made permissible for Federal Reserve banks to buy corporate and/or public obligations other than U.S. Government securities for the purpose of controlling money supply and for backing up notes in circulation and deposit liabilities. However, I believe that by confining open market operations to the governments, the Congress in fact broadens the outlet for U.S. securities, and thus preventing interest rates on the governments from rising further.

(4) As to the composition of securities held in the Reserve banks' portfolio, I consider it wise to leave that at the discretion of the Federal Reserve authorities. Any law requiring the Federal Reserve to hold a certain percentage of securities in a given term, say 40 percent in short-term issues, would put the authorities in a straitjacket. For this reason (and also others) I was opposed to the bills-only policy adopted by the Federal Open Market Committee in the 1950's.

I hope that my statement serves some purpose, and I would be glad to do further studies concerning the operations of the Federal Reserve System for you and your committee.

STATEMENT BY WALTER E. SPAHR, EXECUTIVE VICE PRESIDENT, ECONOMISTS' NATIONAL COMMITTEE ON MONETARY POLICY, NEW YORK, N.Y.

1. "How large a portfolio ['of Federal Government securities'] should the Federal Reserve System hold in relation to the money supply * * *?"

Answer: As a basic principle, debt of the Central Government should not be monetized. The National Government should not create money for itself; it should obtain it by taxation and by borrowing

from savers and investors. The U.S. Government should not use the Federal Reserve banks as a means of creating money and deposits for Government use against Government securities. It is appropriate for these banks to receive Government deposits and to act as Government fiscal agents provided these banks are compensated for the service rendered.

The Reserve banks should make loans and investments in accordance with the nature of the functions which these banks should perform. In brief, these banks, fundamentally, should be rediscount institutions for their member banks and their notes and derivative deposits (those arising from loans and investments) should expand and contract in general harmony with productive activity. The capital funds of Federal Reserve banks should be invested, not loaned, because of the nature of capital accounts. To the extent that the cash assets represented by capital accounts are in excess of investments in real estate, buildings, equipment, Federal Reserve stock, and other necessary items, investments may appropriately be made in Government securities and other debt obligations provided the Government securities are not purchased from the Government.

Because of the nature of the deposits of Federal Reserve banks—demand deposits—the offsetting assets should consist of cash reserve and automatically self-liquidating short-term loans, arising from the rediscount of commercial, agricultural, and industrial paper.

Only gold certificates as reserve and short-term commercial, agricultural, and industrial paper eligible for discount should be held as assets against Federal Reserve notes.

The expression “money supply” is not defined in the question asked. But if it means Treasury currency, Federal Reserve bank deposits and notes, and time and demand deposits of commercial banks, there would not be any valid reason, in my opinion, for attempting to state how large a portfolio of U.S. Government securities the Reserve banks should hold in relation to the money supply for the reasons given above—the considerations of appropriate procedure for the Federal Reserve banks—and because of the varying velocity with which the different varieties of money and credit circulate.

2. In relation to the gross national product? Because of the nature of the figures on the gross national product, and for reasons stated in item 1, there would not be any valid reason, of which I am aware, to suppose that any appropriate relationship between gross national product and the volume of U.S. Government securities held by the Reserve banks could be stated.

3. “Or aggregate liquid assets”? If the Reserve banks were run on correct principles, as indicated in part in item 1 above, the relationship between the Government securities held and other liquid assets could be expected to vary widely from time to time.

4. “Is any other criterion more appropriate”? That was stated in general in my reply to item 1.

5. “If the portfolio grows too large compared to this standard, what should be done with the excess”? If the principle stated in item 1 were followed, “the portfolio” probably would not become too large. But considering the volume of such securities now held by the Reserve banks, they should be sold as rapidly as possible—that is, without shaking the market for Government securities unduly—to savers and investors.

6. "Should the assets be transferred to the Treasury for cancellation"? Excessive holdings of Government securities should be sold to savers and investors for cash. If the Government becomes involved, it should of course buy them at the market rate.

7. "Should the Federal Reserve continue to hold them, draw the interest, and return the unexpended balance to the Treasury"? The Reserve banks should move persistently toward the principle stated in item 1, selling a large proportion of its Government securities to savers and investors.

It should draw the interest specified on the securities it holds.

The Federal Reserve Act, in section 7, quite properly does not authorize the Reserve banks to pay any of its earnings to the U.S. Treasury.

8. "Can we design other objective standards by which to guide Federal Reserve portfolio operations"? These were stated in summary form in item 1.

9. "Should we lay down standards relative to the kind of assets to be held, maturity composition, private versus public instruments?" Yes, provided this would involve returning the Federal Reserve banks to their proper functions. The Federal Reserve banks should be bankers' banks—rediscount institutions financing commercial, agricultural, and industrial activities (and fiscal agents for the U.S. Government), but not chiefly institutions investing largely in that Government's securities and creating deposits and money against such securities.

The right of the U.S. Government to sell its securities directly to the Reserve banks should be repealed, a possible exception being in respect to so-called on-day Treasury certificates since a purchase of these by the Reserve banks during periods of Government financing could act as a stabilizing factor in what otherwise might be an unduly disturbed money market.

10. "Should the Federal Reserve supplement its portfolio of Federal Government securities with other types of assets such as commercial loans, foreign exchange, municipal securities, corporate bonds, mortgages, commodities?" The financing of such activities is in general the proper functions of other types of banks—those which can be close to their customers. The Federal Reserve banks should be bankers' banks, holding the reserves of member banks, acting as rediscount banks for eligible paper, providing a clearing mechanism for the credit items of their member and nonmember clearing banks, and acting as fiscal agents for the U.S. Government.

STATEMENT BY BERYL W. SPRINKEL, VICE PRESIDENT AND ECONOMIST,
HARRIS TRUST & SAVINGS BANK, CHICAGO, ILL.

You are quite correct in pointing out that "portfolio growth is a natural consequence of the need to expand the money supply to meet the growth needs of our economy." As you well know, there are essentially two means by which the growth in the money supply can occur. One is by purchase of assets, at present Government securities, by the Federal Open Market Committee. An alternative which will accomplish the same objective would involve reduction in required reserve

ratios of commercial banks. I find it very difficult to indicate how large a portfolio the Federal Reserve should hold, but I do have a strong conviction that the Federal Reserve should permit and encourage moderate continuous growth in the money supply month after month and year after year. I know of no magic figure which is just the right amount of money, but experience would suggest that a growth in the money supply of about 3 to 4 percent per year would be about right. Although it might be unwise to specify an exact rate as an objective, nonetheless, great volatility in monetary growth clearly should be avoided.

It has been the view of many commercial bankers, including myself, that Reserve ratios for commercial banks have been too high and that the present method of variable ratios between country banks and Reserve city banks leaves much to be desired. Furthermore, it is clear that commercial banks work under a distinct handicap resulting from the requirement that they maintain reserves in the form of nonearning assets against time money. Our competitors have no such restriction and it is my belief that financial institutions should be on an equal basis with respect to their ability to compete in the marketplace for funds. It would therefore be my view that somewhat greater reliance should be placed on reduction in Reserve requirements as a means for encouraging growth in the money supply and hence a lesser emphasis upon increasing the size of the portfolio of financial assets held by the Federal Reserve System.

I would be very much against laying down "standards relative to the kind of assets to be held, maturity composition, private versus public instruments." It would seem to me that the Federal Reserve should have the power to purchase assets other than Government securities in the event a severe crisis made this move advisable. However, I see no need at present for them to purchase assets other than Government securities. It would seem that Federal open-market acquisition of assets should be as neutral with respect to price effects as possible. The usual confinement to Government securities achieves a high degree of neutrality as contrasted to the situation where they are encouraged to acquire varying kinds of assets.

You raised the question as to whether assets should be transferred to the Treasury for cancellation. The real difficulty with this proposal so far as I am concerned would be that it would tend to reduce or even eliminate the independence of the Federal Reserve System from the existing administration. If there were clear evidence that the Federal Reserve was not coordinating its activities both with the administration and the desire of Congress, and if there were evidence that they were clearly doing a poor job in administering their monetary responsibilities, then I would probably be inclined to favor such a proposal. However, it appears to me that the opposite is the case. In my opinion, monetary policy in the past 4 or 5 years has been the best ever achieved by the Federal Reserve System. They have clearly learned from the mistakes committed in earlier periods and they have adopted a moderately expansive monetary policy which has contributed greatly to the long span of continuous economic growth without inflation. Furthermore, there is clear evidence that their policies have been closely coordinated with those of the administration and with the desire of Congress. Therefore, I would oppose any attempt to further reduce

their independence. It is conceivable to me that under some future administration it will be very helpful to have a central bank with the power to arrive at an independent evaluation of current financial policies and that they might well make an independent contribution to the achievement of the objective of the Full Employment Act.

STATEMENT BY THOMAS I. STORRS, EXECUTIVE VICE PRESIDENT,
NORTH CAROLINA NATIONAL BANK, GREENSBORO, N.C.

1. "How large a portfolio should the Federal Reserve System hold in relation to the money supply, the gross national product, or aggregate liquid assets? Is any other criterion more appropriate?"

Categorical answers cannot be given to such questions. The minimum level depends in part upon the System's need for earnings and in part upon the volume of trading in the various types of Government securities that would be necessary, under all conceivable conditions, to secure desired effects in bank reserve positions and to maintain orderly conditions in the Nation's financial markets. At times massive sales of securities may be necessary, either to accommodate large changes in market factors affecting reserves or to compensate for the reserve effects of System trading undertaken to restore orderly conditions in one or more sectors of the Government securities market. Restrictions on the size of the Federal Reserve portfolio should not be such as to hamper the effectiveness with which the System can discharge its important statutory responsibilities. Standards based on some relationship between the Federal Reserve portfolio and the money supply, the gross national product, or total liquid assets could prove particularly hazardous since our knowledge concerning proper relationships among such variables is so imperfect. A far more sensible criterion, it seems to me, would be the amount of securities the System acquires in conducting the responsibilities assigned it by Congress. Under this standard the System would not have "excess securities" in the sense that Chairman Patman implies.

2. "If the portfolio grows too large compared to this standard, what should be done with the excess? Should the assets be transferred to the Treasury for cancellation? Should the Federal Reserve continue to hold them, draw the interest, and return the unexpended balance to the Treasury?"

Nothing at all would be gained by transferring a portion of the System's Government security holdings to the Treasury even if one judges that the System portfolio exceeds some minimum necessary for System operations. The only two tangible effects would be two book-keeping entries: (a) A reduction in a liability (bonds and other types of Government debt) of the Federal Reserve and (b) a decline in the Federal Reserve's liability for Federal Reserve notes and an equal rise in the Treasury's liability for the notes (if the transfer were made in the manner described in H.R. 7601). The taxpayer would gain nothing at all by the cessation in interest payments on the canceled debt since the Federal Reserve is already transferring to the Treasury all the income it now receives except that used to cover expenses, pay statutory dividends, and make small additions to surplus. Treasury interest payments would decline, but its income would drop a like

amount. Even more important, however, a retirement of Government debt in such a manner would provide a severe jolt to confidence in the dollar both here and abroad. It would also be quite confusing to the public to have the Federal Reserve responsible for some of the notes it issues but not for others. Consequently, I see every reason for simply continuing the present practice of returning the unused portion of the System's earnings to the Treasury.

3. "Can we design other objective standards by which to guide Federal Reserve portfolio operations? Should we lay down standards relative to the kind of assets to be held, maturity composition, private versus public instruments?"

I would not favor specifying any sort of maturity patterns or similar restrictions for the System portfolio. Monetary policy requires that the System be left free to vary the types of its permissible security holdings in accordance with the needs of the economy.

4. "Should the Federal Reserve supplement its portfolio of Federal Government securities with other types of assets such as commercial loans, foreign exchange, municipal securities, corporate bonds, mortgages, commodities?"

I see no need for expanding the System's authority to acquire additional types of assets for three reasons:

(a) The markets in which the System now has authority to act—the Government security market, the foreign exchange market, and the bankers' acceptance market—are sufficiently inclusive to accommodate any foreseeable volume of System open market operations. Domestic markets other than the Government security market are simply not broad enough to accommodate any sizable volume of open market transactions and, consequently, could be used very little even if the System were free to operate in additional markets.

(b) The necessity for making additional decisions as to what types of securities to buy would complicate somewhat the task of the Open Market Committee.

(c) Third, an increase in the proportion of private securities bought would likely increase Government interest payments to some extent since open market purchases of private securities exert relatively more downward pressure on yields of private securities than upon those on Government securities. In contrast, purchases of Government securities exert relatively more downward pressure on yields of Government securities.

STATEMENT BY RONALD L. TEIGEN, ASSISTANT PROFESSOR OF ECONOMICS, UNIVERSITY OF MICHIGAN, ANN ARBOR, MICH.

Statement on the Structure and Management of the Federal Reserve System Portfolio of United States Government Securities

In the statement which follows, the factors responsible for the stability of the Federal Reserve System's portfolio of U.S. Government securities during the 1950's, and its relatively rapid rise during the 1960's, are first discussed against the background of the monetary policy mechanism as it is presently constituted. The purpose of this review is to show that secular growth in the portfolio is almost inevitable under existing policy arrangements and that special conditions were

responsible in both periods for the portfolio behavior which was observed. Whether or not a huge Federal Reserve portfolio of governments constitutes a meaningful economic burden is then taken up. It is concluded that the portfolio as such does not impose a burden of any consequence; however, a case can be made for changing the present procedure of financing the operations of the Federal Reserve System, and such a change might logically include a change in the size or composition of the portfolio. The statement concludes with a discussion of some alternative plans along these lines.

RECENT PORTFOLIO HISTORY

The growth of the Federal Reserve System's portfolio of U.S. Government securities from \$24.2 billion at the end of 1957 to its June 1965, level of \$39.1 billion, compared with the stability of the portfolio at or near a value of \$24 billion from 1951 through 1957, is not surprising. It is generally agreed that monetary policy was excessively tight during much of the decade of the 1950's, whereas during the 1960's, monetary policy has generally been as easy as the balance-of-payments situation would permit. Under the present monetary policy system, the Federal Reserve buys Government securities in the open market in order to generate claims against itself (member bank reserves). Thus the System portfolio would be expected to grow relatively slowly during a period of monetary restraint such as the 1950's; on the other hand, relatively rapid portfolio growth would be expected during a period of ease such as the 1960's. There were additional factors at work which heighten the contrast between these two periods. Substantial reductions in member bank reserve requirements between February 1951 and January 1958 freed reserves for the expansion of money and credit and substituted to some extent for open market purchases. Nonbank public currency holdings grew from \$26.3 billion at the end of 1951 to only \$28.3 billion at the close of 1957, and the gold stock was virtually unchanged during this period. In contrast, the burden of supplying reserves to the banks fell upon open market operations after 1957. In addition to providing the reserves appropriate for a relatively easy monetary policy, open-market purchases were required to offset substantial reserve drains which would otherwise have led to serious monetary contraction. The most important of these drains were the gold outflow, represented by a decrease in the gold stock from a level of \$22.8 billion at the end of 1957 to \$14.3 billion in June 1965, and an increase in currency in the hands of the nonbank public of over \$6 billion, from \$28.3 billion in 1957 to \$35 billion in June 1965. There was also a substantial diversion of reserves to cover the rapid growth of member bank time deposits; time deposit required reserves increased from \$2.3 to \$4.5 billion over this period even though the member bank reserve requirement on time deposits was reduced from 5 to 4 percent late in 1962. These reserve drains accounted for most of the growth in the System portfolio during 1957-65.

Under the present monetary policy arrangements, in which open-market operations constitute the chief policy instrument, long-run growth of the System portfolio is almost inevitable in a growing economy. The only alternative methods of allowing for monetary

expansion are through increased member bank borrowing from the Federal Reserve, or through the lowering of reserve requirements. As a systematic way of supplying new reserves, borrowing is counter to Federal Reserve System philosophy (although it is important in the monetary policy setups of other countries, notably Great Britain). Reserves can also be made available by further reductions in reserve requirements. Such action would not only facilitate monetary expansion directly, but would retard the rate at which the System portfolio grows for a given degree of reliance on open-market operations, since the lower are reserve requirements, the greater is potential monetary expansion for a given open-market purchase or the less purchases are needed for a given desired expansion. However, reserve requirement changes are generally considered to be too inflexible to be relied upon for short-run reserve adjustments; more generally, reserve-requirement reduction will tend to increase the Treasury's net interest costs (because debt will be shifted from the System portfolio, where the net cost is practically zero as will be shown below, to the public) and increase commercial bank earnings. Also, the larger credit expansion multiplier resulting from lower reserve requirements introduces added instability into the financial system to the extent that the Federal Reserve misjudges the size of open-market operations needed to achieve particular policy goals. Some or all of these effects may be judged to be sufficiently undesirable to rule out extensive reductions in reserve requirements. Even if some reductions are made to facilitate long-run monetary growth, continued reliance on open-market operations as the dominant policy instrument for achieving both cyclical and secular goals seems advisable, implying that, as the economy grows, the Federal Reserve System will be a net buyer of securities and its portfolio will continue to expand.

To summarize the above discussion, the recent growth of the System portfolio occurred as a normal response to special circumstances which the System was largely unable to control, based on the monetary policy mechanism which has developed over a long period of time and which has been fully operative since 1951. The portfolio is likely to continue to grow secularly under the present system. If it can be shown that a large portfolio constitutes a serious economic burden, means should be found not only to reduce its present size but to prevent it from growing in the future. The question of the nature and extent of this burden is discussed in the following section.

IS THE SYSTEM PORTFOLIO A BURDEN?

Interest payments by the Treasury on the huge and growing Federal Reserve portfolio are viewed in some quarters as a burden imposed on the economy by the operations of the Federal Reserve System. These payments are the source of most System revenue, and they have exceeded System expenses by substantial amounts for many years (including the entire postwar period). In 1964, for example, interest earnings were \$1.32 billion while System expenses were about \$200 million. While there has been no legal requirement for transfer of the System's excess revenue to the Treasury since 1933, when such a requirement in the Federal Reserve Act was repealed, the System has voluntarily repaid most of such revenue over the years as interest on outstanding Federal Reserve notes.

The Federal Reserve System, as a holder in due course of Government securities, is entitled to receive interest payments on these securities as such payments become due, and it is true that the Treasury must levy taxes or borrow to meet these interest payment obligations. Because of the repayment procedure outlined above, however, the large System surplus—and by extension, the System's large portfolio—constitutes no significant burden beyond that imposed by the necessity to operate the Federal Reserve System itself. The net effect of the transactions described above is that the Treasury must finally raise only enough net new revenue to cover the operating expenses of the System (these include the statutory dividend payments to member banks on Federal Reserve stock and, by decision of the Board of Governors, a transfer to surplus of the amount needed to make surplus equal to paid-in capital). In the interim between interest payments by the Treasury to the System and the end-of-year repayment to the Treasury by the System, however, the Treasury may find it necessary to borrow more short-term funds than would otherwise be the case. The System portfolio consists of a variety of issues and maturities, so that there is probably no systematic pattern to such short-term borrowing by the Treasury. To the extent that it occurs and is not offset by other measures, the System portfolio can be said to be responsible for some undesirable random variation in short-term interest rates which would not otherwise be present. This appears to be the only "burden" imposed by the present procedure of interest payments and repayments as such. Its amount is probably insignificant, although it could increase if the portfolio expanded greatly.

It appears, therefore, that the present system does not present serious problems or constitute an excessive burden compared with some alternative arrangement in which the Federal Reserve's annual interest revenue was reduced substantially. The real issue, I believe, is deeper and is concerned with the way in which the Federal Reserve System is organized and administered. The real cost to society is not the total interest revenue which the System receives in any given period, but is measured by the resources which are required to run it. An attempt to reduce the System portfolio in a once-for-all fashion does not come to grips with the basic question: is the present Federal Reserve System organized and controlled in such a way that its goals are achieved with reasonable efficiency? This is surely not the place to suggest or discuss radical reorganization, and it may be that the operations of the Federal Reserve are conducted with a high degree of efficiency. On the other hand, it is troublesome that the System has the power to establish its own budget without formal outside control, thus effectively determining (for a given portfolio) the amount of its revenue which is returned to the Treasury, and that there is no legal requirement that any revenue be returned. At the least, legislation should be reenacted requiring that the Federal Reserve banks repay their excess earnings to the Treasury, even if this is only a matter of form. It would be more desirable, in my judgment, to subject the System to the same budgetary procedures and restrictions which apply to other Government agencies. Its operations would then come under regular scrutiny in the process of determining appropriations, and it could simply be required by law to repay all revenues—both from interest payments on its portfolio and from other sources—

to the Treasury (note that this proposal is consistent with either portfolio reduction or with retention of the present portfolio by the System). This is not meant to imply that operation of the System should be curtailed; in fact, it would be necessary, in the appropriations process, to assure that important System activities—including its ambitious program of research on monetary problems—were not curtailed, and it is conceivable that the net result might even be a larger budget than would be the case under the present procedure.

SOME APPROACHES TO RESTRICTING THE SYSTEM PORTFOLIO

Reforms of the type suggested above might or might not be accompanied by structural changes in the System portfolio; on the other hand, it may seem desirable to reduce the portfolio without other reforms in order to reduce the amount of short-term borrowing done by the Treasury. It is true, after all, that while no serious problem is raised under existing arrangements, the System does not need a portfolio of securities as large as its present holding, either for revenue or for use in open market operations.¹ The purpose of this section is to consider alternative ways of changing the size or composition of the portfolio so as to bring it closer into line with the System's operating needs while at the same time reducing the short-term finance burden on the Treasury. Three such plans will be discussed; each is consistent either with present System organization or with reorganization along the lines suggested previously.

1. *Cancellation of part of the portfolio against the System's liability for Federal Reserve notes.*—Under H.R. 7601, on which hearings are now being held, \$30 billion of the System portfolio would be retired, to be offset by an equal reduction in Federal Reserve liability for Federal Reserve notes. The advantage of the plan is that it would achieve the goal of portfolio reduction without disturbing repercussions on the monetary sector directly or on public confidence. However, there are several disadvantages. Even if portfolio reduction is taken to be a desirable end in itself, this approach will not result in a permanent reduction and portfolio stability at, say, \$10 billion. Unless the mechanical aspects of monetary policy are changed, the portfolio will tend to grow secularly. Of course, its rate of growth can be reduced by lowering reserve requirements as discussed above; this would not only free reserves now but would result in greater potential monetary expansion per dollar of open market purchases in the future. However, the tendency will be toward continued secular growth, and further portfolio reductions may seem desirable. Under this proposal, potential reductions are severely limited by

¹ While precise quantitative estimates of the portfolio size needed for these purposes are difficult to make, it would probably be adequate for the System to hold \$10 billion, or even less, or marketable, interest-bearing securities at present yields, assuming that reserve requirements will remain unchanged and that monetary policy will continue to be about as important relative to the other instruments of stabilization policy as it has been in the past. The \$200 million needed for expenses in 1964, for example, could have been earned on a portfolio of approximately \$5.25 billion, based on the rate of return of 3.82 percent actually earned by the System on its entire portfolio in 1964. As far as open market operations are concerned, System gross sales of securities have not exceeded \$1.5 billion in any month at least since the beginning of 1956, while annual gross sales (excluding repurchase agreements) have not exceeded \$6.7 billion, the level they attained in 1962. Note, however, that the conclusion that \$5 or \$8 billion of securities will be adequate for open market needs does not take account of the maturity distribution required for this function. Data are from various annual reports of the Board of Governors of the Federal Reserve System.

the greatly reduced stock of Federal Reserve notes which remain as liabilities of the System. Unless such notes are issued in substantial quantities in the future, further reductions comparable in scope to the present proposal will be impossible. Secondly, this proposal does not take account of the maturity distribution needed in the portfolio for open market operations. It is important not only that the System have enough elbow room in the aggregate, but also that there are enough securities in its holdings in each maturity class to accommodate potential sales. This is a consideration which must be borne in mind in evaluating any proposed change.

2. *Cancellation of part of the portfolio against the System surplus account.*—Under this proposal, the immediate goal of portfolio reduction would be achieved, and further reductions could be made without difficulty under this procedure whenever they seemed advisable. However, the large negative System surplus which would result would undoubtedly cause some concern in the public mind, even though such concern would be without foundation. The Federal Reserve System itself seems to feel that a substantial positive surplus is needed as a “protective shield against risks” (51st Annual Report of the Board of Governors of the Federal Reserve System, 1964, p. 50). These considerations are perhaps important enough to rule out this proposal as a practical alternative.

3. *Conversion of part of the portfolio into non-interest-bearing debt.*—The true goal of the proposals discussed above is not to reduce the System portfolio, but to reduce the gross interest payments by the Treasury to the System. This goal could easily be achieved by the simple device of exchanging part of the existing portfolio for a new security issued by the Treasury. This security would be noninterest bearing and nonmarketable. Its use would avoid the limits on future reductions and the potential damage to public confidence which are associated with the proposals for reduction in the size of the portfolio which are reviewed above. There is also a degree of flexibility associated with this proposal which is not characteristic of the others. Under it, the portfolio could be reduced to the minimum necessary to provide for System expenses and for immediate open market needs. Any doubts concerning the adequacy of the reconstituted portfolio for open market purposes could be resolved simply by providing for reconversion of some of the new, non-interest-bearing debt back into marketable debt of any maturity desired at the request of the Federal Reserve System (in practice, it should be noted that the tendency for the portfolio to grow will provide a certain degree of flexibility which would apply to all of these proposals). Furthermore, as new surplus marketable debt is acquired by the System, it could be continuously converted into nonmarketable debt by the Treasury without limit.

The above proposals are discussed in the context of a System portfolio composed only of securities of the U.S. Government. I believe that this should continue to be the rule. Among other reasons, open market operations, because of the size of the individual transactions, require a market of exceptional depth and breadth; the U.S. Government securities market possesses these characteristics to a greater extent than any market in private securities. It should be emphasized that within the portfolio of governments, there must be adequate quantities—or the possibility of access to adequate quantities—of se-

curities in each maturity range in which transactions are conducted. Drawing on the experience of the recent past, this would mean that relatively large quantities of securities in the 1-to-5-year maturity range should be available, as well as securities with less than 1 year to maturity.

STATEMENT BY GEORGE TERBORGH, RESEARCH DIRECTOR, MACHINERY & ALLIED PRODUCTS INSTITUTE, WASHINGTON, D.C.

Let me say first of all that I have read the attachment to the chairman's letter, consisting of a colloquy with William McChesney Martin of the Federal Reserve Board. As to this, I must confess myself baffled by Mr. Patman's position, that in paying interest on Government obligations held by the Federal Reserve Board the Treasury is somehow "paying on its debts more than once." If the payment of interest on obligations is "paying debts more than once," this is something all debtors do, whether public or private, and is in no way unique.

I do not presume to take a position here on the proper level of member bank reserve requirements, which apparently is not at issue. I should like to insist, however, that whatever the liabilities of the Federal Reserve System may be, they should be covered by equivalent assets. As to what these assets should be, this is a matter of circumstance and convenience, but in view of the enormous dimensions of the market for Government obligations, I see no reason why the System should be required to go beyond this category. It is technically adequate for the purpose of credit control. Moreover, I see no point in congressional prescriptions requiring portfolio diversification by the inclusion of other types of obligations. The whole matter should be left to the discretion of the Board.

In view of the fact that excess earnings of the Federal Reserve System are recaptured by the Treasury anyway, it seems to me absurd to gag over the fact that the Treasury pays interest on the Reserve portfolio. In short, I conceive the issue raised here, if I correctly understand it, to be a false one.

STATEMENT BY ROLLIN G. THOMAS, HERMAN C. KRANNERT GRADUATE SCHOOL OF INDUSTRIAL ADMINISTRATION, PURDUE UNIVERSITY, LAFAYETTE, IND.

As I interpret the inquiry, the questions raised fall into two categories: First, is the total portfolio of the Federal Reserve banks excessively large in relation to the total money supply and the gross national product? Second, should the portfolio be comprised of money market assets other than U.S. Government securities?

The first question seems to involve the inference that the present portfolio of \$39 billion is excessive. This question can only be answered in the light of the origins of the portfolio and the underlying reasons for its existence:

1. Given legal reserve requirements against member bank deposits, comprised of vault cash plus deposits in the Federal Reserve banks, and any additional cash which member banks may wish to carry as

excess reserves, it is necessary that the reserve funds available to banks be maintained and, over time, be increased sufficiently to permit the increase in the money supply needed to accommodate the growth of the GNP.

2. Because gold exports and increases in money circulation outside of banks reduce bank reserves by equal amounts, such reductions must be restored or replaced if a deflationary money and credit shortage is to be avoided. Between December 1955 and July 1965, our gold stock declined by \$7.7 billion, and during the same period the domestic requirements for money in circulation outside of banks rose by \$5.1 billion. Altogether these developments reduced member bank reserves by \$12.8 billion. At the same time member banks required reserves increased by \$2.9 billion. Therefore, pressures on member bank reserve positions rose by the total amount of \$15.7 billion. This was met mainly by an increase in the Federal Reserve holdings of U.S. Government securities of over \$14.5 billion and by some modest reductions in member bank reserve requirements.

3. As is well recognized, the Federal Reserve bank purchase of U.S. securities in the open market results in an equivalent increase in member bank reserves. Bond sellers receive drafts (or cashiers' checks) on the Federal Reserve bank and deposit them in their commercial bank accounts. These checks are sent in by member banks to the Federal Reserve bank for deposit in members' reserve accounts.

4. Thus, in the ordinary course of business the Federal Reserve banks are able to replenish or increase member bank reserves by purchasing securities in the open market or, alternatively, by lending to (or discounting for) member banks. The purchase of securities is generally preferred to lending to member banks inasmuch as the latter process involves the distasteful (to banks) process of going into debt to obtain necessary reserve funds. Any large scale dependence upon member bank borrowing as the method of obtaining reserves discourages the rise in bank credit and tends to be deflationary.

5. The Federal Reserve banks' portfolio, therefore, arise directly out of the process of increasing the reserves available to member banks as their needs increase. Because bank reserves, as well as paper currency in circulation, are mainly in the form of deposits in the Federal Reserve banks and Federal Reserve notes, both liabilities of the banks, they must be matched by equivalent assets, following ordinary business practices. These assets are gold certificates and Treasury currency holdings, plus the Federal Reserve portfolio of U.S. securities and loans to member banks. To meet member bank needs for increased reserve funds the Federal Reserve banks must either purchase securities or make loans to member banks; i.e., their portfolios must increase.

To be sure, there is an alternative way to provide relief for reserve shortages of member banks. The percentage reserve requirement against bank deposits may be reduced. Such an action would of course be a cause for rejoicing among bankers, but is beside the point in the current discussion.

6. It is difficult to visualize any objective test of an excessively large asset portfolio for the Federal Reserve banks. Because both bank reserves and money in daily circulation are mainly in the form of Federal Reserve bank liabilities such liabilities seem destined to expand more or less continuously as our economy grows.

Therefore, the portfolio under consideration will continue to grow just as the portfolios of commercial banks must grow to provide the necessary increase in money and credit. Therefore, it seems that the central banks' (Federal Reserve banks) portfolio will continue to grow during the foreseeable future. The suggestion is raised that part of the Federal Reserve bank security portfolio might be transferred to the Treasury for cancellation. Presumably this suggestion is made as an alternative to the present practice of returning excess earnings (after expenses) to the Treasury. The primary objection to the gift of the U.S. security holdings to the Treasury by the Federal Reserve banks is that technically this would make the Federal Reserve banks bankrupt. That is, their liabilities would no longer be matched by equivalent assets. In one sense of the word this might be unimportant if concealed from the general public but it would involve a fiat form of central bank liabilities, the foundation of the whole currency and banking system, having less than 100 percent asset backing. Furthermore, it would certainly complicate the bookkeeping operation of the Federal Reserve banks and involve the necessity of inventing some fictitious asset to replace the securities transferred to the Treasury. Perhaps a better plan might involve the exchange of part of the U.S. interest bearing securities for noninterest bearing obligations of the Treasury.

7. Finally, as to the makeup of the Federal Reserve portfolio, there seems no reason to dictate that any given proportions of particular types of loans or securities be maintained. It is important that the Federal Reserve banks be permitted freely to discount paper for member banks. Some proposals would extend the privilege of discounting at or borrowing from Federal Reserve banks to nonmember banks. This might fairly and beneficially be adopted, especially if member bank reserve requirements were applied to nonmembers. Furthermore, the rules of eligibility of assets upon which member bank may borrow at the Federal Reserve might well be broadened to escape some of the rigidities of the old "self-liquidating commercial paper rules" still remaining in the discount regulations. However, the question raised seems to imply that the Federal Reserve banks be permitted or even required to include some given proportion of private credit paper (corporate bonds, commercial loans, municipal securities, mortgages). Such a suggestion is difficult to understand unless it is the purpose that the Federal Reserve banks should be given the task of encouraging specific segments of the economy by purchasing credit paper arising therefrom. You will recall that during the depression of the 1930's the Federal Reserve banks were permitted to make direct loans to business and industry to aid in the rehabilitation of business working capital depleted by the depression. This emergency provision, now expired, was invoked at a time when the private banks and the other sources of loan funds were unable or unwilling to assume normal credit business risks. This is certainly no longer true. Furthermore, the central banks' (the Federal Reserve) basic functions of providing currency and needed bank reserves for the growing economy are incompatible with the credit analysis and lending to local borrowers on the local level.

There is another aspect of the questions posed by your committee which deserves attention. House bill 7601 proposes to retire \$30 mil-

lion of interest-bearing U.S. obligations out of the Federal Reserve banks' portfolio. The ostensible reason given for this proposal is that "no one should be compelled to pay his debts more than once." It is charged that opponents of this proposal "would compel the Government to pay its debts more than once." It "would compel the Government to continue to pay interest on bonds that have already been paid for." But it should be entirely clear that the U.S. Treasury, when it first issued these obligations, obtained funds from the money market and spent them for governmental purposes. In other words, savers and investors and financial institutions that purchased these obligations at the time of their issue surrendered monetary funds in a way exactly as they do when making loans to private borrowers. When the Federal Reserve banks purchased these U.S. obligations from previous holders for the purpose of increasing the money supply, Federal Reserve funds (deposits and notes) were given in exchange. It is absurd to say that this process, in any way, constituted a repayment by the U.S. Government. The taxpayers have not been burdened by the transaction and will not be until taxed to retire the obligations. To be sure taxes are collected to pay the interest on the debt, including that part held by the Federal Reserve banks, but that is a separate question.

Behind the proposals of H.R. 7601 there appears to be another motive not directly revealed in the questions submitted. This motive is to abolish the independent responsibility of the Federal Reserve System to provide suitable amounts of bank reserves and currency needed for the proper functioning of the money and banking system. The skill of the managers of the System has sometimes been less than perfect. This, I think, will be readily admitted. But because one of the avowed policies of the System has been to avoid excessive and inflationary increases in money and credit and the minimizing of economic instability, it has been and is being attacked as being excessively cautious, to the detriment of business and economic growth. Therefore, some opponents of independent central bank control over money and credit would strip the Federal Reserve of its present prerogative of paying its operating expenses out of operating income, mainly in the form of interest on U.S. obligations held in its portfolio, by requiring such income to be paid to the Treasury (or as here proposed, extinguished by canceling the major part of such securities). This would compel the Federal Reserve System to obtain annual budgeted funds of operating expenses through congressional approval. Such a situation would be intended to transfer monetary and credit policy decisions out of the hands of the Federal Reserve authority into the hands of congressional committees. For, should the committee conclude that the Federal Reserve policy of the preceding period was too tight or too easy, it could bring the Federal Reserve to heel by withholding operating funds. Such a situation would, to my mind, create an intolerable barrier to the establishment of effective monetary policy. There is no good reason for doubting the good faith of the Federal Reserve authorities. (The accusation that any tightness of the money supply to impose restraint on inflation is really designed to enrich private bankers scarcely deserves notice.) Monetary policy, as everyone knows, is complex and difficult and is constantly being studied by the Federal Reserve and by academic scholars. That it

should become a matter of determination by a congressional committee seems unthinkable.

Finally the argument that the holding of \$35 billion of U.S. securities in the Federal Reserve portfolio constitutes an unfair burden on the U.S. taxpayers is difficult to substantiate. There would be no such accusation made so long as the securities are held by private institutions and individuals. But, as is well known, the Federal Reserve banks transfer the bulk of their earnings after operating expenses to the U.S. Treasury, in the form of interest on Federal Reserve notes, so that the combined surplus accounts of the Federal Reserve banks shall not exceed their paid-in capital. For example, the earnings on portfolio holdings of U.S. Government securities and the amounts transferred to the U.S. Treasury during the last 3 years were:

Earnings on U.S. securities:	<i>Millions</i>	Transferred to the U.S.	<i>Millions</i>
1962-----	\$1, 039. 2	Treasury:	
1963-----	1, 138. 2	1962-----	\$799. 3
1964-----	1, 323. 7	1963-----	879. 6
		1964-----	1, 582. 1

STATEMENT BY RICHARD E. TOWEY, ASSISTANT PROFESSOR OF
ECONOMICS, OREGON STATE UNIVERSITY, CORVALLIS, OREG.

In my opinion, there is no cause for alarm merely because the Treasury security holdings of the Federal Reserve System have become much larger in absolute terms. As Congressman Patman's letter recognizes, all of the Federal Reserve's income after necessary expenses reverts to the Treasury. Any suggestion that the Federal Reserve might abuse its functions by reason of the size of its income does not merit consideration.

It is possible that savings in handling, bookkeeping, etc., could be effected by the conversion of a sizable part of the System's portfolio into a non-interest-bearing Treasury security. The amount to be converted should be entirely at the discretion of the Federal Reserve, however, and it should have the right of reconverting at par or other acceptable terms into interest-bearing securities of any outstanding maturity it specifies at any time. The amount retained in interest-bearing securities should be enough to provide sufficient income for Federal Reserve functions and to conduct open-market operations efficiently. The Federal Reserve should also be permitted to err moderately on the "safe" side by overestimating its needs for interest-bearing securities without question from the Congress as long as the policy of repaying the balance after expenses to the Treasury is continued.

This plan is offered solely in the interest of efficiency in administering the portfolio; it definitely should not be used as a device to control the amount of Federal Reserve expenses, particularly those associated with the implementation of monetary and credit policy. Of necessity the Federal Reserve must often conduct open-market trading at the "wrong" time as far as income is concerned: It is a buyer when prices are relatively high and a seller when they are relatively low. It has not experienced a net annual loss on security sales in recent years, but this may become necessary in the future since presumably the "bills only" doctrine has been abandoned. The System should not be de-

tered from taking losses on security sales which are in the interest of sound monetary policy.

The Federal Reserve should also explore the feasibility of conducting open-market operations with instruments other than Treasury securities and bank acceptances. The most likely candidates would appear to be high-grade corporate and municipal bonds and Government-backed mortgages. The impact of credit policy on the financial markets would be speeded up as a result and this would be in keeping with the departure from "bills only."

STATEMENT BY EDWARD R. TRUBAC, DEPARTMENT OF FINANCE AND BUSINESS ECONOMICS, COLLEGE OF BUSINESS ADMINISTRATION, UNIVERSITY OF NOTRE DAME, NOTRE DAME, IND.

My comments will pertain to only two of the items of concern to the Joint Economic Committee: the optimum level of Government security holdings by the Federal Reserve and the desired mix of short- and long-term securities held in the Fed's portfolio.

With respect to the initial point, my position is simply that the Fed should hold as many securities as it needs to pursue an effective monetary policy. It has been suggested that other criteria should be applied in determining the long-term level of security holdings; for example, the notion that the Fed's security holdings should rise proportionately to increments in economic activity. The merit of this proposal, however, is closely tied to the validity of three propositions:

(1) A secular rise in income should be accompanied by a proportionate increase in the money supply.

(2) An increase in the money supply should be generated by Federal Reserve purchases of Government securities instead of lowering reserve requirements.

(3) Security holdings of the Fed should not be retired by redeeming them with the Treasury.

The validity of each proposition can be disputed.

Regarding the first point, I feel that economic growth can be sustained by a less-than-proportionate increase in the money supply since investment is relatively insensitive to the narrow range over which interest rates have fluctuated during the last decade. Relatively small gains in interest rates reflect the response of firms to an improved economic outlook. A large part of the corporate demand for money balances stems from a desire for protection against the variance of the difference between cash inflows and cash outflows. During a business advance this variance probably declines because of the reduced uncertainty about when customers and debtors will make payments. This decline in uncertainty, therefore, results in a reduced demand for money which, in turn, is reflected in a lower level of interest rates than would otherwise occur.

The second proposition primarily revolves around the issue of whether bank earnings or Treasury interest costs should be given greater weight in arranging for a secular growth in the money supply; the method chosen would have a significant impact on both variables. Recent empirical studies indicate that bank profits have compared favorably with those attained by other industries in the last few years,

although the recent advance in bank profits has been purchased at the expense of a declining ratio of capital accounts to risk assets. While this increase in risk exposure suggests that some reductions in reserve requirements could be justified, I would prefer that the bulk of the money supply be generated by open-market purchases.

Turning to the third point, I see no reason why all of the Fed's Government security holdings in excess of the minimum amount needed for an effective monetary policy could not be canceled by redeeming them with the Treasury; this policy, of course, would not be inconsistent with continued security purchases by the Fed. The result would be a smaller public debt (as it is currently measured), thereby easing some of the problems associated with debt limit extensions.

It was noted above that, apart from considerations of short-term monetary policy, Treasury interest costs are an important variable affecting the size of Federal Reserve security purchases. To some extent, Treasury interest costs should also influence the maturity preference of these purchases, since long-term securities usually carry a higher rate and their acquisition, therefore, by the Federal Reserve would result in greater interest cost savings. But recent discussions concerning the Fed's role in promoting economic growth have instead focused on the impact of its maturity preference on the structure of interest rates.

I personally would favor a continuation of the bills-only policy, for although short- and long-term securities are not perfect substitutes they are sufficiently close substitutes for a large group of investors so that changes in relative supplies will have little effect on the structure of rates. Empirical studies suggest, for example, that the effect on long-term rates will be approximately the same, regardless of whether the Fed buys \$10 million in bonds or \$10 million in bills. Since there is little difference in rate impact, my preference for the bills-only policy stems from the fact that bond dealers would be reluctant to take a position in Government bonds if the Fed was directly involved in the long-term market because of the sharp fluctuations that would occur in bond prices.

STATEMENT BY GEORGE J. VIKSNINS,¹ ASSISTANT PROFESSOR OF
ECONOMICS, GEORGETOWN UNIVERSITY, WASHINGTON, D.C.

I am honored by Congressman Patman's invitation to comment on the problems raised by the growth in the Federal Reserve System's portfolio of U. S. Government securities.

I have tried to follow your suggestions regarding brevity and hope that the enclosed comments will be useful.

THE SIZE OF THE FEDERAL RESERVE SYSTEM'S PORTFOLIO OF GOVERNMENT
SECURITIES

On June 30, 1965, the Federal Reserve System owned \$39.1 billion in U.S. Government securities—\$38.9 billion having been bought outright and the remainder being held under repurchase agreements. Total System assets as of that date were \$60.5 billion, with \$13.7 billion

¹ At the time of this writing, the author is a consultant to the House Republican conference. The views expressed in this statement are not necessarily those of the conference.

in total gold certificate reserves being the other major asset category. On the other side of the balance sheet, of course, the principal liabilities were Federal Reserve notes of \$34.9 billion and member bank reserves of \$18.2 billion.

My purpose in recounting these familiar statistics is simple—under present law, a “floor” exists under the total portfolio of U.S. Government securities which must be held by the Federal Reserve System. Since there must be a 25-percent gold certificate “backing” for Federal Reserve notes, \$8.725 billion of gold certificates is required for this purpose. The rest of System asset holdings can be used as a backing for the remaining 75 percent of the value of the notes. Of course, “Governments” are the major type of asset and, therefore, at present \$21.2 billion in Governments is the legal minimum. The economic minimum is more difficult to establish, as is discussed below, but it is likely to be \$5 to \$10 billion above the legal minimum. Of course, this legal requirement might be changed, if the problems associated with System ownership of this amount of Government securities exceed the benefits to be gained from maintaining this 25 percent relationship. These benefits are exceedingly difficult to define, let alone measure, but they have something to do with domestic and international “faith in the dollar.”

Since the March 1965 change in gold reserve requirements, member bank deposit liabilities can be backed 100 percent by Governments. The size of these deposit liabilities is linked, of course, to the existing level of commercial bank reserve requirements, which vary from 16½ percent for demand deposits (checking accounts) in “Reserve city” banks and 12 percent for demand deposits in “country” banks to 4 percent for time deposits in both bank classifications. These requirements have been decreasing in the postwar period—the maximum requirements of 26 percent for demand deposits in central Reserve city banks (this classification was eliminated as of July 23, 1962); 22 percent for Reserve city and 16 percent for country bank demand deposits as well as 7½ percent for time deposits (the latter two figures exceeding—for a temporary period—the maximums established by the Banking Act of 1935) were in force at the end of 1948. These values have been decreased in reasonably orderly steps since that year—however, the last decrease took place in 1960.

The Federal Reserve Act, as amended in 1935, provides minimum reserve requirements of 10, 7, and 3 percent for the three classes of deposits. (The first two are demand and the last a time deposit). These levels could easily be reached in an orderly fashion by a simultaneous decrease in reserve requirements and System sales of U.S. Government securities, if it is our judgment that the size of the present portfolio of Governments is too large. Furthermore, let me express the heretical opinion that even the minimums mentioned above are rather useless vestiges of the era of “wildcat banks.” It is quite true that reaching the legal minimums would eliminate a part of the Fed’s “kit of policy tools”—downward revision of reserve requirements as a policy of easing credit would no longer be feasible. Nevertheless, there seems to be general agreement that reserve requirement variations are a crude, “meat-axe” sort of monetary policy, and open-market purchases of Governments—no longer linked to a gold cover on member bank reserves—can be every bit as large as necessary. Since this

problem is completely trivial, the decrease in reserve requirements seems a simple and desirable answer to the committee's question—in fact, it is particularly attractive, due to the opinion, held by many of our colleagues, that the member commercial bank has been overregulated. The reserves required of all other financial intermediaries are usually much smaller and, furthermore, as an example, the Federal Home Loan Bank Board even pays interest to its member depositors (in addition to other subsidies).

However, the basic question still remains—what is wrong or undesirable about the Fed's portfolio of Governments? Congressman Patman quite correctly points out its considerable postwar increase—it has risen by slightly more than 6 percent per year in the past 10-year period, faster than either the money supply or GNP. There are two factors mainly responsible for this rate of growth—the need for a larger money supply to finance our expanding economy, including increases in both Federal Reserve notes and member bank deposits, and the decrease in gold certificate reserves, which the Fed needed to neutralize. In this latter connection, if the administration's program of "voluntary coercion" has been successful in eliminating our balance-of-payments deficit, this source of Fed-held Governments' portfolio further increase would be eliminated.

Yet, of course, expanded money supply needs will continue to lead to further increases in the value of U.S. Government securities held by the Federal Reserve System. Thus, the committee raises a very interesting question—should the Fed's portfolio be permitted to increase without limit? In general, we might consider this in light of some simple cost-benefit analysis. The cost of this portfolio involves basically two factors—first, commercial banks hold required reserves, which are a form of interest-free Government debt and, thus, to an extent subsidize this debt. As I have argued above, this cost might be minimized by a reduction in reserve requirements. The second element involves the "double-payment" idea so often mentioned by Congressman Patman—the Fed, which is part of the Government (at least philosophically) pays for these securities once by creating either Federal Reserve notes or member bank reserves (the latter, for all practical purposes) and then the Treasury pays interest on the Governments to the Fed. The question at issue is what happens to these interest payments—if the Fed provides free services to the banking system or spends lavishly, an objection can be raised to the size of the portfolio. Otherwise, of course, it is only a bookkeeping transaction in which the Government borrows from itself.

In reference to the latter question, the answer can be given only by an accountant or an auditor—however, having been in the employ of the Board of Governors for three summers, I would be willing to offer a lay opinion that the Fed is inherently incapable of lavishness. Or, it is difficult for me to believe that System expenditures are meaningfully out of line with those made by comparable Government agencies, private banks, foundations, universities, or business firms. Banking services are indeed provided by the System "free" of explicit charges. Nonetheless, one can easily argue that such services are but a partial repayment for the interest earnings forgone on a large volume of required reserves, and, furthermore, the provision of such services permits commercial banks to remit at par and clear checks

quickly and efficiently—thus, satisfying the goal of the Federal Reserve Act of furnishing an elastic supply of the medium of exchange. In general, the charge that the Federal Reserve System subsidizes banks out of earnings on its portfolio of Governments is a relatively unimportant one—particularly since the subsidy has the elements of a payment in kind due to the high level of reserve requirements.²

The benefits associated with the Fed's portfolio are basically those of monetary policy flexibility, but it is, of course, highly unlikely that any significant proportion of the present \$40 billion would have to be sold for monetary management purposes. The main benefit is probably that of holding basically an interest-free form of public debt in this form. The Fed normally earns slightly more than a billion dollars and pays to the Treasury about \$900 million as "interest on Federal Reserve notes." My main objection to this procedure cannot really be fitted into the cost-benefit approach: it is that continued Federal Reserve System purchases of virtually unlimited quantities of Governments understate the cost of our large and rising national debt. This is done by lowering the total interest cost of any given volume of borrowing by credit creation (and continually assured reextension).

My proposal, therefore, for this problem area is quite simple: the Fed should be limited to a maximum percentage of the total public debt or a maximum amount, to be established by the Congress. Practically speaking, the rate of increase in the System's portfolio of Governments could, of course, be linked to the rate of increase in GNP, national income, or any convenient macroeconomic magnitude. However, in my opinion, the basic undesirable feature is the relationship of the size of this portfolio to the public debt and, therefore, if a ceiling is to be established, it would be preferable to link the portfolio to the size of the total debt. This would limit infinite monetization of the debt, which is certainly possible under present law. Twenty percent of the total marketable debt or \$50 billion, whichever is reached sooner, might be such a ceiling—although no particular "scientific" limit can be said to exist. After this ceiling is reached, further expansion in the money supply should take the form of either regular decreases in member bank reserve requirements or possible acquisitions of other credit instruments (meanwhile established as desirable social investments), such as foreign exchange of underdeveloped nations, mortgages on public housing, and the like.

In closing, I would not consider this a "burning issue" of national economic policy at the present. The Board of Governors and the FOMC have traditionally been dominated by cautious and prudent men—as a partial offset, perhaps, to the built-in inflationary bias of politicians. Thus, it is likely that the debt will be monetized and held in this interest-free form only with considerable reluctance on the part of the Fed. Yet, times change and so do men—we may well see an end to the "leaning against the wind" philosophy at 21st Street and Constitution Avenue and the purchase of an outboard motor.

² We might also mention in this connection that this is by no means the only subsidy granted to business in general or financial institutions in particular. The subsidy granted to savings and loan associations is considerably more favorable than that given commercial banks—the Federal Home Loan Bank System makes long-term advances to member associations at rates often below those needed to raise funds through the market and pays interest on reserves that the associations have on deposit.

STATEMENT BY JERRY VOORHIS, PRESIDENT AND EXECUTIVE DIRECTOR,
THE COOPERATIVE LEAGUE OF THE USA, CHICAGO, ILL.

I agree entirely with the point which you have been so effectively making to the effect that under the present scheme of things the people of the United States through their Government are actually called upon to retire the Government securities held in the portfolio of the Federal Reserve System twice over. For the Federal Reserve System creates the money using the national credit for this purpose when it purchases Government bonds in open market operations. At this point those bonds should properly be retired with no further obligation on the people or the Government. But this is not the case. Instead, those bonds continue to draw interest, and even the principal must ultimately be paid off a second time out of taxes.

My own suggestion would be that if it is deemed necessary for the Federal Reserve System to hold Government securities as backing for Federal Reserve notes, then at the very least whenever it does so, those bonds which the System has purchased with newly created money should be replaced by non-interest-bearing securities of the Government bearing no due date. This would relieve the taxpayers of the necessity of continuing to pay interest on such securities and would give them, as they should have, the benefit from the use of the money-creating power by the Federal Reserve System.

Another way of getting at the same end would be the one suggested in the fourth paragraph of your letter; namely, to let the Federal Reserve continue to hold the bonds and draw the interest but to return all the unexpended balance from the interest to the Treasury of the United States.

In my judgment, a still better way of dealing with the matter would be to carry out your own proposed program for making the Federal Reserve System a true agency of our Government so that any interest paid to the Federal Reserve System on Government securities held by it would automatically be the property of the people as a whole and net income to the Treasury of the United States.

I do not feel myself competent to judge how large a portfolio the Federal Reserve System should hold in relation to the money supply, but if this could be determined with fair accuracy, then still another alternative to solve the problem which you so properly pose might be to say that any Government securities purchased over and beyond the necessary amount fixed by Congress for the portfolio should upon purchase be transferred to the Treasury for cancellation.

STATEMENT BY HENRY C. WALLICH, PROFESSOR OF ECONOMICS,
YALE UNIVERSITY, NEW HAVEN, CONN.

My response can best be given under three headings: (1) How often is the portfolio paid for? (2) How large should it be? and (3) Of what securities should it consist?

(1) I believe that it is correct to say that the portfolio is paid for by the Government only once. This is true whether we regard the Federal Reserve as a part of the Government, or treat it as a separate entity. In the former case, the securities are paid for when the Fed-

eral Reserve buys them. The second payment, by the Treasury to the Federal Reserve, is washed out by the receipt of these funds by the Federal Reserve from the Treasury. This is simply an intra-Government transaction. In the latter case, treating the Federal Reserve separately from the Government, the securities are paid for when the Treasury pays the Federal Reserve.

The appearance of a double payment could arise if the Federal Reserve is regarded as part of the Government when it makes the purchase, and as a separate entity when the bond matures and is paid off by the Treasury. Of course, it is necessary to be consistent in the treatment of the Federal Reserve with respect to both purchases.

(2) Since the Federal Reserve channels back to the Treasury a large part of its interest receipts, I see no loss to the Government from the maintenance of a large Federal Reserve portfolio. There is, on the other hand, an advantage for the public in knowing that Federal Reserve liabilities are backed by assets that have a value in the marketplace. If part of the portfolio were removed from the Federal Reserve, the Federal Reserve would have to receive some generalized claim on the Government to make its books balance. Insofar as this had any effect, it probably would be one of reducing confidence in our monetary arrangements. The alternative course, to allow the Federal Reserve to show liabilities greatly in excess of assets, strikes me as even less desirable.

Cancellation of some part of the public debt, even though held by the Federal Reserve, might in itself raise serious questions. It would open the doors to public spending through pure money creation. It might also raise fears in the minds of savings bond holders and other less sophisticated investors that their securities might be canceled.

I conclude that the Federal Reserve portfolio should be large enough to cover its liabilities and capital accounts to the extent that they are not covered by gold certificates and miscellaneous assets.

(3) I believe that in normal times we are wise in limiting the Federal Reserve portfolio to Government obligations and short-term loans to member banks and the money market. In times of emergency, the central bank should be free to lend on any assets it chooses, and perhaps to acquire directly a wider range of assets than normally. These might well comprise corporate and municipal bonds.

To allow the central bank to acquire mortgages, commodities, commercial loans, and perhaps common stocks outright strikes me as undesirable even in an emergency. If the circumstances require it, some intermediary can always be employed that would be financed by the central bank and would shield it against the adverse possibilities of direct ownership. The same applies with greater force in normal times. The outright purchase of any asset is a form of subsidy. If the Government decides to extend subsidies, it should keep that act as separate as it can from money creation. Otherwise there is danger that the volume of money will be determined by the amount of subsidies to be given.

Purchase of Government obligations by central bank also is a form of subsidy. However, given the large size of the public debt, its homogeneity, and the fact that creation of public debt is not greatly affected by its interest cost, I see no serious disadvantage.

STATEMENT BY CLARK WARBURTON, McLEAN, VA.

Total assets of the Federal Reserve banks, as implied in your letter, should grow at a rate relevant to the expansion of the money supply needed as an accompaniment of the growth of the economy. In view of the complexity of the forces which influence the quantity of money needed for this purpose and the amount of Federal Reserve bank assets needed in connection with that quantity of money, no general rule, I think, can be given the Federal Reserve banks with respect to their aggregate assets, either in relation to the money supply, gross national product, aggregate liquid assets, or any other statistical magnitude in the economy. However, it would be desirable to replace the criteria for Federal Reserve operations in the Federal Reserve Act (including whatever modification of them may be implied from the Employment Act of 1946) by a more specific directive to the Federal Reserve authorities to orient their operations on the objective of supplying the economy with the quantity of money consonant with its growth needs and maintenance of reasonable stability in the level of prices.

Formal cancellation of a portion of the U.S. Government obligations held by the Federal Reserve banks would not really change the essential character of Federal Reserve bank assets nor reduce the obligations of the Treasury associated with the operations of the Federal Reserve System. Liabilities of the Federal Reserve banks, such as member bank reserve balances, not matched by other types of assets, would be obligations of the Government—similar to the situation with respect to Federal Reserve notes, which have always been obligations of the Treasury (as well as obligations of the Federal Reserve banks) and with respect to U.S. notes (“greenbacks”) held by Federal Reserve banks or their member banks and now counted in their legal reserves.

A change in the form of Government obligations held by Federal Reserve banks would not, so far as I can see, have any appreciable effect on the income of the U.S. Government or on the net interest paid by the Federal Government—so long as the earnings of Federal Reserve banks in excess of their expenses and appropriate additions to surplus are returned to the Treasury. On this point, it seems to me the Federal Reserve Act might well be amended to restore its original provision regarding disposition of the earnings of the Federal Reserve banks after specified additions to surplus.

In regard to replacement of the Federal Government securities in the asset portfolio of the Federal Reserve banks by other types of assets, such as those mentioned in your letter, I see no reason for making any substantial change in the present arrangements. However, some of the suggestions that have been made for alterations in the conditions attached to rediscounting by member or nonmember banks might well be accepted.

STATEMENT BY RICHARD WARD, ASSISTANT PROFESSOR OF FINANCE,
UNIVERSITY OF SOUTHERN CALIFORNIA, LOS ANGELES, CALIF.

THE PUBLIC DEBT AND THE CENTRAL BANK

A central bank is not at all necessary for the functioning of the monetary system as it exists today. The Government could do directly what it now does through the Federal Reserve, which functions chiefly as a means of separating monetary policy decisions from the executive branch of Government. Abolishing the central bank would introduce no fundamental change in the technical process of the maintenance of the monetary system.

The intragovernmental nature of central bank transactions is of fundamental importance in assessing the role of the central bank portfolio, and it thereby merits elaboration. I illustrate with a simple description of the monetary process as it would appear without the central bank. In this system, as today, the Government has two means of financing a Federal budget deficit: The issuance of interest-bearing obligations or the creation of money; i.e., the issuance of non-interest-bearing obligations. Its guide for deciding between the two is the general state of the economy and the public's need for liquid assets. Money provides the most liquidity, and at the other end of the spectrum long-term Government securities are the least liquid of the Government's liabilities. When it creates money, the Government pays for goods and services by checks, which when deposited in banks are claims on the Government which serve as legal reserves. Under the fractional reserve system the banks can expand the money stock by a multiple of reserves, so that only a portion of total money creation finances Government debt. In addition to deposit claims the Government also creates currency claims. To the extent that the public draws currency, the Government merely substitutes one type of liability for the other.

In the opposite case of a budget surplus the Government initially receives deposits from the public in the form of taxes. These deposits then extinguish bank reserve deposits, but if this result is not desired, the Government may buy up an equivalent amount of its own securities, thus returning the reserve money to the public and the banking system. If the Federal budget is in balance, there is no tendency for Government monetary or nonmonetary liabilities to change. The Government can instigate change if it desires by buying its securities with monetary liabilities, thus increasing the public's holding of money and decreasing its holdings of Government securities. This is not the procedure used today, but this is the effect of what is done now through the Federal Reserve.

The fact that we have set up a central bank which "holds" Government securities as an intermediary in the monetary process does not change this sketch of the fundamentals of the monetary process. If we chose at some time to do away with this intermediary, the currency and deposit liabilities of the Federal Reserve would become the liabilities of the Treasury. No meaningful valuation of Government assets could be assigned to the Treasury, but then it is not meaningful to call Government securities assets of the Federal Reserve, since the Federal Reserve is itself an arm of the Government. In the same way social

security obligations to claimants are liabilities of the Treasury. It is all right for the fund to "hold" Government securities, but that need not give social security claimants any more or less reason to expect that the Government will honor these claims than if there were no special funds set up.

DEBT MANAGEMENT

In the foregoing analysis, which stresses Government liabilities and the real assets acquired in their creation, it makes little difference what sort of securities the Federal Reserve holds in its portfolio. The really important decision is what the public holds—both the amount of money and securities and the maturity of securities. It is all part of the same process of deciding in accord with economic conditions how liquid the public's claims on the Government should be. If the Federal Reserve holds all bills or all 20-year bonds, the maturity of publicly held issues need not thereby be affected.

Though it can be done, I do not think it desirable to divorce the economic decision of financing the Government from the economic decision of deciding how much financing is necessary, i.e., the size of surpluses or deficits incurred. All of these are decisions to be made by the administration in power, and I would prefer that the machinery be so established. If this were done, the problem of central bank portfolio management disappears, and the issue emerges in its true nature as the problem of managing the Government's monetary and non-monetary liabilities.

On the assumption that such sweeping change is not forthcoming, I offer, within the same framework, some less drastic suggestions. As stated earlier, it is not what the Federal Reserve holds in securities that counts, but what it buys from and sells to the public. If we assume that the decision with respect to the size of the money stock remains exclusively with the Federal Reserve, then the remaining decision is the maturity of the public debt outstanding. The policy-making authority for this decision is not clear. The Federal Reserve can change the maturity distribution of the publicly held debt by, say, buying bonds and selling bills. If it wished, however, the Treasury could always undercut this by selling bonds and using the proceeds to buy up some of its own bills. Or, it can do the same thing, a little more slowly, by refinancing all maturing issues by issuing bonds. Even though we have given the Federal Reserve control over the money stock and the mechanism to enforce it, the management of the publicly held debt is not so well defined.

To clear the matter up Congress should assign responsibility to one agency or the other. Although a good case can be made for turning this function over to the Federal Reserve, my preference is the Treasury. The Treasury should have the exclusive right to determine the maturity of the securities involved in Federal Reserve dealings with the public. For monetary purposes the Federal Reserve need specify only the amount of transactions. The Treasury should decide the issues to be traded. My principal reason for advocating this procedure is that the alternative of transferring the power to the Federal Reserve would decrease the area of control exercised by the administration. Centralizing such decisions in the Federal Reserve involves far more than just the Federal Reserve's portfolio, which is equal to only 13 percent of the Government debt held by the public and the

Federal Reserve combined. To control the maturity distribution of the Government debt the Federal Reserve would then have to be charged with all Government security sales. There are also other intragovernmental holdings to consider, which together are much more than Federal Reserve holdings, though most of these are now in special nonmarketable issues. It would seem necessary for the Federal Reserve to control acquisitions of these special funds if it is to control the distribution of public holdings with a minimum of market activity.

Monetary policy requires only that the money managers decide the volume of securities they buy or sell in order to affect reserves. The actual participation on the market is more properly a function of the Treasury, which issues debt far in excess of Federal Reserve holdings. It might even be desirable that the Treasury be in charge of the open market desk, which as a side benefit would prevent the Federal Reserve from using such vague guides for monetary policy as the "feel of the market."

The case has sometimes been made that the Federal Reserve could more effectively distribute securities than does the Treasury. It would be possible to assign this function to the Federal Reserve, even if the Treasury retained the basic decision over what is to be issued. I do not see any reason, however, why the Federal Reserve can do a better job than can the Treasury or that it has any inclination to do it differently. The Federal Reserve conducts its open market operations through the same securities dealers with which the Treasury consults. The Treasury and the Federal Reserve have no difficulty cooperating on technical matters. It is the policy matters in which Congress must be specific in delegating authority.

There is, however, one desirable procedural change, which is for the Federal Reserve to purchase securities directly from the Treasury. This would eliminate some turnover in the market and avoid some payment or dealer margins. It is not feasible, however, for all purchases to be direct, since the timing and amount of the Federal Reserve's need to supply reserves do not necessarily coincide with the timing and amount of the Treasury's borrowing and spending. Alternatives might be worked out through greater use of Treasury balances in private banks, but this seems less desirable than the Federal Reserve's continuing some market purchases.

The Federal Reserve should explore devices to minimize the necessity of its entry into the market. Others have suggested such devices. "Float" could be eliminated by the simultaneous debiting and crediting of the banks involved in a check clearing. Increasing banks' reserve settlement periods would allow time for banks to make up reserve deficiencies and reduce the necessity for defensive operations by the Federal Reserve to keep reserve levels stable. Uniform reserve requirements would reduce the reserve changes necessitated by shifts of deposits between banks of different reserve classes. Much of the Federal Reserve's transactions are offsetting over a period of time because of such defensive operations. In the first half of this year, for instance, the System purchased \$11.4 billion of securities (including repurchase agreement transactions) in excess of what was necessary to replace maturing issues. In the same period it sold \$9.4 billion, for a net change of only \$2.1 billion. (The discrepancy is due to rounding.)

MONETIZATION OF NONGOVERNMENT DEBT

The monetary analysis which I have employed emphasizes the role of Government securities in the monetary process. Though other assets are employed for money creation, Government securities are the most desirable for this purpose. Their acquisition by the central bank means that the Government, rather than private interests, derives the benefits of reserve money creation. It would be undesirable for the central bank to enlarge its portfolio to include additional private or State and local government debt. If the Government wishes to enact special programs for such borrowers, it can do so directly, as it has in many cases, without the subsidy being administered by the central bank. Any program which is financed by money creation simply cuts down the amount of money creation that can be used to finance the remainder of the Government's expenditures.

Programs enacted by Congress and administered by the appropriate Government agency are kept under public scrutiny. A program financed by money creation and administered by the Federal Reserve is not. Congress oversees loans to small business and farmers; it has no say over loans to multibillion-dollar banks, which can borrow from the Federal Reserve discount window and their name will not even become known to the public, nor so far as I know to Congress. Such a program, financed through the central bank and automatically monetized, is not even subject to the appropriation process. Federal Reserve acquisitions of bankers' acceptances provide preferential treatment to a particular segment of the market. The Federal Reserve should discontinue their purchase.

Similar objections hold with respect to central bank acquisition of foreign exchange. If the central bank is charged with the program, foreign currency holdings are automatically monetized, a method which obscures to the public the true cost. The real resources required to acquire foreign assets become more apparent if the Government must tax or borrow to acquire them. There is no reason why foreign exchange should be singled out for special treatment any more than farm surplus acquisitions should be financed through the central bank.

The foreign exchange program rests in the central bank in many countries because it evolved from the pure gold standard, in which balance-of-payments deficits and surpluses had an automatic tendency to affect the money stock. In the absence of such a standard, monetary policy is discretionary and no longer is directly connected to the balance of payments. I might add that under present international arrangements, with the dollar the only gold convertible currency, I do not favor the United States holding foreign currencies as international reserves through any agency. Negotiations now underway may lead to changes which would make such holdings desirable, but there is no necessity for the central bank to assume this function, which is closely involved in foreign policy. The Federal Reserve's present foreign currency program involves it not only in spot holdings but in the assumption of liabilities for future delivery of foreign currencies. The size of these liabilities, which complicate assessment of the Nation's international reserve position, is not made known to the public. This is an example of the way such activities can enlarge in scope.

The Federal Reserve no longer holds gold, but it does hold gold certificates which were deposited by the Treasury as a means of mone-

tizing the gold stock, i.e., creating money with which to purchase gold. This decision is up to the Treasury, which so far has chosen to monetize most of its gold. It makes little difference whether this arrangement is continued. If the Treasury did not deposit gold certificates, more Government securities could thereby be monetized, but more Government securities would have to be issued—to pay for the gold—with no net effect. This again emphasizes the central bank as an intergovernmental, bookkeeping arrangement.

An historical incident illustrates how the Treasury can bypass the central bank. Normally Government gold purchases add to the central bank's gold certificate holdings and increase bank reserves by an equivalent amount. If total reserve levels are to remain unchanged, the Federal Reserve must sell an equivalent amount of Government securities. In the late 1930's gold inflows from abroad were too large relative to the central bank's security holdings to use this procedure. Consequently the Treasury sold securities to the public and used the proceeds to buy gold, which it did not monetize. There is no umbilical cord connecting central banks and gold.

THE PORTFOLIO SIZE

In the present system the size of the Federal Reserve's portfolio must vary directly with the desired money stock and the reserve ratio. There is no reason to believe that the money stock need ever to contract as long as it is not excessively expanded in some period. Thus, except for the possibility of reducing reserve requirements, the central bank portfolio will likely grow. Under these assumptions it would be possible to periodically "retire" Federal Reserve Government security holdings, the only practical effect of which is that interest payments on these from the Treasury to the Federal Reserve cease. Alternatively Congress could simply discontinue interest payments on a portion of Government securities held by the Federal Reserve. Unless the Federal Reserve becomes subject to the appropriation process, which I favor, I would consider either of these courses undesirable. The procedure is meaningless unless it is carried far enough for the Federal Reserve to feel the restriction on earnings. If it goes that far, it may lead the Federal Reserve to actions to protect its earnings, even though these actions are contrary to its desired monetary policy. As long as the central bank exists, the public should have no doubt about its earnings ability.

In summary, in the absence of virtual elimination of the Federal Reserve as a separate entity, there are few changes in portfolio policy that are desirable. The major suggested change is to shift to the Treasury the determination of the maturity of the securities the Federal Reserve buys and sells. Federal Reserve holdings other than Government securities should be strictly limited. Such assets would be acquired as a result of automatic money creation, removing them from public scrutiny and involving the central bank in affairs not directly related to monetary policy.

STATEMENT BY ROBERT WEINTRAUB, PROFESSOR OF ECONOMICS,
UNIVERSITY OF CALIFORNIA, SANTA BARBARA, CALIF.

The subcommittee's inquiry into the growth of the Federal Reserve's portfolio of U.S. Government securities is important and timely.

1. On the importance of the Fed's portfolio

The Fed is the Nation's monetary authority, and hence whether its ranking executives like it or not, the Fed is responsible for the growth of the Nation's stock of circulating media. The significance of the quantity of money to the economy's performance is widely recognized, if it is not already a commonplace, and need not be detailed here. It is enough to point out that all our recessions and depressions were preceded by sharp decreases in the growth of the money stock (to less than 1 percent per year), all our recoveries from these episodes often were ignited by sharp increases in the growth of the money stock, and most important all periods of economic growth without inflation have been sustained by monetary growth in the 2½ or 3-6 percent per year range—the present expansion being a case in point.

The growth of the money stock (currency plus demand deposits) is determined by many forces including, in the direct or immediate sense, the required and desired reserve ratios of member banks to their deposit liabilities, the public's preferences for holding (*a*) cash and (*b*) time deposits relative to demand deposits, and the monetary liabilities of the Government. These liabilities consist of (1) Federal Reserve notes or currency; (2) Federal Reserve deposit liabilities to member banks; and (3) Treasury currency and coin outstanding; the Federal Reserve's liabilities comprising about 90 percent of the total.

At any given time, the stock of money (*S*) equals the product of the sum of the Government's liabilities (*L*) and a multiplier (*m*) which is determined by the required and desired reserve ratios and the public's preferences among cash, demand, and time deposits. Mathematically, $S = L \cdot m$.

The growth of the Fed's portfolio of Government securities is of extreme importance because it is the principal source of the Federal Reserve's monetary liabilities, today equaling nearly 75 percent of these liabilities and hence more than two-thirds of the total of all of the Government's monetary liabilities (*L*). Inasmuch as the Fed's power to add to or subtract from its portfolio is limited only by the gold reserve requirement (which itself is not immutable as recent history proves), it is clear that the Fed can control the size of the monetary liabilities of the Government (*L*) and thereby the money stock (*S*) merely by controlling its portfolio of Government securities. Whatever else happens to change (*L*), for example a gold drain, can be more than offset easily and immediately merely by adjusting the size of the portfolio. Thus the Fed's control over (*L*) is absolute. As a corollary of this control the Fed can make the money stock behave very nearly precisely as it wants. Insofar as (*m*) is continually jiggling small deviations from target money stocks must be expected. But it may be reasonably urged that large persistent deviations cannot

occur unless the Fed is misusing or not using its power to adjust the size of its portfolio of Government securities.¹

2. On the size of the Fed's portfolio

Manifestly, the size of the Fed's portfolio must be governed so that the stock of money grows at least $2\frac{1}{2}$ and perhaps as much as 6 percent per year. The precise growth of the money stock in any given year must be whatever it takes in view of labor force and technological developments, to achieve the goals of the 1946 Employment Act. As a corollary, the precise growth of the Fed's portfolio must be whatever it takes to achieve the desired monetary growth. Both the money supply target and the corollary portfolio policy can be revised as the year passes. Sharp revisions are not likely to be necessary in years in the near future if the Fed begins each year with a monetary growth target midway between $2\frac{1}{2}$ and 6 percent and a portfolio growth target 1.1 or 1.2 times as large in percentage terms. As a first approximation, this policy implies that over the long haul the Fed's holdings of Government securities will grow at about 5 percent per year. But this rate of growth assumes no longrun change in the monetary multiplier (m) or in other sources of the Government's monetary liabilities (L). If the multiplier falls, as it has since 1961 reflecting the public's shift to time deposits with the periodic increases in the interest paid on each dollar of these deposits, the Fed's portfolio will have to grow at more than 4 percent per year to achieve a 4.25 percent rate of growth of the money stock. Similarly, if other sources of the Government's liabilities fall over time, as they have in recent years reflecting largely the gold drain, the Fed will have to additionally increase the annual rate at which it adds to its portfolio of Government securities. Probably we can expect a continuing shift to time deposits and hence a continuing decline in (m). Also we can expect a continued gold drain, and moreover, we have to expect a future decrease in the Treasury's currency and coin outstanding. Thus (L) also will tend to decrease in the long run if not controlled. This means that the size of the Fed's portfolio must increase relatively more rapidly in distant than in near years. In the distant future it will have to grow at more than 5 percent per year to achieve a 4.25 percent per year growth in the money stock. The precise relationship between the growth of the Fed's portfolio and the growth of the money stock cannot be forecast. But it can be stated with confidence that today it is greater than unity and it will tend to rise over time.

Finally, in this connection, it is useful to recognize that the Fed need not passively accept the observed existing relationship between required portfolio growth and desired monetary growth. The Fed can exercise direct control over the relationship between its portfolio and the money supply by increasing or decreasing required bank deposit reserve ratios. Such changes, respectively, would decrease and increase the monetary multiplier (m). Because the overwhelming bulk of the interest income (about 85 percent today) which the Fed

¹ Viewed in a purely arithmetic context, it may be objected that the effect on (S) of an increase in (L), which results from the Fed's purchases of Government securities, can be exactly offset by a decrease in (m), which results from a rise in desired free reserves. This objection is, however, unreasonable since the Fed's purchases are made in the open market and the money stock (S) is directly increased when the Fed buys from nonbank holders of Governments. Thus the objection contemplates banks calling loans when the Fed buys in the open market. This could occur but not in sufficient amount and duration to prevent the Fed from increasing the money stock (S) if it was really intent on achieving such an increase.

derives from its portfolio of Governments is returned to the Treasury it follows that any policy change that increases the Fed's portfolio (and, given interest rates, its interest income), will decrease the annual transfer payment from taxpayers in general to Government securities holders in particular. Assuming only that it is desirable to reduce the cost to the taxpayers of carrying the debt, it would be appropriate therefore for the Fed to raise bank reserve requirements. This could be done gradually. Such a policy will achieve the desired decrease in debt cost to taxpayers by reducing the monetary multiplier (m). For reductions in (m) necessitate larger increases in (L) and hence in the Fed's portfolio of Government securities to achieve the same growth of the money stock (S).

3. On the question of whether bulk of the Fed's portfolio should be transferred to the Treasury

The usual argument for not transferring the major part of the Fed's portfolio of Governments back to the Treasury is that this would in some unspecified way undermine confidence in the dollar. Perhaps the transfer would be interpreted to mean the United States will not honor its financial obligations. But, in fact, debt instruments held outside the Fed are honored by payment of currency and/or deposits in Federal Reserve banks. Debt instruments held by the Fed already have been honored. Thus this fear is groundless. More likely the motivating fear is that the transfer (somehow) would be a license to the United States to run continuing fiscal and balance-of-payments surpluses. That this is the underlying fear is a deduction from the fact that the Treasury can redeem debt from the Fed only if it first accumulates dollars, bank balances, or gold; these are the only "coin" the Fed will take. But the notion that transferring the bulk of the Fed's portfolio to the Treasury would have the slightest effect on future U.S. fiscal and balance-of-payments transactions is simply farfetched. Moreover insofar as the balance of payments is stressed the argument confuses money and credit. People, including foreigners, hold dollars because its value (measured in purchasing power) is relatively stable not because of the collateral (gold) backing on hand.

The Treasury's debt has economic significance only because it involves an annual transfer of money income from taxpayers in general to debt holders in particular. But, as noted above, the overwhelming bulk of the debt held by Fed involves no such transfer, the interest income received being returned to the Treasury. Therefore, today, it is downright silly to think of the Government securities held by the Fed as the obligations (i.e., debt) of U.S. taxpayers, beyond a minimum amount of at most \$10 billion which is required to pay the Fed's operating expenses and provide a reservoir of marketable instruments that the Fed can sell in the unlikely event of a sudden burst of velocity induced inflation in order to quell same quickly. To end the illusion that the \$30 billion residual securities in the Fed's \$40 billion portfolio are part of the debt, today's residual securities should be transferred to the Treasury immediately and any residual acquired in the future as a result of the necessity of providing fuel (i.e., base or high-powered money) for required monetary growth should be transferred as soon as it is acquired.

4. *Opinions on miscellaneous matters*

(a) As long as there is Government debt outstanding there is no reason for the Fed to buy other financial assets. Giving the Fed power to do so would make it possible to influence prices and yields of specific debt instruments, i.e., to favor one company or economic sector against others. Hence I would not want to see the Fed supplement its portfolio of Governments with commercial loans, municipal securities, corporate bonds, etc.

(b) I believe strongly that Congress should require the Fed to state biannually, after formal consultation with other Government economic bodies, the percentage rise in the money stock that is required to achieve the goals of the 1946 Employment Act this half year and the percentage rise in its portfolio of Government securities that will be required to generate the desired increase in the money stock. Deviations from either the immediate or ultimate targets should be explained in a report to the Congress within 3 months of the end of the 6 months target period.

STATEMENT BY WELDON WELFLING, PROFESSOR OF ECONOMICS, WESTERN RESERVE UNIVERSITY, CLEVELAND, OHIO

The increase in the Reserve System's holdings of securities since 1955 represents, of course, an increase in currency in circulation of about \$8 billion, a decrease in the gold stock of about \$7 billion, and an increase in bank reserves of about \$2.5 billion.

The System's holdings of Federal securities, per se, are less important than the resulting changes in the money supply and interest rates. Between 1940 and 1951 System purchases increased the money supply above and depressed interest rates below equilibrium levels, a condition which contributed to rising prices and costs until 1958.

Of an increase of Federal debt of about \$45 billion since 1957, \$14.5 billion has been absorbed by the Reserve System, over \$7 billion by Government agencies and trust funds, and \$23 billion by the public. The net effect has been an increase of \$2.3 billion in bank reserves and an increase in the money supply of about \$26 billion, or an average of \$3.25 billion per year.

Assuming the need for an expanded money supply over a period of time, there are numerous methods of providing it. Monetizing interest-bearing Federal debt is only one way. Taking the currency component alone, the \$8.3 billion increase since 1955 could have taken the form of non-interest-bearing Treasury notes instead of Federal Reserve notes. If the public's demands for currency had been translated into demands on the Treasury for notes, the Federal Reserve System would have had no need to restore this amount of bank reserves through open market purchases. The technical gold reserve position of the System would be improved by the absence of \$8 billion of total liabilities.

By the same token, if the machinery of the Reserve System is used to provide the annual increases in currency, there is no sound objection to the System taking non-interest-bearing obligations from the Treasury in exchange for Federal Reserve notes, which could then be deposited in tax and loan accounts.

Similarly, required increases in bank reserves could be supplied in the same manner. Either new non-interest-bearing debt could be issued or open market debt could be made noninterest bearing to the Reserve banks.

Needless to say, any such shift to use of non-interest-bearing debt should be limited to increments in the money supply deemed appropriate by the monetary authorities. It should not reflect budget deficits but be a way of financing such part of a deficit as would be monetized as a matter of monetary policy under present arrangements.

Essentially, the question of whether the Treasury should pay interest to the System, as to any other holder (including Federal agencies and trust funds), is one of determining the source of the System's income, rather than a question of monetary policy. Considered purely as a monetary mechanism, the present arrangement works as well as would one monetizing non-interest-bearing Federal debt.

STATEMENT BY EDWARD L. WHALEN, ASSISTANT PROFESSOR, DEPARTMENT OF ECONOMICS AND DIVISION OF ECONOMIC RESEARCH, INDIANA UNIVERSITY, BLOOMINGTON, IND.

THE STRUCTURE AND MANAGEMENT OF THE FEDERAL RESERVE SYSTEM'S PORTFOLIO

The existing Federal Reserve portfolio of U.S. Government securities is a byproduct of past open-market operations. The appropriateness and effectiveness of the monetary policy which initiated these open-market operations constitute a really substantive issue for evaluation. The size of the Federal Reserve portfolio is a matter of lesser importance representing as it does the results of past decisions and actions whose effects for good or ill already have transpired. Nevertheless, the question regarding the size of the Federal Reserve's portfolio relative to the money supply, gross national product, or aggregate liquid assets has been raised and deserves an answer.

The Federal Reserve portfolio relative to other economic variables

Figures for the Federal Reserve's holdings of U.S. Government securities, the money supply, gross national product and aggregate liquid assets for the 10-year period from 1955 to 1964 are shown in table 1. The last three columns of the table present the ratio of the money supply, gross national product and aggregate liquid assets to the Federal Reserve's portfolio. A decrease in these ratios indicates that the Federal Reserve's holdings have increased relative to the economic magnitude involved, and this phenomenon has occurred only in the case of the money supply. Federal Reserve holdings of Government securities have declined relative to gross national product and the liquid assets included in the table. Thus, according to two of the three standards suggested by the question, the size of the Federal Reserve's portfolio is less of a problem now than it was 10 years ago.

TABLE 1.—Federal Reserve portfolio relative to the money supply gross national product, and selected liquid assets (amounts in billions of dollars)

Year	U.S. Government securities held by Federal Reserve banks ¹	Money supply ²	Gross national product	Selected liquid assets ³	Ratio: column 3÷column 2	Ratio: column 4÷column 2	Ratio: column 5÷column 2
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1955.....	24. 8	135. 2	397. 5	332. 5	5. 45	16. 0	13. 4
1956.....	24. 9	136. 9	419. 2	343. 2	5. 50	16. 8	13. 8
1957.....	24. 2	135. 9	442. 8	356. 0	5. 62	18. 3	14. 7
1958.....	26. 3	141. 1	444. 2	373. 1	5. 37	16. 9	14. 2
1959.....	26. 6	142. 1	482. 1	393. 9	5. 34	18. 1	14. 8
1960.....	27. 4	141. 1	502. 6	399. 2	5. 15	18. 3	14. 6
1961.....	28. 9	145. 5	518. 7	424. 6	5. 03	17. 9	14. 7
1962.....	30. 8	147. 6	556. 2	459. 0	4. 79	18. 1	14. 9
1963.....	33. 6	153. 2	583. 9	495. 3	4. 56	17. 4	14. 7
1964.....	37. 0	159. 4	622. 6	529. 9	4. 31	16. 8	14. 3

¹ U.S. Government securities held by all Federal Reserve banks at the end of the month of December.

² Averages of daily figures, seasonally adjusted.

³ The selected liquid assets held by the public include demand deposits and currency less demand deposits held by mutual savings banks and savings and loan associations, time deposits at commercial banks, mutual savings banks, Postal Savings System deposits, savings and loan shares, U.S. Government savings bonds and U.S. Government securities maturing within 1 year.

Source: Board of Governors of the Federal Reserve System, Federal Reserve Bulletin.

Even if all three ratios had moved in the same direction, the results would be difficult to interpret. Many factors affect the ratios between the size of the Federal Reserve System's portfolio and the three economic magnitudes appearing in the table. Take, for instance, the money supply. Decreases in the ratio between the money supply and the Federal Reserve's portfolio may be the result of attempts to offset the contractionary effects of a deficit balance of payments, an increased public preference for currency instead of demand deposits, a growth in excess member bank reserves, or increases in reserve requirements.

The relationship between gross national product and the Federal Reserve's portfolio is complicated not only by all the factors influencing the money supply relative to the Federal Reserve's portfolio, but also by an additional variable: the velocity of money.¹ The velocity of circulation of money itself is a very complex variable whose fluctuations may reflect separately or in combination changes in the demand for money or structural and institutional changes in the economy. Similarly, the ratio between a measure of liquid

¹ The ratio between gross national product and the Federal Reserve's portfolio can be expressed as the product of the velocity of money and the ratio of the money supply to the Federal Reserve's portfolio. This relationship can be demonstrated through a few simple equations. Let R_M be the ratio between the money supply and the Federal Reserve System's portfolio, so that $R_M = M/B$ where M stands for the money supply, and B represents the portfolio balance. Gross national product, Y can be expressed as the velocity of money, V , times the money supply $Y = V \cdot M$. Dividing both sides of this equation by B gives the ratio between gross national product and the portfolio balance $Y/B = V \cdot M/B$ which is equal to $Y/B = V \cdot R_M$. Thus, gross national product relative to the Federal Reserve's portfolio is influenced multiplicatively by the factors determining the velocity of money and the factors determining the ratio of the money supply to the Federal Reserve's portfolio.

assets and the Federal Reserve's portfolio is influenced by a wide variety of factors which makes the significance of changes in this ratio subject to question.

Thus, interpreting changes in any one of these three ratios is exceedingly difficult. Harder still is the task of establishing the minimum level for a particular ratio at which the Federal Reserve's portfolio would be judged excessive. And, since the Federal Reserve System has little control over these ratios, imposing such a standard would only add to the political and institutional impediments to vigorous monetary policy. Therefore, the Federal Reserve's holdings of U.S. Government securities relative to the money supply, gross national product or aggregate liquid assets do not seem to provide appropriate criteria for judging the size of its portfolio.

Other standards

Is any other criterion more appropriate? Two possible standards for evaluating the size of the Federal Reserve's holdings of U.S. Government securities are suggested. First of all, because of the primary importance of monetary policy, its portfolio should be large enough to insure flexible open-market operations. Second, granting the existing financial independence of the Federal Reserve System, its portfolio should be large enough to cover all of its necessary expenses.

By either of these two standards, the present portfolio of the Federal Reserve System is larger than necessary. Legislation before the Banking and Currency Committee suggests that \$30.0 billion of the \$38.5 billion of U.S. Government bonds held by the Federal Reserve banks could be eliminated without limiting the flexibility of open-market operations. In 1964, a portfolio of slightly more than \$5.5 billion in U.S. Government securities would have generated interest income sufficient to cover not only the expenses of the Federal Reserve System but also the dividends it paid to member banks in that year.² Although disagreement may arise over the exact amount of the surplus in the Federal Reserve's portfolio, both standards indicate that it is substantial.

Disposal of the surplus balance

What should be done with the surplus? Two alternative courses of action are possible. The surplus portion of the Federal Reserve's portfolio could be transferred to the Treasury for cancellation, or the Federal Reserve could continue to hold the securities, draw interest on them, and return the unexpended balance to the Treasury. In spite of the evidence that the Federal Reserve's portfolio is larger than necessary, the latter alternative seems preferable. The economic consequences of the present arrangement are not serious, and the arguments for retirement and cancellation of Government debt held by the Federal Reserve are not convincing.

² A minimum portfolio balance of \$5,513 million was computed for calendar year 1964 as follows: Total expenditures for the year, consisting of net expenses and dividends paid to member banks, amounted to \$228 million. The difference between this figure and \$21 million of income from all sources except interest income on U.S. Government securities is \$207 million, the expenses which had to be covered by interest income on Government securities. A rate of return of 3.76 percent was computed on the portfolio held by the Federal Reserve banks by dividing current earnings on U.S. Government securities by an average of total U.S. Government securities held by the Federal Reserve on Dec. 31, 1963, and Dec. 30, 1964. At this rate, the balance necessary to cover the remaining expenses of \$207 million is approximately \$5.5 billion.

One of the arguments for retirement and cancellation implies that the Federal Government is forced to repay the principal on Government securities held by the Federal Reserve twice instead of once. The first time it pays for them is when the Federal Reserve System, an agency of the Government, purchases Government securities from the public. It pays for them a second time when these securities are redeemed by the Treasury. The confusion in this argument lies in the fact that for the first transaction the Federal Reserve is considered to be part of the Federal Government; in the second transaction, it apparently is not. If the Federal Reserve were properly seen as part of the Government in the second transaction, then the Treasury's redemption of the securities held by the Federal Reserve would correctly be seen as an internal bookkeeping transaction.

The argument is clouded by an additional observation that the Federal Reserve really doesn't pay for the Government securities it buys; it merely creates member bank reserves or issues Federal Reserve notes. However, a Treasury redemption of Government securities held by the Federal Reserve has the same effect on the public's money supply and bank reserves as a Treasury redemption of Government securities held by the public. In either case, if the Treasury chooses to retire part of its indebtedness, the public's holdings of Government securities is reduced; if the Treasury refunds part of its debt with the proceeds of a new issue, the new issue replaces the public's holdings of the retired securities. In both situations, the money supply and bank reserves remain unchanged, and the equivalence of the net effects of Treasury redemption demonstrates that the principal on the Government debt in either case is paid for only once.

Sometimes the impression is given that the Federal Reserve somehow bilks the public in its open market purchases of Government securities. It trades non-interest-bearing bank reserves and Federal Reserve notes for income-earning U.S. Government securities. However, since the public is not coerced into selling its Government securities, the transaction presumably is a reflection of individual or commercial bank preference for cash or bank reserves. And, in order to induce the sellers to part with their securities, the Federal Reserve has to make its offering price sufficiently attractive to compensate the owners for the future income they anticipate receiving from these income-producing financial assets.

Another argument for retirement and cancellation of part of the Federal Reserve's portfolio implies that taxpayers continue to pay interest on Government securities held by the Federal Reserve. True, the Federal Reserve does receive income from its holdings of Government securities, but a large portion of these earnings is returned to the Treasury. The real cost to the public is not the interest paid on the Government securities; rather, the expenses of the Federal Reserve, in excess of its income from other sources, constitute the real burden to taxpayers.

Choosing between the present arrangement or retirement and cancellation of part of the Federal Reserve's portfolio essentially is a choice between two sets of bookkeeping transactions. The rationale for a change from one to the other should be on grounds of administrative convenience and efficiency but not on their economic effects,

which are virtually nonexistent. On grounds of administrative desirability, the proposal to retire and cancel part of the Federal Reserve's portfolio is lacking in several important respects.

A transfer of part of the Federal Reserve's portfolio to the Treasury for retirement fails to correct a tendency for the Federal Reserve's portfolio to grow in excess of its needs. As the Federal Reserve expends credit in response to economic growth, open market purchases in the long run will tend to exceed open market sales, and the portfolio balance again will increase. Thus, under present institutional arrangements, future adjustments are likely.

Not only is the tendency for the Federal Reserve's portfolio to become excessively large not corrected, but also the procedures suggested by the proposed legislation will not be satisfactory for future adjustments. In order to maintain the accounting integrity of the Federal Reserve's balance sheet, a debit entry is required to offset the credit entry removing a portion of the Government securities from its portfolio. Under the proposed legislation, the required debit entry would be accomplished by relieving the Federal Reserve banks of their liability for Federal Reserve notes outstanding, and this liability would be transferred to the Treasury. At the end of December 1964, the Federal Reserve note liability amounted to \$34.7 billion; the proposed legislation would reduce its liability by \$30 billion. But, if Federal Reserve holdings of U.S. Government securities grow more rapidly than Federal Reserve note liabilities, as it has in the recent past, how are future adjustments to the Federal Reserve portfolio to be effected?³

Finally, the proposal to retire and cancel U.S. Government securities held by the Federal Reserve is not consistent with accounting practices applied to other Government agencies. The Federal Reserve System is not the only Government agency holding U.S. Government securities. At the end of the month of December 1964, U.S. Government agencies and trust funds, exclusive of the Federal Reserve banks, held \$60.6 billion in U.S. Government securities; this is well over 1½ times the amount held by the Federal Reserve banks. Should not a policy of retirement and cancellation of Government debt held by the Federal Reserve be applicable to these other Government agencies also?

Retention by the Federal Reserve of its present holdings of U.S. Government securities does not necessarily imply that nothing should be done, however. The Federal Reserve policy of returning its unexpended earnings to the Treasury should be made obligatory, and for the sake of consistency in Government accounting practices the expenses of the Federal Reserve should be subjected to annual audit by the General Accounting Office. A substantial reduction in Federal Reserve expenditures could be achieved by retiring the capital stock of the Federal Reserve banks, thus eliminating annual dividend payments to member banks. In other words, retention of the present arrangement makes more imperative guarantees that the unexpended income returned to the Treasury is maximized.

³ The Federal Reserve note liability increased \$7.8 billion, from \$26.9 billion at the end of 1955 to \$34.7 billion at the end of 1964. During the same period, the Federal Reserve's portfolio of U.S. Government securities increased \$12.2 billion, from \$24.8 to \$37 billion. Thus, the Federal Reserve note liability is likely to be inadequate to compensate for future adjustments to the Federal Reserve's portfolio.

Management of the Federal Reserve portfolio

Advice to the Federal Reserve on its portfolio management is roughly equivalent to recommendations concerning its open-market operations. The types of financial assets and their maturities which the Federal Reserve Open Market Committee buys and sells are vitally important for effective monetary policy. When conditions warrant, the Federal Reserve should seek to alter not only the general level but also the structure of interest rates through open-market purchases and sales of longer term financial instruments. Since 1961 Federal Reserve behavior indicates that the "bills only" policy has been abandoned and that open-market operations have been appropriate to the U.S. domestic and international situation.

Extension of the spectrum of the Federal Reserve's portfolio to include private as well as public evidences of debt appears to offer an opportunity to make open-market operations a selective as well as a general instrument of credit control. Generally, Federal Reserve policy has shied away from direct interference in credit markets, and probably from the standpoint of overall economic efficiency this inclination has been a wise one. However, conditions in which selective credit control would be necessary are not inconceivable, and in such situations the Federal Reserve should be encouraged to participate in the markets for private obligations of the maturities. For ordinary long-term operations, however, such broad participation is probably unnecessary. Open-market operations in short-term Government securities appear adequate to compensate for cyclical credit needs and technical adjustments.

The search for objective standards by which to guide the Federal Reserve's portfolio management—which is equivalent to guidance on its open-market operations—is likely to be a will-o'-the-wisp. The multitude of possible situations and the variety of combinations of equivalent actions dooms an attempt to formalize open-market reactions to changing credit conditions to probable failure. Fortunately, the Federal Reserve System has been able to insulate itself from this type of outside interference in normal times. However, in the absence of outside interference, the Federal Reserve sometimes imposes its own rules of thumb, as the "bills only" episode indicates. All commitments to such objective standards which may inhibit adoption of novel but effective and appropriate monetary policies are better discouraged than promoted.

STATEMENT BY WILLIAM E. WHITESSELL, DEPARTMENT OF ECONOMICS,
FRANKLIN AND MARSHALL COLLEGE, LANCASTER, PA.

The Portfolio of the Federal Reserve System

The Federal Reserve System occupies a unique position in the American economy, and therefore its policies and procedures should constantly be subjected to the closest scrutiny. Past System operations have given rise to a huge portfolio of the U.S. Government securities, and additions are regularly made to this portfolio as the Federal Reserve increases the money supply through open market operations. The very presence of the System's large portfolio presents a number of questions: What should be the size and composition of the Federal

Reserve's portfolio? What should be done with the securities not needed by the Federal Reserve System in the discharge of its responsibilities as a central bank? Can we design objective standards by which System portfolio operations may be guided, including questions of the maturity composition of securities in the portfolio and the types of assets the portfolio should contain? The following discussion is designed to direct thinking toward solutions to these and closely related questions.

GROWTH OF THE MONEY SUPPLY: OPEN MARKET OPERATIONS AND
REDUCTION OF RESERVE REQUIREMENTS

The Federal Reserve may meet the need for a secular growth of the money supply either by employing open market operations or reducing member bank reserve requirements. The choice between the two is not solely a matter of individual preference even though either method will allow for the needed growth of the money supply, but the intricate theoretical issues raised by the choice need not detain us. The important point here is that while the Federal Reserve has made use of gradual reductions in reserve requirements since 1951 without any offsetting increases it is presently using open market operations to provide for further increases in the money supply. This naturally results in an increase in the size of the Federal Reserve's portfolio of Government securities.

Under most circumstances the effects of expanding the money supply through the use of open market operations will be different from the effects of an equivalent expansion through reduction in reserve requirements. The spending units induced to increase spending will be different in each case as will the types of expenditures consequently affected. On the one hand, imprecise knowledge in the area prevents us from making specific predictions as to the ultimate effects of using either alone or a mix between the two. On the other hand, however, we do know something about the consequences of choosing one over the other in terms of effects upon Treasury interest costs and bank earnings.

Federal Reserve purchases of Government securities in the open market for the purpose of increasing member bank reserves has an immediate and direct benefit to the Treasury since most of the revenues accruing to the System are turned over to the Treasury. Open market operations absorb Government securities into the portfolio of the Federal Reserve, and this reduces the carrying costs of the debt to the Treasury. Lower reserve requirements, on the other hand, are favored by the commercial banks because of the effects on their profit positions.

It would be a mistake to assume that the interest costs to the Treasury involved in the different choices open to the Federal Reserve are negligible. While the absolute dollar amounts for 1 or 2 years may seem relatively small when compared to total interest costs, one

should not overlook the fact that interest savings are cumulative and, over time, appreciable in absolute dollar amounts.¹

A final consideration involves the effects of various levels of reserve requirements on the position of leverage given to the Federal Reserve. Lower reserve requirements increase the amount of money which can be created per dollar of additional reserves as well as increasing the amount which the money supply will have to contract per dollar of reduction in reserves available to the banking system.

THE SIZE OF THE PORTFOLIO OF THE FEDERAL RESERVE SYSTEM

The portfolio of the Federal Reserve is currently at about \$39 billion. The present size of the System's portfolio and the promise of an increase in that size if the Federal Reserve follows the practice of providing reserves for the banking system through open market operations suggest the need for consideration of policy questions with respect to the System's management of its portfolio of Government securities.

The absolute size of the portfolio of the Federal Reserve is not significant as an abstract entity. It is meaningful only when one considers the size of the System's portfolio in relation to some set of economic objectives which he envisions for the Federal Reserve. From the point of view of the responsibilities with which the Federal Reserve is presently charged, it could probably hold a considerably smaller portfolio and still discharge fully its obligations as a central bank under various likely situations which one might assume. The absolute size, above this required minimum, becomes significant only as it relates to semipolitical decisions with respect to Federal Reserve-Treasury relationships or Federal Reserve-commercial banking system relationships.

It would, therefore, be a mistake to attempt to tie the size of the Federal Reserve portfolio to some other economic aggregate such as gross national product, aggregate liquid assets, or even the money supply. A substitute proposal for the type of discretionary monetary policy which we now have would most likely have as its key feature some kind of formula for increases in the money supply over a given period of time at a given rate adjusted perhaps for the secular trend in velocity. The increase in the money supply under such a proposal would presumably be tied to some economic aggregate or aggregates which reflect the growth or the level of economic activity. Under such a proposal one might expect to find increases in the size of the System's portfolio tied in some more or less close fashion to an economic aggregate such as gross national product or aggregate liquid assets. The suggestion has a certain appeal not only to the quantity theorist in economics but to individuals who have observed monetary policy

¹ See the calculations made for the Joint Economic Committee by John Kareken in "The Government's Management of Its Monetary, Fiscal, and Debt Operations," pt. 6A, hearings before the Joint Economic Committee, 86th Cong., 1st sess., 1959, pp. 1252-1253. Also, see the note on bank profits. *Ibid.*, pp. 1254-1255.

Professor Kareken has pointed out another difference between open-market operations and changes in reserve requirements and that is the effect of the system's choice of method on the structure of interest rates. Open-market operations have the effect of changing the ratio of Treasury debt to total outstanding debt instruments and a new ratio of a particular maturity of Treasury securities to total outstanding securities. While this may be assumed to have some effects in the market, it is not clear that these effects will be so great as to unduly influence the Federal Reserve's decision as to which method to use. See John H. Kareken, "On the Relative Merits of Reserve-Ratio Changes and Open-Market Operations," *Journal of Finance*, vol. 16, No. 1, March 1961, p. 70.

in action and long for something "less personal" and hopefully less fallible to substitute for the sometimes ill-timed and/or improper or inadequate actions of the Federal Reserve. The evidence in support of such a position is subject to contradiction; and despite its appeal, it is by no means clear that such a policy would result in an improvement over discretionary policy as now practiced.

Suggestions to tie the growth of the Federal Reserve System's portfolio of Government securities to GNP or the establishment of a hoped-for optimum ratio between aggregate liquid assets and System holdings are likely to prove to be quite inadequate as a substitute for discretionary monetary policy in which the portfolio size is related only in a very imprecise way to GNP or some other economic aggregate. Changes in the velocity of money or shifts in portfolio preferences among holders of financial assets or any combination of other factors could in a very short time render even more complex mechanical arrangements inadequate to cope with the situation. Unsustainable booms could develop and then be encouraged to reach proportions which demanded severe readjustments simply because of the permissive increases of the money supply some formulas might allow. Thus, in spite of the appeal of such policies, the Federal Reserve should be reluctant to adopt them without refinements and provisions not yet suggested by their advocates.

The exact rate of growth of the money supply must depend on considerations of the strength of private demand and the nature of fiscal policy since these two factors affect the demand for money. This may require different rates of growth of the money supply at different times, and situations may arise when more than one method of encouraging growth of the money supply should be used.

THE FEDERAL RESERVE'S PORTFOLIO AND THE COMMERCIAL BANKS

The Federal Reserve was not designed as a profitmaking institution of the Federal Government. We have already noted, however, that by the very nature of its operations the Federal Reserve affects both the profitability of the commercial banking system and the interest costs to the Treasury. Thus, while there exists no economic need to do anything with the securities held by the System, there may be some requirement for action to stem pressures for moves which might not be deemed beneficial to the longrun interest of the country as a whole.

The Treasury recoups a large proportion of the interest costs on the securities held by the Federal Reserve because of the high "tax" on System earnings. On the other hand, considerable "political" pressures may be generated by the banking community in the direction of persuading the Federal Reserve to turn over income producing assets, in effect, by reducing reserve requirements. The argument would probably follow the lines of: (1) the Federal Reserve is not a profitmaking institution; (2) the System does not need the securities held in its large portfolio; (3) reserve requirements are at unusually high levels in terms of equity as between commercial banks and other non-controlled institutions and in historical terms; and (4) therefore, the Federal Reserve should gain the advantages of greater leverage by lowering the reserve requirements for the member banks.² Most

² Since the American Bankers Association has pushed the adoption of a planned reduction in reserve requirements in the past it is not illogical to expect a renewal of interest in the plan at the next favorable opportunity, most likely the next recession.

bankers, viewing the operation of the System from the position of their individual bank, tend to view reserve requirements as sterile investment of "their" earning assets. This creates continual pressure from the banking community for a reduction in required reserves, although it is true that substantially all of member bank reserves have been created by the Federal Reserve System.

The Federal Reserve has not raised reserve requirements since 1951 although it has lowered them several times during recession periods since that date. This continual movement in only one direction suggests that the Reserve officials view reserve requirements as being too high and that the successive moves downward are designed to bring the requirements to more nearly satisfactory levels. The Federal Reserve has never formally stated its position with respect to where reserve requirements should eventually come to rest, if indeed they should be lowered only to a certain level. This gradual reduction of reserve requirements during periods of recession without offsetting increases during periods of prosperity may perhaps give some clue as to the receptiveness of the Federal Reserve to the suggestion by the commercial banks that reserve requirements are at levels which are "too high." The creation of additional reserves by open market operations has the dual effect of reduction in interest costs to the Treasury while providing relatively less profit to the commercial banks than would be the case if reserves were supplied through lowering reserve requirements. However, there is no clear evidence that the Federal Reserve should lower reserve requirements.

The problem of pressure on the Federal Reserve to lower reserve requirements as the System's portfolio of Treasury securities becomes relatively larger could be met by legislative action which would withdraw the Federal Reserve's ability to further reduce reserve requirements. This suggestion has been made in other contexts,³ but it is equally applicable as a means of reducing the political pressures on the System from private interests.

It has been suggested that the System could, as another alternative, return its "excess" securities to the Treasury for cancellation. Any such suggestion would in the future, as it has in the past, almost surely meet with strong political opposition by those who cite the danger of what they choose to call in disparaging terms "fiat money." Opponents of such a proposal would almost surely point out the possibilities of envisioned international repercussions and domestic suspicions of the soundness of the Government in the management of its finances. These claims may have contained some truth in the early postwar years, but today the validity of such claims is of secondary importance to the potential political and perhaps psychological impact.

The Federal Reserve System presumably has no incentive to spend more money simply because it receives more in interest payments from the Treasury. Therefore, if it were decided that changes in legislation concerning reserve requirements would be unwise and if it were also decided that there should be a reduction in the size of the System's portfolio, consideration could be given to still another

³ See the suggestions of Warren L. Smith in "Reserve Requirements in the American Monetary System," *Monetary Management*, Englewood Cliffs: Prentice Hall, 1963, p. 216; and Milton Friedman, in his statement in "Employment, Growth, and Price Levels," pt. 9A, hearings before the Joint Economic Committee, 86th Cong., 1st sess., 1959, p. 3022.

alternative. A certain portion of the securities now held by the Federal Reserve represents a permanent monetization of Federal debt. This fact could be recognized by a simple and convenient intra-governmental memorandum of debt; interest could be paid at a nominal rate or even entirely excluded from consideration. The Federal Reserve would thus become the Government's underwriter, not unlike the case with the Bank of England.

Policy implications.—At least two policy implications emerge from the foregoing discussion: (1) Until it is convincingly demonstrated that the Federal Reserve has to supply subsidies to the banking system, it would be preferable to increase the money supply through the use of open market operations rather than through further reductions in reserve requirements. If it were decided that it is necessary to subsidize the banks because of the peculiar position they occupy with respect to their opportunities for profit in competition with the financial intermediaries of the economy, then an argument can be made for providing that financial subsidy through congressional appropriation rather than by reductions in reserve requirements. Congress would then periodically have an opportunity to review the profitability of this unique industry, and there would be little question as to the cost of the subsidy provided. (2) The interest savings to the Treasury are substantial enough to recommend open market operations in preference to reduction in reserve requirements as a method of supplying the needed increases in the monetary stock of the economy.

DEVISING OTHER OBJECTIVE STANDARDS FOR FEDERAL RESERVE OPERATIONS

There is an undoubted appeal to the idea that objective standards can be devised for the operations of the Federal Reserve with respect to its conduct of operations in the Government securities market. It seems quite probable that one of the advantages seen for a policy of "bills only" was that it largely eliminated the difficulties inherent in the decision of what market sectors to enter to effect monetary decisions. A rather mechanical response in one sector of the market, even though that sector be the one most often appropriate for the usual open market operations of the System, did not prove to be satisfactory in the case of bills only; and we are unlikely to discover simple rules or objective standards which should be followed by the Federal Reserve as it conducts its open market operations. Some general guidelines can be handed down, but one should be careful to allow for needed flexibility in System operations because of the range of problems which it currently faces and because of the unforeseen problems it will surely face in the future. For example, one may indicate a preference that the Federal Reserve, according to its judgment, deal in its open market operations in the various securities that are outstanding but at the same time not attempt to impose a precise formula or measurement on such dealings. One may also direct the Federal Reserve to use open market operations to expand the money supply without specifying exactly what securities are to be bought in the open market to accomplish this end. In short, the need is for a flexible attitude as opposed to the inflexibility exhibited during the bills only period.

Standards relative to the assets held by the Federal Reserve System.—Some individuals have suggested the possibility of supplement-

ing the present holdings of the Federal Reserve with other types of assets such as commercial loans, mortgages, commodities, municipal securities, corporate bonds, and foreign exchange. The Federal Reserve, by discounting commercial paper and through the execution of its other normal functions, now deals in a relatively small way in some of these. However, it would be unwise for the System at this time to attempt larger operations in the areas indicated because of the multitude of troublesome details which would have to be worked out. For example, direct control of corporate and State and local securities issues would raise serious questions with respect to the constitutionality of such action, and it appears that attempts at control over these issues by Federal Reserve purchases or sales of them would likewise raise questions about the legitimate functions of the System.

Furthermore, there appears to be little or no need for significant System operations beyond what is now being done in these areas. A substantial reduction in the Federal debt in the hands of the public could conceivably weaken the effectiveness of monetary controls. The smaller size of Government debt held by the public relative to the larger and growing private debt might mean that transactions of sufficient size to accomplish monetary aims would be difficult to achieve or that the connections between Government and private debt markets might be appreciably weakened. This situation, if it should arise, might call for a reevaluation of the desirability of System dealings in private debt instruments on a relatively large scale; but there appears to be no necessity for such considerations at the present time. Debt holders who prefer Government instruments might conceivably have to make some small shifts in their portfolios as a result of relative declines in the availability of Government securities, but the growing importance of Government guaranteed debt and the demonstrated flexibility of the financial system are likely to minimize the seriousness of any relative decline in available direct Government debt. In short, any problems here are likely to be very longrun ones.

A further consideration relative to System dealings in the types of assets suggested is that such operations have direct implications for the question of resource allocation. Should the Federal Reserve as a matter of normal policy extend its operations into these other areas when the effect would almost surely be that of bidding up the rates on these various types of loans. This would place the System not only in a position of direct competition for such loans with other sectors of the financial community, but depending on which securities or loans it chooses to buy, would have the effect of encouraging expansion of some sectors sometimes at the expense of others. At best, such a policy would have little beneficial effects; and at worst, it could create severe destabilizing pressures in the areas in which it chose to operate.

Assets held by the System and velocity considerations.—Perhaps one of the implicit questions with respect to an expansion of System holdings of other assets is that of whether or not changes in velocity are able to appreciably affect the ability of the Federal Reserve to achieve its goals of credit restraint during periods when it may seem advisable to apply restraint in the economy. There can be little doubt that the development of financial intermediaries in the economy has resulted

in some slippage in monetary controls, as has the existence of non-member banks outside of direct System control; and this slippage has probably been rather significant. Serious consideration should be given at the present time to extending controls of some kind over the operations of both financial intermediaries and nonmember banks. There are questions here which relate to matters other than stabilization alone—questions of equity, efficiency of allocation of resources, and the proper scope of governmental authority—but these are matters which simply must be dealt with.

If the aim of Federal Reserve holdings of assets other than Government securities is in general that of controlling the perverse variability of velocity, there would seem to be surer and certainly less complex means of accomplishing this goal. The imposition of reserve requirements on financial intermediaries, for example, would give the authorities the power to control the growth of intermediary claims directly should this prove to be necessary. Such action would avoid the difficulties involved with a rather tenuous relationship between some marginal amount of Federal Reserve holdings of other financial assets and control of velocity changes. After all, it may not even be desirable to give the Federal Reserve complete control over changes in velocity even if that were a real possibility. It can reasonably be argued that the increased leverage of monetary action which results from the growth of intermediaries may strengthen the monetary authority in the sense that the effects per dollar of action are thus increased. On the other hand, it can be argued with equal vigor that such developments weaken the monetary authority because of the difficulty of getting finer adjustments. If the restraints on the scale of Federal Reserve operations were to become significant, there would be a greater reluctance to use monetary action. Additional reluctance on the part of the monetary authorities may be induced by the corollary fact that the increased leverage caused by a growth of intermediary claims tends to produce some uncertainty concerning the short-run impact of monetary operations. On balance, there does appear to be a strong case for extending controls to financial intermediaries, but these controls should take the form of more, not less, direct controls than the supplementing of Federal Reserve holdings of other assets.

Even though it is admitted that the presence of financial intermediaries and nonmember banks does affect the degree of control exercised by the monetary authority, this does not mean that the monetary authorities' attempts at control are empty gestures. Monetary policy is not so impotent that variations in velocity offset its intended effects entirely, but some potentially serious problems are present.

SUMMARY

This brief examination of questions relating to the Federal Reserve's management of its portfolio has emphasized the following key points:

1. The secular growth of the money supply should be provided by System open market operations rather than further reductions in reserve requirements.

2. The absolute size of the Federal Reserve System's portfolio is important not as an abstract entity but as it relates to the economic objectives of System operations. The analysis indicates that the Fed-

eral Reserve should not adopt proposals which tie the size of the portfolio inflexibly to a specified ratio between itself and GNP, aggregate liquid assets, or the money supply.

3. If it were deemed necessary for the Federal Reserve to reduce its holdings of securities in excess of those which are needed for the execution of essential central bank functions, consideration could be given to the use of an intragovernmental memorandum of debt with interest at a nominal rate.

4. There is undoubted appeal to the idea that impersonal, objective standards can be set for guiding System portfolio operations, but there is presently no convincing evidence that this is possible.

5. It would probably be unwise for the System at the present time to extend its operations to include other types (or greater amounts in a few cases) of assets such as commercial loans, mortgages, commodities, municipal securities, corporate bonds, and foreign exchange.

6. This does not imply that the Federal Reserve should not consider extensions of controls over financial intermediaries and over non-member commercial banks. In fact, analysis suggests just the opposite.

The Federal Reserve should be flexible enough to consider all of the ideas put forth by its critics, but this does not in any way imply that certain suggestions cannot be rejected without a trial period of operations.

STATEMENT BY C. R. WHITTLESEY, PROFESSOR OF ECONOMICS AND FINANCE, WHARTON SCHOOL OF FINANCE AND COMMERCE, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA.

In the first place, I feel much as my friend Seymour Harris does with respect to the contribution which you have made in the area of monetary policy over a great many years. You may be interested to know that I was one of the six or eight economists (Paul Douglas among them) who joined with Irving Fisher in attracting attention to the 100 percent Reserve plan for effecting a relative basic reform of the banking system. I cannot say that I thought that the plan had any prospect of adoption but I was convinced of its logical merit. I mention it here in the hope that it will absolve me from appearing particularly deferential to the status quo.

Secondly, it would seem to me to be wiser from a tactical standpoint to concentrate on issues which are as clear cut as possible and where the action that should be taken is least open to doubt. Also, instead of identifying the Fed with bankers generally it would seem better to assume that they recognize as well as others that they are quite different and that the whole justification for there being a central bank lies in that fact. Moreover, as far as possible reform should be effected within the framework of existing institutions. It is the last observation that brings me directly to the questions presented in your letter.

There is no optimum ratio for the Fed's portfolio in relation to money supply, gross national product, or any other specific criterion. One can argue that there is some amount below which the portfolio should not fall. It can readily be shown that there is some amount

above which it need not rise. But it does not follow, nor is it true, that either figure can be determined with any degree of exactness. To repeat, there is no criterion of the sort asked for.

No serious harm is done by holding securities in excess, even greatly in excess, of the amount that is really necessary. (Various means could be suggested for eliminating the excess.) As matters now stand the Treasury passes money out to the Federal Reserve in interest on these securities and gets it back again out of excess earnings. This arrangement, which was adopted as an expedient and without having been planned, may strike one as untidy. To the unsophisticated it may even be misleading. But it does not make enough difference to justify the effort and exacerbations that would result from trying to change it.

I am opposed to laying down arbitrary (if this is the meaning of "objective") standards for portfolio operations. The unlamented bills only policy was such a rule and any other measure of a significantly restrictive character could similarly obstruct the attainment of desired central banking goals. In principle it would be much better to move in the direction of greater freedom, as proposed in the final query. There is little prospect that such powers would be exercised to any great extent in the foreseeable future; and even less that they would be abused.

STATEMENT BY FRAZAR B. WILDE, CHAIRMAN OF THE BOARD,
CONNECTICUT GENERAL LIFE INSURANCE CO., HARTFORD, CONN.

Since 1913 our monetary system has been based upon the competency and good judgment of the Board of Governors of the Federal Reserve System. If we are to have a successful result, the Board must have maximum flexibility both by tradition and by law in exercising its enormous responsibility.

There can be no perfect performance in a business of such size and complexity. Any kind of formula restriction or interference with the Board's freedom of judgment will inevitably work to the Nation's disadvantage. This is the evidence of history throughout the world when countries have tried to use automatic formulas, such as a rigid gold standards in monetary management, rather than rely upon the judgments of highly skilled individuals.

Under a system which relies basically upon human judgment, it follows that the man or men appointed require talents of an unusual nature. They must be highly intelligent and economically literate as well as possess an extraordinary degree of objectivity and strength of character. Any monetary manager is subject to continuous daily pressures, not only from those of us who don't understand monetary management but also from those who may have some understanding but whose judgment is often based upon short-term reasoning. The best possible test of the competency and integrity of a central bank is evidence that many times the operation is proceeding somewhat contrary to what popular opinion and judgment think it should be.

The reason the Congress set up the Federal Reserve System as a semiautonomous institution, definitely not subordinated to the administration and answerable only to the Congress on the basis of its performance, was that the Congress recognized the risk of making a po-

litical football out of monetary policy and the institution charged with administering it. The basic responsibility of the Board is to play a major role in the progress and stability of our economy. It does this through the operation of the monetary system in providing adequate credit for trade and commerce. It must not provide too much or too little. It must avoid at all times the risk of rapid changes in the price level. In other words, it is a major instrument in the successful growth and stability of the economy. Of course, it cannot do it alone. National fiscal policy must operate in harmony with monetary policy to assure success.

Bearing these principles in mind—and they are fundamental—the specific questions in your letter are largely answered. The Board, to be successful, must be guided by the collective judgment of its members in assessing the situation, the outlook, and need at a given time. The position they take will reflect the total circumstances of the country and in the world at the time a decision is made. They will have to weigh especially trend indications because it is not the situation of the day which requires action on their part so much as the trend lines and direction in which the economy is moving.

They should not be asked to follow a formula. They should decide on the size and composition of the portfolio needed as their judgment dictates. The kind of assets and the maturity composition have to be determined in light of the problems of the time. The portfolio, while still open to their judgment, should be largely Federal Government securities. Special assets, such as municipal securities, corporate bonds, mortgages, and commodities, would not be appropriate under any circumstances that I could foresee.

Your letter indicates some concern about the interest earned on Federal Reserve assets. Since the interest received by the Federal Reserve finds its way almost entirely back to the Nation, it doesn't seem as though this is a problem. If there is an excess of assets, I presume that the Board in its judgment would sell the excess in the marketplace. Cancellation could be misunderstood.

In view of the enormous problems which our country faces both domestically and internationally in the monetary field, I hope that it will be the continued judgment of the Joint Economic Committee and of the Congress that no significant changes should be recommended in the structure or rules of the present System.

STATEMENT BY F. O. WOODARD, HEAD, DEPARTMENT OF ECONOMICS,
WICHITA STATE UNIVERSITY, WICHITA, KANS.

A recent letter from the Honorable Wright Patman, chairman of the Joint Economic Committee, relative to the Federal Reserve's acquisition and ownership of Government securities, is both timely and vital. At the very least, the antiquated methods used in this area are expensive and time consuming. I agree with Congressman Patman that a change is necessary. However, I am not so concerned, as is Congressman Patman, with the double purchase of the debt by the Government, but rather with the turnover procedure necessary under the present system. This refunding procedure involves an unnecessary expense to the Treasury.

My suggestion is a simple one. Replace the very large amount of permanently monetized securities now held by the Fed (perhaps 25 or 30 billion) with special Treasury issues bearing no maturity date. This will eliminate the need for the Treasury to periodically refund this portion of Federal debt. The chances of the Fed needing this portion of the debt for monetary control purposes is very slight, but, should a need arise, a reconversion of the special issues into marketable issues could be easily arranged.

STATEMENT BY FELIX EDGAR WORMSER, CONSULTING MINING ENGINEER,
GREENWICH, CONN.

I am of the opinion that the Federal Government should be prepared to obtain the funds it needs through taxation, or borrowing from the citizenry. I question whether it was the intent of the originators of the Federal Reserve System to monetize public debt with the consequent serious monetary implications that lead to questions of monetary policy as noted in your letter.

In any event I think that all governmental bodies, Federal, State, county, and municipal, should always be prepared to pay interest on the money they borrow. The Federal Government, as is well known, happens to be in a unique governmental position in that it can print and issue money, if it so desires, to pay its debts—fiat money—but that does not mean it is desirable to do so although our history records periods when it was done.

I am in hopes that someday your distinguished committee will come to grips with the grave question of the quality of our dollar. I believe you would wish, as I do, that our great Nation use the finest kind of currency that has ever been devised through centuries of experience. That being a reasonable premise, should we not return to the use of a dollar redeemable in gold which obviously is superior to one that is not redeemable?

Moreover, I am tempted to ask, is any monetary system based upon Government compulsion, such as the one we use today, consonant with the basic American tradition of freedom?

I hope you will excuse my emphasis on these monetary fundamentals rather than supplying answers to your questions on monetary management.

