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THE PUBLIC DEBT: HINDRANCE OR ADVANTAGE TO CREDIT CONTROL?

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WE PROBABLY CAN SAY, without provoking serious controversy, that broadly speaking there are two schools of thought on this question. One view is that a large public debt immobilizes the usefulness of monetary and credit policy. The other view is that the public debt has made monetary and credit policy more effective and more useful than ever.

This paper will be confined to three questions. What is the nature of the case for each of these two points of view? What are the conditions necessary if credit policy is to be effective, given a large public debt? How can debt policy fit into a general program of economic stabilization?

I

A considerable tonnage of literature has emerged during the last six years dealing with how a large public debt impedes the proper exercise of credit policy. These issues are by now generally understood, and no useful purpose would be served in any extensive re-exploration of this material. It will only be necessary here, therefore, to sort out the principal reasons given for concluding that the emergence of the debt hinders the operation of credit policy.

1. The inevitably large bank holdings of governments imposed by a large public debt tends to immunize the commercial banking system from the effects of Federal Reserve policy. This point is obvious. Their bulging portfolio of government securities provides the banks with a ready means of relaxing constraints on their inclination to expand credit otherwise imposed by a tightening reserve position. Securities can readily be sold in the market. If the market is congested, securities can be allowed to mature into cash, since most bank portfolios contain securities maturing every week.

2. For most banks the Treasury, not businesses or other private borrowers, is the residual borrower. Private borrowers are the bank's depositors. Competitive pressures, therefore, require that a bank accommodate those on whom it depends for its own existence. Consequently, the bank's response to a tight reserve position is apt to

be a reduction in holdings of Treasury obligations, if necessary in order to take care of its private borrowers.

3. The market weaknesses produced by a more disinflationary credit policy may discourage private buyers of Treasury obligations. People are not inclined to buy securities during a period of falling security prices. Yet the Treasury's requirements for funds for new money or for refunding must be met. The net result of a tighter monetary policy could, therefore, be enlarged Federal Reserve open market purchases of Treasury obligations, and creation of additional bank reserves, and further expansion of bank credit and the money supply. The Treasury repeatedly emphasized this point in its replies to the Patman Committee.¹

4. Treasury debt operations either for new money or for refunding may of necessity be in excess of the funds currently available in the financial markets. A small borrower may be able substantially to enlarge the funds acquired by outbidding other borrowers on terms. The Treasury, however, because its operations are so large relative to the whole money and capital markets, as Mr. Roosa has pointed out, "cannot be fully certain that the magnitude of these funds, after they have been assembled, will be sufficient to meet the Treasury's needs."² Mr. Roosa goes on to point out that normally the Treasury can count on meeting its requirements if offerings are well designed "unless interest rates should be rising at the time under the pressure of a general tightness in credit availability."³

II

There is, however, a more optimistic view of what the public debt means for the usefulness of credit policy. According to this view, the public debt has extended the influence and effectiveness of monetary and credit policy. The public debt, large and widely held, means that the influence of Federal Reserve policy on financial markets generally is not limited to the remote echo effect produced by altering the reserve position of the commercial banks. The effects of Federal Reserve policy are extended quickly throughout the whole economy.

We might, I think, refer to this as the New York Federal Reserve Bank school of thought, since it has been so persuasively

1. *Monetary Policy and the Management of the Public Debt. Replies to Questions and Other Material for the Use of the Subcommittee on General Credit Control and Debt Management* (82d Congress, 2d Session, 1952), pp. 105-11.

2. Robert V. Roosa, "Integrating Debt Management and Open Market Operations," *American Economic Review, Proceedings* (May, 1952), p. 217.

3. *Ibid.*, p. 17.

discussed by various officials of that institution. Mr. Sproul puts this whole matter very succinctly.

It is a hopeful aspect of the situation, however, that the same circumstance which is primarily responsible for the problem helps to make its solution seem possible. Because of the size of the public debt, and its relative importance in the whole structure of public and private debts, the Federal Reserve System is now able to carry on its open market operations in a broad homogeneous market, embracing Government securities of all maturities, and the effects of its operations are more quickly felt in all areas of the private sectors of the market than used to be the case.⁴

The case for this more optimistic view is an impressive one. The large volume of government securities widely distributed means that the effects of Federal Reserve policy extend directly to all parts of the financial community. If security prices weaken and interest rates rise under pressure of open market sales, all financial institutions and the capital market generally are immediately affected. Prices of securities in all portfolios have declined. More important is the effect of market weaknesses on the demand for new securities. Viscosities are directly introduced into the market in which companies needing funds must float their new issues. In the "good old days" these longer-term borrowers and lenders were affected by Federal Reserve policy only to the more remote and uncertain extent to which short-term rate changes produced echo effects on longer rates. Now the influence is more direct and more immediate.

This is abetted by the trend toward the increased institutionalization of savings. In 1951, for example, of \$13.4 billion of liquid saving by individuals only \$3.5 billion represented direct purchases of securities.⁵ The remaining \$10 billion was channeled through various financial intermediaries such as insurance companies and pension funds. This means that decisions about how and when savings are made available to potential borrowers are now primarily made by professional credit and portfolio managers, with their inevitably greater sensitivity to changes in market conditions.

Moreover, with the widely distributed public debt, the Federal Reserve exerts a more direct effect on not only the financial markets but the economy generally. Market weaknesses reduce the range of assets which can be considered appropriate for necessary liquidity

4. Allan Sproul, "Changing Concepts of Central Banking," in *Money, Trade, and Economic Growth, Essays in Honor of John H. Williams* (New York: Macmillan Co., 1951), p. 321. Cf. also essay by Robert V. Roosa of the New York Federal Reserve Bank in the same volume.

5. Securities and Exchange Commission, Statistical Series Release No. 1114, October 5, 1952.

requirements. And the uncertainties associated with these developments are very apt to create an added awareness of the need for the protection which greater liquidity affords.

The connection between changes in liquidity and the flow of spending on output is, of course, complex. We know, in fact, too little about these matters. The increased attention being given to these problems even at the theoretical level, suggests, however, that this is a point of some significance in appraising the present effectiveness of credit policy.⁶

These observations about the significance of the debt for credit policy point up two conclusions. *The public debt does limit the Federal Reserve's freedom of action. On the other hand, the existence of the public debt has extended the range of influence of Federal Reserve policy.*

Whether, therefore, on balance the public debt means a more or a less effective execution of credit policy depends on the net result of these two diverging considerations. What are the conditions which must be met if the first is not to outweigh the second? What determines, in a word, whether the public debt means a more or a less effective credit policy? It is to these matters we now turn.

III

If the existence of the debt on balance is to sharpen the effectiveness of credit policy, two basic conditions must be met.

1. Modest changes in Federal Reserve policy must produce changes in the volume of private spending on goods and services. That the Federal Reserve is now able to exert substantial influence on yield rates and prices of securities generally through policy changes which thirty years ago would have seemed quite modest seems now pretty well established.

What is less clear is whether these modest shifts in yield rates and security prices, and associated changes, influence private spending. Are some capital outlays a casualty of these developments? To what extent can the volume of consumer spending be made different from what it otherwise would have been? If so, how do these things work out? What is the nature of the evidence? On these matters we have insufficient theoretical and empirical evidence, and this constitutes a substantial difficulty in arriving at any conclusion about whether monetary policy is now more or less useful. We can say this. A modest tightening of credit is probably not inflationary;

6. Cf. Kenneth E. Boulding, *A Reconstruction of Economics* (New York: John Wiley & Sons, Inc., 1950), particularly pp. 79-94.

a severe credit stringency will almost surely produce a recession.

It may, however, be that moderate changes will not significantly deflect the momentum of private spending. Economic relationships may have enough "play" so that we are dealing with a threshold problem—the pressure of credit policy must build up to a certain point before it can produce a visible displacement in private spending.⁷ This point may or may not be beyond the limits imposed on credit policy by the public debt.

The price stability of the last eighteen months seems, however, to suggest that moderately restrictive Federal Reserve policy can exert a significant influence on business conditions. Unemployment is at levels generally considered too low to be consistent with price stability. Banks have been under substantially enough reserve pressure to push member bank borrowing up to about the \$2 billion level and thereby re-establish the influence of discount policy. Yet during the last eighteen months loan rates have increased only 0.2 per cent, and yields on long-term Treasury obligations are only fractionally above year-ago levels.

2. Within the limits of modest changes in Federal Reserve policy, the Treasury must be able to meet its requirements for funds, either new money or refunding, through normal market processes. Indeed the Treasury's success in the market importantly determines the limits of Federal Reserve policy. If the Treasury is to meet with reasonable success in the market, four interrelated conditions must be met.

a) Cost of servicing the debt must be a secondary consideration. The Treasury must obviously set rates on new obligations reflecting market conditions if it is to attract sufficient new funds. If rates are held lower, the debt operation will almost certainly go sour without Federal Reserve help. That is, of course, obvious. One further point is, however, worth making. Any Secretary of the Treasury will readily agree that the debt's service charge is certainly a consideration subordinate to economic stability generally in shaping debt policy. The complexity and uncertainty of the relationship between a tighter credit policy and, for example, the cost of living index or gross national product may incline any finance minister, at the time each specific decision must be made, to be very much aware of this easy and frequently used way to calibrate the success of his administration—i.e., did he service the debt cheaply? Holding down the interest cost of the debt may,

7. Cf. George Katona, *Psychological Foundations of Economic Behavior* (New York: McGraw-Hill Book Co., 1951), particularly pp. 142–45.

in a word, not be an important consideration, but it may be a very pressing one.

In their joint replies to the Patman Committee the Federal Reserve Bank presidents state the matter very positively, "It is the Treasury's inherent responsibility for combatting inflation that it offer securities which are acceptable to the market."⁸

b) The debt must not be "too large"—a term, which is, of course, a bit difficult to define. The nature of the problem can, however, be made clear. Government securities are for understandable reasons generally regarded as quite liquid assets. The economy generally needs a certain amount of these liquid assets for "secondary reserves." When the supply of these securities is substantially in excess of the needs of businesses and people for liquid assets, however, the excess will tend to be infirmly held. And there will be a tendency to shift out of government securities and into other assets, or in order to finance stepped-up spending generally. How large the public debt can be, therefore, depends in part on whether the Treasury can fund that part of the debt not needed for "secondary reserves" into securities generally considered to be illiquid.

While many of these problems would be easier to deal with if the debt were a bit smaller, there is little evidence that the size of the present debt creates a problem beyond the capacity of the financial markets to handle. The ratio of total debt, private and public, to the size of the economy is smaller now than before World War I and considerably below the ratio prevailing prior to the Great Depression. Apparently, we are not being asked to hold a volume of securities out of line with the size of the economy (Table 1).

c) The liquidity of the debt is a function of its maturity distribution as well as size. Here a real problem remains. While the total debt is now \$50 billion lower than in mid-1946, the volume of marketable securities due or callable within one year is \$9 billion larger.

The volume of commercial banks Treasury obligations callable or maturing within five years was 29.8 per cent of their deposits in mid-1952, compared with 25.9 per cent in mid-1946. It is clear that the management of the debt in the postwar period has augmented the liquidity overhang as more and more of the debt got bunched at the short maturity end. Thus, though the debt in the hands of the

8. *Monetary Policy and the Management of the Public Debt. Replies to Questions and Other Material for the Use of the Subcommittee on General Credit Control and Debt Management* (82d Congress, 2d Session, 1952), p. 687.

public was declining, reflecting Treasury cash surpluses, the size of debt operations was expanding because of refunding requirements.

The maturity distribution of the debt clearly must be lengthened. The Federal Reserve cannot otherwise be certain that it will not need to come to the Treasury's rescue if a very heavy private demand for long-term funds should coincide with large debt operations. We should not assume, however, that any major alteration in the maturity structure of the debt can be accomplished quickly. If the debt is to be composed of additional longer-term securities, someone must buy them.

TABLE 1

TOTAL NET PUBLIC AND PRIVATE DEBT AND GROSS NATIONAL PRODUCT
(Dollar Amounts in Billions)

YEAR	TOTAL DEBT	G.N.P.	RATIO OF	
			Debt to G.N.P.	Pvt. Debt to Total Debt
1916	\$ 82	\$ 48	1.70	.98
1925	163	91	1.78	.88
1929	191	104	1.84	.91
1940	191	101	1.88	.77
1945	407	215	1.88	.38
1951	519	329	1.58	.54

Source: U.S. Department of Commerce; G.N.P. data for 1916 and 1925 are my own estimates.

TABLE 2

MATURITY DISTRIBUTION OF U.S. GOVERNMENT
MARKETABLE SECURITIES
(Dollar Amounts in Billions)

Callable or Maturing	Dollar Amounts		Percentage Distribution	
	6/30/46	9/30/52	6/30/46	9/30/52
Within 1 year	\$ 61.9	\$ 70.8	32.6	50.5
1-5 years	19.0	29.4	10.0	21.0
5-10 years	44.9	13.3	23.7	9.5
10-20 years	20.0	26.7	10.6	19.0
Over 20 years	43.6	...	23.1	...
Total	\$189.6	\$140.2	100.0	100.0

Source: *Federal Reserve Bulletin*.

TABLE 3

COMMERCIAL BANK DEPOSITS AND HOLDINGS OF U.S. GOVERNMENT SECURITIES
(Dollar Amounts in Billions)

YEAR (June 30)	DEPOSITS	GOV'T SECURITIES			
		ALL GOV'T SECURITIES		MATURING OR CALLABLE IN 5 YEARS	
		Amt.	Ratio of Deposits (Per Cent)	Amt.	Ratio of Deposits (Per Cent)
1946	\$142.9	\$76.6	53.7	\$37.0	25.9
1948	138.1	57.6	41.6	47.4	34.2
1950	142.8	59.0	41.0	49.2	34.2
1952	160.7	53.9	33.6	47.8	29.8

Source: *Federal Reserve Bulletin*.

d) We must have an adequate budget and fiscal policy. If tax revenues are inappropriate and inadequate, Treasury requirements for funds may be in excess of what can readily be attracted in a period of generally active private demand for funds. Since Treasury needs must be met somehow, the Federal Reserve would be impelled to step in with a volume of market purchases otherwise inappropriate to the general credit and economic situation.

Here the postwar record has been quite impressive. Excepting 1949, every fiscal year since the end of the war has shown a cash surplus. For the whole period (fiscal years 1947–52) the aggregate cash surpluses were \$22 billion. It would hardly be realistic to expect that we would do much better.

IV

Can we manage the debt so it will do more for us than to permit a more effective operation of credit policy? Can it, in short, have a role of its own to play in a general stabilizing policy? This is a side of the debt management question which can use some more thinking and study. It is a question which was not so extensively explored in the Patman material, and only a few observations will be made about this here.

One approach to this matter has been in terms of contra-cyclical shifts in the liquidity “center of gravity” of the debt. Some Treasury obligations are more liquid than others. A three-month Treasury bill is, of course, considered to be more liquid than a long-term bond. Thus by lengthening maturities and generally shifting the debt into less liquid securities during a boom, some restraint might be imposed on spending. In a recession the debt should, of course, be shifted into more liquid securities. This is a matter which needs more systematic analysis. We do not yet know very much about how changes in the debt’s liquidity do influence private decisions to spend. It is clear that extremes of liquidity or illiquidity seem to produce correspondingly extreme results. Moreover, the “right” basic maturity distribution is certainly the essential starting point for good monetary and debt policy generally.

The real question is whether alterations in the maturity distribution and liquidity of the debt substantial enough to promise a visible effect on private spending would not require unrealistically large debt operations, since in a boom large sales of longer-term, relatively illiquid securities would be difficult to carry out.

Henry Simons has provided us with a lead which we might usefully explore further. You will recall his proposal that government

bonds be sold during a boom to mop up funds, with the process reversed in a recession.⁹ The Treasury should, in a word, withdraw funds from the spending stream during a boom by borrowing them. It would in effect be pre-emptive borrowing since the budget (assuming appropriate fiscal policy) would be enjoying a cash surplus. The funds thus withdrawn from the spending stream could then be immobilized in Treasury tax and loan balances or used for debt retirement in such a way as not to enlarge the public's money supply or bank reserves. A volume of this pre-emptive borrowing so small as to produce little visible statistical change in the debt structure might still withdraw a significant volume of funds which private borrowers would otherwise acquire and spend. This presumably was the rationale of postwar savings bond issues, conducted at a time when the Treasury was already showing a cash surplus.

These are issues which might usefully be further explored. If some elbow room could be found for such debt operations, debt management policy might be fitted with monetary, credit, and fiscal policy into a general stabilizing program. Taxation and fiscal policy can withdraw funds from the spending stream in a boom, but experience shows it to be cumbersome and inflexible.

Through debt management, funds difficult to reach by taxation can also be withdrawn from the spending stream.

Through credit and monetary policy the creation of new money can be limited. These are simply alternative and complementary ways to influence the pace of spending—all by altering the volume of spendable funds in the hands of the public.

Where do we come out in this analysis of the significance of the debt for credit policy? These conclusions are, I think, clear. A large public debt does limit the Federal Reserve's freedom of action. The large debt, however, also extends the Federal Reserve's influence and increases the sensitivity of the economy to Federal Reserve policy.

If the latter is to outweigh the former, two basic conditions must be met. There must be some sensitivity of private spending to moderate policy changes. The Treasury must be able to meet its requirements for funds through normal market processes. This requires a proper budget policy, a debt structure which does not provide chronically a volume of highly liquid securities in excess of the economy's requirements, and a willingness to adjust yield rates

9. Henry Simons, *Economic Policy for a Free Society* (Chicago: University of Chicago, 1948), chaps. vii-x, particularly chap. ix.

on new Treasury issues in line with the market. Experience of the last few years seems to indicate that credit policy can exert a substantial influence on business conditions—though I believe current discussions suggest that the Federal Reserve and credit policy have as much to fear from their enthusiastic friends as from their enemies.

Finally, we need to explore further the question of how far debt management can not only help credit policy but play a limited role of its own in altering the volume of the public's spendable funds.