

Post-World War II Adjustment, 1945-1951

The coming of peace brought the opportunity for a fresh approach to our nation's economy after the trauma of depression and war. A new attitude, based on the belief that the market economy would respond favorably to a policy of enlightened government intervention of a limited and pragmatic nature, became prominent and provided the intellectual and political climate for legislation proclaiming a positive role for public policy. Reflecting the ideological shift away from laissez-faire induced by the experience of the 1930s, and apprehensive of how the economy would perform if government withdrew more or less completely from the economic playing field now that hostilities were over, Congress enacted the Employment Act of 1946. For the first time in our national history the government assumed responsibility for the management of the economy with particular emphasis on the maintenance of employment.

The Congress declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking work, and to promote maximum employment, production, and purchasing power.¹

The act created new governmental structures for monitoring, analyzing, and reporting on the economy, with the expectation that policies would be forthcoming appropriate to future needs and circumstances. Congress provided itself with the Joint Economic Committee, and the president was given

a Council of Economic Advisers. Since the Employment Act of 1946 states objectives for the nation, the Federal Reserve System is implicitly bound by it, but the objectives, of a broad and general nature, did not add to or subtract from the central bank's role in any noticeable way.

In the five-year period immediately following World War II, monetary policy was constrained by the fiscal/monetary policies that had been used to finance the war. Before a transition to a new peacetime mode could be effected, the start of the Korean War in June 1950 added a strong new dimension and urgency to monetary issues. The result was a major controversy between the Federal Reserve System and the Treasury in 1950–1951 that culminated in a landmark decision called the Accord which was announced on March 4, 1951, and which marked a major turning point in monetary policy.

There were two principal monetary legacies from World War II. One was inflation stemming from the huge war-induced accumulation of liquid assets; by mid-1948 this inflationary storm had blown itself out. The second legacy was the continuation of the pegging policy by the Federal Reserve System. With the start of the Korean War the system faced up to the inflationary potential of continuing its policy of support of the market for government securities dating from 1942, and went to the mat with the Treasury over this crucial issue. It is around these core problems that the following discussion is organized.

The 1946–1948 Surge of Inflation

At the beginning of 1945, as the end of World War II approached, economic activity peaked and then contracted slightly until October; a strong three-year expansion followed until November 1948. Contrary to widely held expectations, no depression occurred. The Office of War Mobilization and Reconversion projected unemployment of between 7,400,000 and 8,300,000 in 1946,² but unemployment kept below 2,500,000. Instead of sinking into the economic equivalent of Bunyan's Slough of Despond, economic activity turned out to be vigorous. It had been thought that the drastic decline in government war expenditures would bring on a painfully sluggish transition period until private expenditure could be rallied, but in fact expenditures for consumption, private investment, and exports were much greater than anticipated. Contrary to previous postwar experiences—the sharp collapse of 1920–1921, for example—the transition from war to peace was surprisingly smooth.³

The postwar inflation started slowly: by June 1946 the cost of living index was a mere 3 percent higher than the V–J Day level. Prices had been held in check during the war by direct controls which were in the process

of gradual relaxation. It would of course take time for the production of civilian goods to fill the shortages resulting from years of lost output when resources were directed to military purposes. But with the war over, there was public and congressional impatience with controls, and Congress allowed most wage and price controls to expire on June 30, 1946. After this the smouldering inflation quickly flared up as people sought to convert money and near-money into goods and services. Wholesale prices during 1946 increased more than for all of 1939-1945. The inflationary means were created during the war, but the effects were largely delayed until after the war, with a peak in prices coming in August 1948.

In short, more than 60 percent of the entire increase in the cost of living between 1939 and late 1948, and nearly 70 percent of the total rise of wholesale prices, occurred after the end of the war when government spendings had fallen far below their wartime levels and federal deficits were changed to surpluses.⁴

During the war, people save an unusually large share of their incomes; basic consumer goods were rationed to provide for equitable distribution and there was not much else to buy.⁵ By the end of the war, liquid asset holdings of the private sector (excluding financial institutions) were more than triple the prewar level, as shown in table 6-1.

The Washington economists responsible for forecasting postwar economic activity used prewar data to derive a consumption function, computed a multiplier, and made estimates for investment spending, government spending, and so forth. Their GNP prediction for 1946 proved to be far below the actual level, much to the benefit of the nation but embarrassment

Table 6-1
Estimated Liquid Asset Holdings of Individuals and Businesses,^a 1939,
1945
(\$ billion)

	1939 ^b	1945 ^b
Currency	5.8	25.5
Demand deposits	20.9	60.2
Time deposits	26.3	47.7
Savings and loan shares	4.0	7.2
U.S. government securities	12.0	86.9
Total	69.0	227.5

Adapted from Lester V. Chandler, *Inflation in the United States 1940-1948*. New York: Harper and Brothers, 1951, p. 79.

^aHoldings of banks and other financial institutions are excluded.

^bEnd of year.

of the forecasters. With the benefit of hindsight their big mistake became apparent: the consumption function had shifted upward as people drew on their vast holdings of liquid assets. The pent-up demand for consumer goods made consumer spending much larger relative to income than in prewar years for which data were available.

Considering the circumstances, the postwar inflation might have been considerably greater than it was. The rise in prices and incomes between 1946 and 1948 was attributable more to a modest rise in velocity than to a growth of the money stock in those years. $V1$ grew by 14 percent from its extraordinarily low level of 1946 but still in 1948 was far below the rates of the thirties; $M1$ was only 4 percent higher in June 1948 than in June 1946. Since the Federal Reserve System had not regained control of the money stock, its slow growth seems rather unexpected, perhaps even mysterious.

The foremost monetary puzzle of the immediate postwar period is why the money stock did not grow at a very much more rapid pace. This sharp difference from its behavior after World War I, when the most rapid rate of increase in the stock of money came after the end of the wartime deficits, does not reflect any fundamental difference in monetary policy. After both wars, the Reserve System continued the wartime policy of providing all the high-powered money demanded at a fixed rate: in World War I, through maintaining an unchanged discount rate; in World War II, through supporting the price of government securities at unchanged levels. And the reversal of the gold flows, from an outflow after World War I to an inflow after World War II, should have fostered a more rapid rate of monetary expansion after the later war.⁶

Both the low rate of increase in $M1$ and the small rise in $V1$ indicate that the public was willing to hold large amounts of liquid assets at low rates of interest. If the public had wished to sell off more of its income-earning liquid assets, the prices of government securities would have tended to fall, causing the Federal Reserve to buy more of them, thus boosting the monetary base and the money stock. If the public had wished to part with more of its money balances by spending for output, velocity would have risen more. But why should people have been content to hold an abnormally high ratio of liquid assets to income? More precisely, why was the public willing to reduce the ratio of its money and other liquid assets to its income so gradually? If it had been impatient to do so, the increases in the money stock and inflation would have been more pronounced. One reason the public did not spend more was the substantial government cash surpluses of \$5.7 billion and \$8.0 billion in calendar years 1947 and 1948. A second reason was the expectation of a major postwar slump accompanied by falling prices. Although inflation was indeed rife from mid-1946 to mid-1948, it

was widely viewed as the ride up on the roller coaster which would soon come hurtling down. If one thinks that prices will soon be plunging and jobs will be hard to get, there is good reason to hang on to cash balances and other liquid assets. Inflation during 1946–1948 caused concern, but deflation was expected to follow, and this expectation moderated the inflation.⁷

Removing the Peg

Adoption of the policy of supporting the government securities market in 1942 was quickly and easily done, and tended to create a harmonious “partnership” between the Federal Reserve System and the Treasury. Ending that policy after the war was a slow process that became an acrimonious struggle before a denouement was reached in the form of the Accord of March 4, 1951. In its later stages the dispute between the Treasury and the Federal Reserve System involved the president and Congress—it was an acute, even dramatic, struggle over the restoration of monetary control to the central bank. We will trace the relationship between the Federal Reserve and the Treasury from 1945 to 1951 to see how it was affected by changing circumstances until the Federal Reserve once again was in a position to carry out a flexible monetary policy of its own making.

During the war and for a time afterward, the Federal Reserve System willingly supported the government securities market, viewing its cooperation with the Treasury as necessary to meet urgent political and economic requirements of the times. But inflation and the specter of much worse inflation concerned the Federal Reserve authorities, understandably so of course, since they are traditionally and primarily responsible for preserving the value of the dollar. A central banker who isn't concerned about inflation is like a physician who isn't concerned about infection.

Early in the postwar period the Federal Reserve moved gingerly away from its wartime stance, inching its way toward a more independent policy, with the Treasury urging caution.⁸ In April 1946 the Federal Reserve System, against the wishes of the Treasury, eliminated the preferential discount rate on bank borrowings collateralized by government securities. On July 10, 1947, the first change was made in the pattern of rates on government securities when the Treasury bill rate was allowed to rise above its posted $\frac{3}{8}$ percent level. The Treasury agreed with this move apparently because the Federal Reserve System, on April 23, 1947, adopted a policy of paying about 90 percent of the net earnings of the Federal Reserve Banks to the Treasury.⁹ Shortly thereafter the rate on certificates was also raised. These relatively minor rate changes were adjustments in and not a repudiation of the policy of a fixed pattern of rates. The long-term $2\frac{1}{2}$ percent rate was still sacrosanct. In 1948 Allan Sproul, president of the Federal Reserve Bank of New

York, testified in favor of continued support of the market, and in 1949 the chairman of the Board of Governors, Thomas B. McCabe, confirmed the policy before a congressional committee.¹⁰

Continuation of the pegging policy clearly suited the Treasury's needs by holding down the interest cost on the national debt and easing the problem of rolling over (refinancing) the debt. But why, in view of its need to regain control over the money stock to ward off inflation, was the Federal Reserve willing to continue the wartime policy for some years into peacetime? Briefly and starkly put, the central bankers did not want to risk precipitating an economic collapse. The system's leaders maintained that they still had multiple objectives to meet, one of the most important being stability in the market for government securities. If market participants were to conclude that government securities would fall in value, financial institutions would experience an erosion of their assets, with the danger of a wave of bankruptcies. Credit might become extremely tight and costly. It was not primarily to assist the Treasury in its refunding operations that the Federal Reserve authorities continued to be so "cooperative," but to avoid serious damage to the national economy. They feared that a serious decline in production and employment would follow from a vigorous policy of credit contraction. Their statements imply no middle way between (a) supporting the market at stable prices and (b) withdrawing support regardless of what might happen to government securities prices and interest rates. It was a case of all or nothing. Presumably a policy of raising long-term interest rates gradually was viewed as inadequate to halt inflation but more than adequate to frighten bondholders into massive selling.

In August 1948, after the surge in the price level, Congress gave the Federal Reserve System temporary authority to increase reserve requirements and to restore direct control over consumer credit. Since prices peaked that same month, the timing was hardly ideal. The following year when Chairman McCabe asked Congress for authority to continue these powers, and to extend the reserve requirements to all insured banks, Congress turned thumbs down and allowed the temporary authority to lapse on June 30, 1949. By then prices were falling, so Congress saw no need to allow the Federal Reserve to keep the special inflation-fighting gear which had been provided when inflation was perceived as a present danger.

With the economy weakening in 1949, the Federal Reserve System shifted to a policy of increasing the supply of money. Now, for a time, the system could support lower interest rates; the Federal Open Market Committee announced that it was no longer committed to a fixed pattern of rates, meaning that rates could fall. But while the Federal Reserve would be flexible in allowing rates on government securities to fall during recession, would it pursue a symmetrical policy involving tighter money and higher interest rates when the economy became bullish again? Senator Paul Douglas of Illinois,

a distinguished University of Chicago economist, conducted searching hearings on monetary policy in 1949 and questioned Chairman McCabe concerning the extent to which the Federal Reserve System's new policy meant "flexibility both ways." McCabe said that the Federal Reserve System did indeed mean flexibility both ways, but he made it clear too that the continuing partnership between the Treasury and the Federal Reserve System required the Federal Reserve to convince the Treasury of any future need for rising rates. Yet while Treasury-Federal Reserve agreement and cooperation were stressed in public statements, basic considerations were driving a wedge between the two agencies. The Treasury's needs regarding debt management inhibited the Federal Reserve System from utilizing open-market operations to carry out its fundamental responsibility of controlling credit. This caused the system to be increasingly restive, and by 1950, as we shall see, it decided that it was necessary to break free of its bonds (or of the Treasury's bonds!).

The economic contraction that began in November 1948 did not develop into a depression or severe recession; the serious postwar slump had not just been late in arriving, it never materialized. By October 1949 the mild recession touched its low point, and a vigorous four-year recovery began. In 1950, however, a *deus ex machina* appeared: North Korea invaded South Korea on June 25, and three days later United States forces were ordered to aid South Korea.

The outbreak of the Korean War had a profound shock effect on the American economy. Coming when the memory of World War II was still green, and with the possibility that it might escalate into World War III, it touched off a speculative boom as consumers and producing firms, anticipating future shortages, bought all sorts of items—finished goods, intermediate goods, and raw materials. Wholesale prices rose by 16 percent from June 1950 to February 1951. Velocity rose rapidly as holders of liquid assets used them to add to their stocks of physical assets. As noted earlier, before 1950 the widespread anticipation of a major fall in prices had acted to restrain spending. As time passed, and with only a slight fall in the price level during the recession of 1948–1949, the basis for this expectation was eroded. The start of the Korean War led instead to expectations of scarcity and rising prices, so the psychological inhibitions against parting with liquid assets were replaced by incentives to do so. The surging demand triggered by the new war became the basis for severely strained relations between the Federal Reserve and the Treasury.

The officials of the Federal Reserve and the Treasury now had to set policy to finance the government's activities under obviously inflationary circumstances as military action expanded rapidly in an atmosphere of great uncertainty. The nation's resources were close to full employment in mid-1950, unlike the situation in 1939–1940. The two agencies could not reconcile their approaches: the result was serious disagreement that became

public in August 1950 and persisted until March 1951. The Federal Reserve authorities decided that they could no longer subordinate monetary policy to the financing and debt-management needs of the Treasury by supporting a fixed pattern of interest rates. In effect they issued a declaration of independence. The discount rate was raised in August 1950 and at the same time the Board of Governors and the Federal Open Market Committee announced their readiness "to use all the means at their command to restrain further expansion of bank credit consistent with the policy of maintaining orderly conditions in the government securities market."¹¹ They added that restraint was essential in the area of monetary and credit policy. The Federal Reserve timed its announcement shortly before the Treasury was to announce the terms of a large refunding operation, thereby putting pressure on the Treasury to set higher rates on the new securities than on the maturing securities. When the Treasury refused to be swayed and maintained the existing rates for its new securities, the Federal Reserve felt compelled to buy a major fraction of them to avoid having the Treasury offering overwhelmingly rejected by the market, but at the same time the Federal Reserve sold comparable securities from its large portfolio at higher yields. The dispute was thus evident in the market—the Fed had not backed down but had forced the controversy into the open. The "partners" could no longer settle their differences unobtrusively behind closed doors. As yet, however, the Federal Reserve limited itself to a moderate rise in short-term rates and held firmly to maintaining the 2½ percent rate on the longest-term bonds. Relations between the Treasury and the Federal Reserve continued to be strained for the remainder of 1950.

By early 1951 the key 2½ percent rate became a pivotal issue. After a meeting early in January of Treasury Secretary Snyder and Chairman McCabe with President Truman, Snyder stated publicly that the 2½ percent rate had been agreed upon for future Treasury financing. Shortly afterward both Sproul and Eccles openly expressed objections. Snyder was roundly criticized in the financial press for trying to intimidate Federal Reserve officials. The leading figures in the two agencies became deadlocked in a hostile atmosphere, unable to resolve their differences as the Treasury faced major funding needs. President Truman intervened by meeting with the Federal Open Market Committee at the White House on January 31, 1951. A White House press release followed, stating that the Federal Reserve authorities had pledged to support the stability of government securities for the duration of the emergency, meaning (according to a Treasury statement) stabilizing the market prices of government securities at existing levels. Some members of the Federal Open Market Committee, notably Eccles, made known that they had a different interpretation. The FOMC sent a letter to the president stating that they had assured him of their cooperation with the Treasury so as to maintain public confidence in the securities but omitting reference to a pattern of

rates. Press discussion continued around a theme of emasculation of the Federal Reserve's independence, and the mood continued to be rancorous. Then on February 19 Chairman McCabe took the bull by the horns by advising the Treasury that the Federal Reserve was "no longer willing to maintain the existing situation in the Government security market."¹² Congress, with Senator Douglas in the lead, indicated support for the Federal Reserve. The president set up a new ad hoc study committee, but the Federal Reserve and the Treasury avoided "outside" interference by reaching a settlement on their own in the form of the statement below issued on March 4, 1951. The accord is of great significance because it brought an end to Federal Reserve support of the government securities market at pegged prices and enabled the Federal Reserve to resume a truly independent monetary policy. Just what policies would emerge remained to be worked out, as we shall see in the next chapter.

The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and at the same time, to minimize monetization of the public debt.¹³

The buying binge and price inflation associated with the start of the Korean War subsided early in 1951. Consumer prices rose much more gradually and wholesale prices fell as anticipated shortages did not appear. Perhaps also, inflationary expectations were diminished by the well-publicized behavior of the Federal Reserve System as related to the accord.

To summarize the general behavior of the money stock over the five years beginning in mid-1946 it is convenient to divide the period into three parts. During the first eighteen months (June 1946-January 1948) M1 grew by 5.4 percent. It fell gradually for (almost) two years (January 1948-January 1950) by approximately 2 percent. Then for the last eighteen months (January 1950-June 1951) it rose by 6.6 percent. Between 1946 and 1948, velocity of M1 rose by roughly 14 percent, fell by 3 percent from 1948 to 1949, and increased by 19 percent between 1949 and 1951. For the whole five years from June 1946 to June 1951, the M1 money stock increased by only 10 percent; between 1946 and 1951 the velocity of M1 increased by 32 percent. Table 6-2 presents the data.

Table 6-2
Money Stock and Velocity of Money, 1946-1951

<i>Money Stock</i>	<i>June 1946</i>		<i>January 1948</i>		<i>January 1950</i>		<i>June 1951</i>	
M1	\$106.8 billion		\$112.6 billion		\$110.3 billion		\$117.6 billion	
M2	\$139.3 billion		\$147.9 billion		\$146.3 billion		\$154.0 billion	
<i>Velocity^a</i>	<i>1946</i>	<i>1947</i>	<i>1948</i>	<i>1949</i>	<i>1950</i>	<i>1951</i>	<i>1951</i>	<i>1951</i>
M1	1.52	1.62	1.73	1.68	1.89	2.00		
M2	1.16	1.23	1.31	1.27	1.43	1.53		

Adapted from Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States 1867-1960*, a study by the National Bureau of Economic Research. Princeton: Princeton University Press, 1963, pp. 718-719, 774.

^aVelocity refers to money income divided by the money stock.