

2 Marriner S. Eccles and Thomas B. McCabe: 1945–1951

The war with Japan ended in August 1945. The Federal Reserve had played a major role in the war effort by preventing the yield curve from rising and, especially, the rate on Treasury bills (hereafter, t-bills) from rising above 0.375%. As a result of its extensive purchases, the Federal Reserve's share of outstanding federal debt had risen by 50% between December 1939 and December 1945, more than half of which was in the form of t-bills.¹ The future course of the economy was very uncertain. A large number of economists feared that the economy might tumble back into a depression because of the expected large reduction in federal spending on the war and sharp reductions in armed forces personnel. Others recognized that production facilities had been severely depleted by high wartime operating rates and that stocks of consumer durables and housing were depleted by the Great Depression and wartime shortages. They feared that inflationary pressures would become very great, especially if rationing and price controls were removed quickly. Both would be removed in 1946. In addition to these concerns, the Federal Reserve was worried that a rise in interest rates might inflict large capital losses on banks and others who were holding bonds.² As a result, its initial policy in the postwar period was to continue pegging interest rates on government securities.

It is important to recognize that information available in 1945 was seriously incomplete as can be seen in Table 1. Quarterly National Income and Product Account (NIPA) statistics would not become available until 1947 and many financial measures that guided decisions in later periods were not available. The money stock measure, M1, is a rough approximation of the formally defined quantity, which the Federal Reserve began to report only in January 1959. The unemployment rate and civilian participation rates were redefined in 1948; comparable data for earlier years are not available.

¹See Goldenweiser (1951, pp. 197, 210).

²Interest rates and prices of bonds are inversely related; when market rates rise the prices of outstanding bonds fall.

Table 1. Summary Quarterly Data for 1945:1 through 1951:1

quarter	M1	dis- count rate	treas- ury bill rate	dis- count bor- rowing rate	unem- ploy- ment rate	civilian partici- pation rate	nomi- nal GDP	GDP defla- tor	annual % rate infla- tion	federal surplus	reserve bank credit
1945:1	n.a.	1.00	0.38	0.198	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	19.8
1945:2	n.a.	1.00	0.38	0.527	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	21.6
1945:3	n.a.	1.00	0.38	0.312	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	22.9
1945:4	n.a.	1.00	0.38	0.428	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	24.3
1946:1	n.a.	1.00	0.38	0.345	n.a.	n.a.	n.a.	n.a.	n.a.	-14.0	23.9
1946:2	n.a.	1.00	0.38	0.223	n.a.	n.a.	n.a.	n.a.	n.a.	-6.6	23.4
1946:3	n.a.	1.00	0.38	0.132	n.a.	n.a.	n.a.	n.a.	n.a.	-0.9	24.2
1946:4	n.a.	1.00	0.38	0.158	n.a.	n.a.	n.a.	n.a.	n.a.	0.9	24.4
1947:1	109.8	1.00	0.38	0.161	n.a.	n.a.	237.2	15.10	n.a.	5.9	24.2
1947:2	111.6	1.00	0.38	0.123	n.a.	n.a.	240.5	15.33	6.42	5.2	22.4
1947:3	112.6	1.00	0.74	0.117	n.a.	n.a.	244.6	15.60	8.46	2.0	22.5
1947:4	113.1	1.00	0.91	0.223	n.a.	n.a.	254.4	15.99	6.43	7.9	22.8
1948:1	113.1	1.25	0.99	0.219	3.7	58.7	260.4	16.11	3.29	7.7	21.8
1948:2	112.1	1.25	1.00	0.118	3.7	58.8	267.3	16.25	5.48	5.1	21.2
1948:3	112.2	1.41	1.05	0.103	3.8	59.0	273.9	16.56	4.14	1.4	22.1
1948:4	111.8	1.50	1.14	0.121	3.8	58.8	275.2	16.60	-0.30	0.2	23.9
1949:1	111.2	1.50	1.17	0.142	4.7	58.9	270.0	16.53	-2.99	-3.4	22.7
1949:2	111.4	1.50	1.17	0.125	5.9	58.8	266.2	16.35	-3.36	-6.5	20.8
1949:3	111.0	1.50	1.04	0.093	6.7	59.1	267.7	16.26	-0.96	-6.5	18.6
1949:4	111.0	1.50	1.08	0.099	7.0	59.4	265.2	16.27	-0.42	-6.2	18.5
1950:1	112.0	1.50	1.10	0.095	6.4	58.9	275.2	16.22	0.17	-8.4	18.4
1950:2	113.7	1.50	1.15	0.083	5.6	59.2	284.6	16.29	5.01	2.8	18.1
1950:3	114.9	1.61	1.22	0.128	4.6	59.3	302.0	16.63	7.99	13.5	19.0
1950:4	115.9	1.75	1.34	0.118	4.2	59.3	313.4	16.95	11.23	14.2	20.6
1951:1	117.1	1.75	1.37	0.261	3.5	59.3	329.0	17.58	8.42	17.2	22.9

Sources: Federal Reserve Bank of St. Louis FRED data bank and Board of Governors of the Federal Reserve System, (1976a). M1 was constructed by averaging monthly data from the last source, (p. 17). The inflation rate was constructed from the immediately preceding series (base 2000 = 100) as an arc elasticity, centered in each quarter. Data on the quarterly federal surplus are from the FRED data bank until 1947:1 and thereafter from the BEA web site. All dollar-denominated quantities are in billions of current dollars. The data reported in this and subsequent tables differ from information that was available to the Federal Reserve when it was making policy decisions, but generally not greatly. Later estimates are used in the hope that they are likely to be more accurate, but they are surely not error free.

The discount window and t-bill interest rates in the table clearly indicate that the Federal Reserve was shielding bondholders against rising interest

rates through the first half of 1947 in the presence of strong inflation. Then, at the end of Chairman Eccles term, first the t-bill rate and then the discount rate were allowed to rise.³ During these years the discount rate was always above the t-bill rate and, in this limited sense, a penalty rate. The rise in interest rates precipitated a controversy between the Eccles-era Federal Reserve and the Truman administration, which may have contributed to Eccles being replaced by McCabe as Federal Reserve Chairman.⁴ Unlike Eccles, McCabe was a more passive leader. Eccles, who remained on the Board, and Allan Sproul, the President of the Federal Reserve Bank of New York, often presented FOMC positions to the public. Rising interest rates and a 1948 tax cut led to growing federal deficits as can be seen in the table. The tax cut turned out to be fortuitously well timed because the economy was entering a recession, as can be inferred in the table from the civilian unemployment rate and the fact that real GDP was lower in every quarter of 1949 than it was in the last half of 1948.^{5,6}

Because of deflation beginning in the fourth quarter of 1948, it can be inferred that the real t-bill rate rose sharply then and stayed high into the second quarter of 1950, which implies that monetary policy was not expansionary. The Federal Reserve's efforts to raise short-term interest rates were not well timed, but were unlikely to have caused the recession. The recession ended in the first quarter of 1950 when real GDP rose rapidly.

A "normal" recovery from the recession was disrupted by North Korea's invasion of South Korea in June 1950. Apparently, U.S. consumers and firms vividly recalled World War II shortages, because they went on a buying binge that resulted in a high rate of inflation. Purchases of consumer durable goods jumped 20% in the third quarter and stayed high for the subsequent two quarters. Gross private domestic investment jumped

³Eccles was Chairman or Chairman Pro Tempore from November 15, 1934 through April 15, 1948.

⁴Eccles remained on the Federal Reserve Board until July 14, 1951, when he resigned. He was "demoted" to Vice Chairman by President Truman on April 15, 1948 when McCabe's appointment was approved by the Senate. See "McCabe Confirmed for Reserve Post," *New York Times*, (April 13, 1948, p. 39). For another interpretation of Eccles's demotion, see Meltzer (2003, pp. 656–657).

⁵Between the end of World War II and the early 1970s, the world was effectively in a quasi-fixed exchange rate system that had been constructed at the 1944 Bretton Woods conference. In such a system, fiscal policy is able to increase economic activity by cutting taxes and/or by increasing government spending.

⁶Real GDP in year 2000 prices equals one hundred times nominal GDP divided by the GDP price deflator. The real t-bill rate is the nominal rate minus the contemporaneous rate of inflation, as indicated by percentage changes in the deflator.

30% between the second and fourth quarters of 1950 and also stayed high for several more quarters. As is evident in the table, the GDP deflator rose rapidly after the second quarter. The annualized GDP inflation rate in the fourth quarter of 1950 reached 11%. In part because taxes were not indexed for inflation, the federal budget surplus rose rapidly toward the end of the period.

Because of inflation, real short-term interest rates were again negative. The Federal Reserve allowed nominal short interest rates to rise at the end of the period, but not by enough for investors to earn a positive real rate of return. The Federal Reserve recognized the problem and pushed hard to be released from its obligation to peg the yield curve and keep interest rates low. The Treasury continued to press for low rates so that war finance could be achieved inexpensively, as happened in World War II. The two agencies finally reached an agreement on March 4, 1951, the “Accord”, in which the central bank agreed to abstain from raising interest rates during periods when the Treasury was auctioning bonds, but was allowed to push interest rates up at other times if it wished.⁷ During the period when bonds were being auctioned, the Federal Reserve was said to be “even keeling.” The negotiations leading to the accord had been very contentious and led to the resignations of Thomas B. McCabe and Marriner S. Eccles from the Board in March and July 1951, respectively.

There are two further features of this period that should be noted for the subsequent discussion. First, the M1 surrogate variable in Table 1, which was not a focus of discussion during this period, loosely rose and fell in consonance with nominal GDP. However, the income velocity of money, the ratio of GDP to M1, varied considerably over time. The income velocity of money was 2.2 in the first quarter of 1947, 2.5 in the fourth quarter of 1948, and 2.8 in the first quarter of 1951. During this period there was not a tight relation between GDP and M1.

Second, the amount of credit extended by the Federal Reserve, the final column in Table 1, was quite variable. One reason for this was a large inflow of gold to the U.S.; the stock of gold rose from \$20.0 billion at the end of 1945 to a peak of \$24.6 billion in September 1949 as a consequence of other nations’ needs to pay for postwar reconstruction.⁸ It was necessary

⁷For interesting and informative brief surveys of the extended struggle leading to the Accord, see Degen (1987, pp. 113–117) and Mayer (2001, Chap. 4).

⁸There was a shortage of dollars in the immediate postwar period that led countries to send gold to the United States, which was then converted to dollars at the price of \$35 per ounce. At this time the Soviet Union was the principal innovator in establishing the postwar Eurodollar market when one of its banks began creat-

to offset this inflow with open-market sales of government securities by the Federal Reserve in order to avoid a potentially explosive expansion in banking system reserves. Inflows of gold would be negative in the subsequent twenty years, which would require open-market purchases. Another less important reason for fluctuations in Federal Reserve credit was that there were changes in reserve requirements on deposits at banks that were members of the Federal Reserve System. In 1945 reserve requirements on demand deposits were 20% at central reserve city and reserve city member banks and 14% at country member banks. Beginning in 1948 they were raised as the Federal Reserve desperately sought to fight inflation while keeping Treasury borrowing costs down. Reserve requirements were lowered to combat the recession in 1949 and then raised again in early 1951 as inflation reappeared.⁹ Apart from small increases between 1968 and 1973, this would prove to be the last time that reserve requirements were raised in order to fight inflation; this policy instrument would effectively be abandoned for reasons that are explained in the following chapters. Finally, there were fluctuations in currency in circulation both in the U.S. and abroad that needed to be accommodated.

Both nominal interest rates and monetary aggregates were concerns of the central bank, but the emphasis was decidedly on the former during these years. Undoubtedly, the reason for this was the continuing awkward relation between the Federal Reserve and the Treasury that had its origins in the pegging of the yield curve during and after World War II. Nominal interest rates would remain the principal indicator of the thrust of monetary policy in the next twenty years.

ing dollar-denominated deposits against which dollar-denominated drafts could be written. The drafts were widely accepted because they were backed by Soviet gold that could be converted into dollars. The Soviet Union was reluctant to use U.S. banks for fear that its dollar-denominated deposits would be confiscated. See Friedman (1971, p. 17).

⁹For details, see Board of Governors of the Federal Reserve System (1976a, p. 608). Friedman and Schwartz (1963, pp. 604–612) provide a useful discussion of changes in reserve requirements and other regulations during this period.



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