



Policy Note

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WRIGHT PATMAN'S PROPOSAL TO FUND GOVERNMENT DEBT AT ZERO INTEREST RATES: LESSONS FOR THE CURRENT DEBATE ON THE US DEBT LIMIT

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As the February 7 deadline for raising the US federal government debt limit approaches, discussion has concentrated on whether the eventual congressional resolution will require a government shutdown, a reduction in spending to match the increase in the limit, or some other last-minute measure. Such horse trading is not new; the limit has been used repeatedly in the past as a means of influencing a sitting administration's spending proposals (see Robinson 1959).

The current discussions are dominated by a belief that the size of the debt is simply too large to be financed and that the government risks bankruptcy. The favored solution is expenditure contraction to reduce the size of government, rather than tax increases. Previous congressional hearings on increasing the debt limit, held every time the limit is increased, have dealt with both theoretical and practical issues that seem to be missing in the current partisan debates.

The most perceptive analyses of the problem of financing large debt stocks have been advanced in times of war. Prior to World War I, the US Congress directly authorized any incremental increase in government debt required to meet the expenditures mandated in the budget. It was only in 1917 that Congress, facing escalating war expenses of unpredictable magnitude,

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passed the Second Liberty Bond Act, which amalgamated a number of prior borrowing authorizations and set an upper limit on overall debt issue. As rising deficit expenditures caused funding needs to surpass the prevailing debt limit, it was simply raised by amending the Act.

In 1943, a year after the United States entered World War II and more than a year before the Normandy invasion, Congress again faced unpredictably large war expenditures exceeding the prevailing debt limit. The congressional debates in January and February on legislation to amend the Second Liberty Bond Act to raise the debt limit contain an insightful discussion of the problems of financing what was expected to be a historic increase in government debt. Unlike current discussions, few congressmen were willing to argue that the increase in the limit should be used to constrain spending, but there was an informed discussion over how the increased expenditures could be financed.

In this debate, Representative Wright Patman proposed a plan that sought to facilitate financing of the increased debt. He considered an arrangement by which the US government would bypass the private financial system and place debt directly with the District Federal Reserve Banks as follows:

If it desires, the Treasury can deliver bonds to the 12 Federal Reserve banks directly and receive credit for the amount of the bonds on the books of the 12 Federal Reserve banks. Then as the Treasury pays its debts, checks are given on these 12 Federal Reserve banks and the funds are transferred from the Treasury to the ones receiving the checks. In this way the Government is paying interest to the Federal Reserve banks just the same as it pays interest to the private banks and to individuals, although the Federal Reserve banks operate on the Government's credit. (US House 1943, 41)

But Patman argued that even this particular arrangement would be illogical and inefficient. First,

if the receiver of a Treasury check . . . desires the money instead of credit in his local bank, he is given Federal Reserve notes. These notes are not obligations of the Federal Reserve banks, they are obligations of the United States Government. Therefore, the

Government and Congress, particularly, finds itself in the idiotic position of permitting the Treasury to deliver one form of Government obligation—interest-bearing notes—to the privately owned Federal Reserve banks and receiving credit therefor, and then when the Federal Reserve banks are called upon for the money they issue another form of Government obligation, Federal Reserve notes, to satisfy the demand. In each case Government obligations are used. The net result is that the taxpayers are paying [interest] for the use of their own credit. (41–42)

In addition, since US Code Title 12, Chapter 3, Subchapter VI, paragraphs 289 and 290, mandates the return of District Banks' profits to the Treasury to pay down outstanding government debt, the government is simply paying interest "for the use of its own credit," only to receive it back again to extinguish debt that it had had to create to pay the interest.¹

For Patman, the most obvious and simplest solution took the form of H.R. 1, "a bill providing for the issuance of non-negotiable United States bonds to Federal Reserve banks and terminating the authority of the Treasury to issue other interest-bearing obligations of the United States to commercial banks, and for other purposes" (US House 1943, 62). In simple terms, the bill required that all government debt be placed directly with the Federal Reserve Banks, eliminating the problem of market financing. Since the debt would not pay interest, it also eliminated the need to return the interest received by the District Banks to the Treasury, reducing the size of the accumulated debt.²

Today, this proposal sounds radical, if not wrongheaded. Discussion of the size of the government debt is now dominated by the idea that government spending is constrained by the necessity to convince bond market investors (sometimes called vigilantes) to buy government securities—and this means interest rates high enough to attract demand. Patman's proposal would seem to be based on a misunderstanding of the operation of financial markets and a sure recipe for government default and/or inflation.

However, Patman marshaled support for his proposal not only on constitutional grounds, but also by referencing the expertise of Federal Reserve and US Treasury officials on the subject of the operation of the US financial system.

He prefaced his argument by noting that the US Constitution, in Article I, section 8, reserves to Congress the “power to coin money and regulate the value thereof.” Supreme Court rulings on the 1862 Legal Tender Act extended this power to the issue of currency notes. In the United States, after the 1913 Federal Reserve Act, the Treasury was responsible for minting coin and the District Banks were responsible for issuing notes in a private-public partnership with the Treasury, but, contrary to the Constitution, the primary means of payment consisted of the deposit liabilities issued by private financial institutions. Patman thus concluded that

the Government of the United States, under the Constitution, has the power, and it is the duty of the Government, to create all money. The Treasury Department issues both money and bonds. Under the present system it sells the bonds to a bank that creates the money, and then if the bank needs the actual money, the actual printed greenbacks to pay the depositors, the Treasury will furnish that money to the banks to pay the depositors. In that way, the Government farms out the use of its own credit absolutely free. (US House 1943, 65)

Patman argued that not only is this arrangement unconstitutional, but it is also illogical and provides an unnecessary subsidy to the banking system. “I am opposed to the United States Government, which possesses the sovereign and exclusive privilege of creating money, paying private bankers for the use of its own money. These private bankers do not hire their own money to the Government; they hire only the Government’s money to the Government, and collect an interest charge annually” (US House 1943, 38). Patman argued that “if money is to be created outright it should be created by the Government and no interest paid on it” (64).

Patman supported his argument that the government in effect pays the banks to create what is in essence the government’s own money with the expert testimony of then-Chairman of the Federal Reserve Marriner S. Eccles,

the top authority of the Federal Reserve Board here in Washington, [who] testified before the Banking and Currency Committee of the House during the hearings on the Banking Act of 1935, on private banks

creating deposits and thereby becoming virtually private individual mints, as follows: “In purchasing offerings of Government bonds, the banking system as a whole creates new money or bank deposits. When the banks buy a billion dollars of Government bonds as they are offered—and you have to consider the banking system as a whole, as a unit—the banks credit the deposit account of the Treasury with a billion dollars. They debit their Government-bond account a billion dollars, or they actually create, by a bookkeeping entry, a billion dollars.” (US House 1943, 60–61)

The same is true, Patman added (again with the aid of Eccles’s testimony), of sales of government debt to the Reserve Banks, which are technically private institutions:

When the Honorable Marriner S. Eccles, Chairman of the Federal Reserve Board, was before the Banking and Currency Committee of the House . . . on Tuesday, September 30, 1941, I interrogated him about how he obtained for the 12 Federal Reserve banks the \$2,000,000,000 in Government bonds, which the System is now holding and charging the Government interest thereon . . . :

“MR. PATMAN. *** How did you get the money to buy those \$2,000,000,000 in Government securities?”

“MR. ECCLES. We created it.

“MR. PATMAN. Out of what?”

“MR. ECCLES. Out of the right to issue credit, money.

“MR. PATMAN. And there is nothing behind it, is there, except the Government’s credit?”

“MR. ECCLES. We have the Government bonds.

“MR. PATMAN. That’s right; the Government’s credit.” (62)

Congressman Patman need not have interrogated the chairman. He could simply have based his argument on the pamphlet *The Federal Reserve System—Its Purposes and Functions*, published by the Fed itself and dated May 1, 1939, which clearly states,

Federal Reserve Bank credit . . . does not consist of funds that the Reserve authorities “get” somewhere in order to lend, but constitutes funds that they are

empowered to create. The process of creation is one of giving the promises of the Federal Reserve Bank—in the form of Federal Reserve notes and reserve deposits—in exchange for the promise made by others to the Federal Reserve Banks, the reason for the exchange being that the Federal Reserve Banks’ promises are recognized by law as having a particular monetary utility not possessed by the promises of individuals and institutions. (Federal Reserve 1939, 85)

It also notes that “a bank’s purchases of investments, i.e., notes, bonds, mortgages, etc., is an extension of credit just as loans are; and bank investments increase bank deposits just as loans do. For the sake of simplicity, the terms ‘lending and extension of credit’ are often used where the purchase of investments by banks as well as lending by banks is meant” (40).

Congressman Patman was thus led to conclude that when the government issues bonds to finance its war expenditures, the sale to banks is completed by the creation of private bank deposits, which the government uses for its expenditure at a cost of the interest paid to the banks. In addition, the banks have the bonds available for collateral against the creation of reserve credits at the Federal Reserve, which would allow them to create additional deposits through additional purchases of government securities or to pledge them against the receipt of Federal Reserve notes. Since the government could arrange this operation directly, Patman argued that the interest received by the banks or the District Federal Reserve Banks is a direct subsidy to the banks and an unnecessary cost to the government, and thus to taxpayers.

He proposed in H.R. 1 that the Treasury should create a nonnegotiable zero interest bond that would be distributed to the Federal Reserve Banks in exchange for reserve credits at the District Banks, which could be used for expenditures or converted into Federal Reserve notes to be used to finance government expenditure. The bonds would have a maturity of 40 years or less and, being nonnegotiable, would not be available for sale to the public. There would be a prohibition on selling any additional government bonds to commercial banks, and he also noted that the public would not be likely to seek to acquire them (although the recent postcrisis experience suggests otherwise).

As mentioned, this proposal appears radical, except that it is close to the policy currently employed by the Federal Reserve in the form of zero interest rates (ZIRP); a policy that some

analysts have suggested may become permanent, while others have argued that, as a theoretical matter, the interest rate on government securities should be zero because they are free of credit risk. Indeed, Patman’s proposal might thus be seen as an early and extreme form of the exceptional monetary policy implemented through ZIRP and QE (quantitative easing), for it would set the short-term bill rate at zero and produce the equivalent of a flat Treasury yield curve, since all financing could be achieved by rollover of short-term bills. If the policies are equivalent, why have the Fed and the Treasury not introduced Patman’s proposed solution—since it would seem to satisfy the policy objectives of both?

To see why there may be resistance to the Patman proposal, consider the implications of the financing of government debt at zero interest rates. As argued by Mathew Forstater and Warren Mosler (2005), any “government deficit spending results in net credits to member bank reserve accounts. If these net credits lead to excess reserve positions, overnight interest rates will be bid down by the member banks with excess reserves to the interest rate paid on reserves by the central bank” (538). Since paying interest on bank reserves is equivalent to paying interest on government debt, a zero interest rate paid on government debt means a zero rate on reserves and a zero interbank rate. Now, the Fed does not in fact determine the Fed funds rate; it sets a target rate and then engages in open market operations to induce the market to that rate. But with zero interest government bonds there would be no open market operations and the Fed would lack a tool to generate a positive interest rate. If the Fed were employing a ZIRP/QE policy, Patman’s proposal would not create a problem, as the Fed’s policy rate and the government debt rate would both be zero.

However, if the central bank seeks to impose a policy rate above zero, it can only do this by selling debt at a positive interest rate, paying interest on excess reserves, or increasing required reserve requirements³ sufficiently to absorb the excess reserves created by the deficit spending. Indeed, Patman’s proposal would have worked perfectly well during World War II had the Fed introduced it, rather than setting short rates near zero and pegging long rates at 2.5 percent.

But the policy was not followed. Instead, the “wholly unsound” principle of “borrowing from the commercial banks before borrowing from the Federal Reserve” was adopted, as Richard A. Musgrave described it in his contribution to a 1951 joint congressional committee report (US Congress 1951, 70).

As a result, Patman's proposal became unworkable in the postwar period, as the commercial banks built up large holdings of government securities that could be readily converted into reserves if the Fed accepted the request from the Treasury to keep rates constant. It is interesting that, in contrast to Patman's focus on keeping Treasury securities out of the portfolios of the commercial banks, this postwar discussion concerned how to keep the securities in the banks' portfolios and prevent them from being converted into reserves to back expanded lending. Thus, the compatibility of zero interest on government debt and zero policy rates produced a conflict in policy under more normal conditions, as would be seen in the discussions that eventually led to the Fed–Treasury Accord of 1951.

As Forstater and Mosler observe,

If the central bank has a positive target for the overnight lending rate, either the central bank must pay interest on reserves or otherwise provide an interest-bearing alternative to non-interest-bearing reserve accounts. This is typically done by offering securities for sale in the open market to drain the excess reserves. . . . Where interest is not paid on central bank reserves, the “penalty” for deficit spending and not issuing securities is not (apart from various self-imposed constraints) “bounced” government checks but a zero percent interbank rate. . . .” (2005, 538–9)

In short, if the Fed believes a positive policy interest rate is required to combat excessive monetary expansion supporting inflation, Patman's zero rate on government debt cannot be implemented unless a positive interbank rate can be achieved without selling interest-paying debt to the banks through open market arrangements.

The solution that was first proposed by the Federal Reserve in its annual report for 1945 and repeated annually until the Fed–Treasury Accord of 1951 was for additional authority: “to empower the Board of Governors to require all commercial banks to hold a specified percentage of Treasury bills and certificates as secondary reserves against their net demand deposits” (Federal Reserve 1946, 8).⁴ It was also noted that the measure, “by thus partially insulating a portion of the public debt, would make it possible to limit the volume and raise the cost of private credit without necessarily increasing the interest cost to the Government” (Federal Reserve 1948, 9).⁵ In

congressional testimony, economist Richard Musgrave supported this view:

By transforming [Treasury] debt into supplementary reserves, the holding of which would be mandatory in addition to prevailing cash reserve requirements, a setting may be created in which the availability of private credit may be restricted and short-term commercial rates may be permitted to rise without, at the same time, incurring an increase in interest payable on the bulk of bank-held Treasury debt. (US Congress 1951, 69)

The lessons of this discussion are: first, that the problem of financing the debt is not the issue—the Federal Reserve can finance any level of the debt the government desires—and second, that the debt can be financed at any rate the government desires without losing control over interest rates as a tool of monetary policy. The question is whether the size of the deficit to be financed is compatible with the stable expansion of the economy. That is, will the deficit contribute to inflationary speculation or to increased output and employment?

This is the issue that was raised by the Fed in the aftermath of the Korean War, when the Treasury sought to maintain Fed purchases of debt to support interest at wartime levels, and the Fed believed that it was necessary to reduce credit expansion by raising rates to combat inflation. Thus, the question at issue was the same as that raised by the implementation of Patman's proposed legislation: how to produce an increase in rates without increasing the rate of interest paid on government debt. The operative solution, in the form of the Fed–Treasury Accord, was followed up with a major congressional investigation, culminating in a report of the Subcommittee on General Credit Control and Debt Management and a series of hearings and expert testimony on that report (US Congress 1952).

The crux of the problem is evident in this exchange between Senator Paul Douglas and Secretary of the Treasury John Snyder:

SENATOR DOUGLAS. . . . If the Federal Reserve is asked to buy large quantities of Government securities in the open market, does it not create added bank reserves in the Federal Reserve System, and the answer to that has been “Yes”; isn't that correct?

SECRETARY SNYDER. That is correct.

SENATOR DOUGLAS. The next question was, with added bank reserves in the Federal Reserve System, does this not lead, too, to increased bank loans, and the answer was “Yes.”

The third question was do these increased bank loans in a period of comparatively full employment lead to an increase in production or do they lead to an increase in prices? . . .

SECRETARY SNYDER. Well, they could well lead to an increase in prices.

[. . .]

SENATOR DOUGLAS. . . . What I am asking is: Should it not be a function of Government to prevent the supply of bank credit from expanding more rapidly than the quantity of physical production, because if the quantity of bank credit does expand more rapidly than the quantity of physical production the inevitable result, as you have admitted, is an increase in prices. (US Congress 1952, 20–21)

The exchange makes clear that the relevant question is not whether or at what rate the debt issue can be sold; it is whether the economy is near full employment. At that point, the size of the deficit does become an issue—but not because of financing constraints or an irresolvable tension between desired bond rates and desired policy rates. With the aid of supplemental required reserves, the government can maintain low or zero bond rates while allowing the policy rate to rise. However, as Eccles notes (1947), the special reserve measures proposed by the Fed would have to be accompanied by a reliance on fiscal policy: “We should have the largest possible budgetary surplus while the inflation danger exists” (2–3). But this is simply another version of Abba Lerner’s idea of functional finance (1943). The government deficit and outstanding debt should be determined by the level of activity, not the size of the outstanding debt or deficit and whether or at what rate it can be financed. In the context of the current discussion of the increase in the debt limit, it seems clear that the economy is not facing the risk of rising prices—indeed, the Fed is doing its best to prevent deflation. In which case, the size of the debt and the deficit should not be the major concern in the debate over raising the debt limit.

Notes

1. Section 7 of the original Federal Reserve Act reads: “After all necessary expenses of a Federal reserve bank have been paid or provided for, the stockholders shall be entitled to receive an annual dividend of six per centum on the paid-in capital stock, which dividend shall be cumulative. After the aforesaid dividend claims have been fully met, all the net earnings shall be paid to the United States as a franchise tax, except that one-half of such net earnings shall be paid into a surplus fund until it shall amount to forty per centum of the paid-in capital stock of such bank.”
2. After the 1935 reform of the Federal Reserve, direct acquisition of government securities was limited. But Patman noted that direct acquisition had already been authorized by the Second War Powers Act of March 27, 1942, for three years, to a limit of \$5 billion, and that such authorization could easily be extended for a longer period and to the new proposed debt limit of \$210 billion. It was eventually extended to 1950, but the original limit was maintained.
3. A variant of this solution was proposed after the war, when the Fed sought to impose supplemental reserve holdings of Treasury securities.
4. This proposal was never implemented because it would have required a change in the legislation governing the calculation of reserves, which were originally linked to the classification of banks as central reserve city, reserve city, or country banks. The shift to graduated requirements on deposit liabilities was only implemented in the 1960s.
5. This judgment is more fully explained in Eccles (1947).

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