TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

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FROM Mr. Edmiston

TO Mr. Eccles

Federal Reserve Control of Inflation and Deflation.

Powers to Control Inflation.

The major powers of the Federal Reserve System to control inflation rest in its determination of rediscount rates and its open-market operations used jointly or separately.

Rediscount rates.

In the face of credit expansion and boom conditions the Banks and the Board may increase the rediscount rates, thereby increasing the cost of accommodations to member banks and hence tightening money rates in the open market. This tightening tends to carry over to the long term market, thus discouraging borrowing on long term and bringing new investment (at least when financed by bonds) to a halt.

Open-market operations.

In order to make the increases in rediscount rates felt, it is essential that member banks be borrowers at the Federal. To force indebtedness the Federal may sell government securities, pulling funds out of the market and thereby drawing down reserve balances which must be replaced. This not only makes increases in rediscount rates effective, but also tends to prove a further deterrent to expansion in that American bankers have a tradition against excessive indebtedness and there is a tendency to credit contraction rather than to go into debt even to the Federal to replace depleted balances.

In addition the Federal Reserve may apply the following methods to stop unwise credit expansion.

Qualitative control by direct action.

Under the law the Board may withhold Federal Reserve accommodations from banks which are deemed using Federal Reserve funds to finance speculation. There is no doubt that this power could be effectively used to curtail expansion but it is a drastic measure and might appear, at times, as an unwarranted discrimination against particular banks. Another difficulty with this type of action is that it is hard to tell which banks to apply it to. The calls for accommodation may come from banks which are using funds for so-called legitimate purposes, but after turnover in the banking system the funds are ultimately placed into speculative channels.

Moral suasion and publicity.

Federal reserve authorities may appeal to banks to curtail loans by pointing out there is an unhealthy credit situation developing and this may bear weight with certain bankers. (Much of the Bank of England's influence is attributed to this type of cooperation.) Also by giving publicity to their views the Board may be able to direct banking sentiment into action which will curtail further expansion.

Effectiveness of control measures.

It seems to me that the Federal Reserve System has rather strong potential powers to control an undesirable inflation of bank credit. Especially is the system in a favorable position in view of its present holdings of $2\frac{1}{2}$ billions of governments which can be sold if occasion demands. However, it is of major importance that the Federal Reserve controls be applied at relatively the early stages of a boom. Here to my mind is the greatest weakness in

Federal Reserve machinery, namely, to get quick and decisive action, and is the result of two major factors:

(1) The failure to set up the criteria for guiding credit policy, which is attributable in part to the poor state of our economic knowledge.

(2) The decentralization of authority which means a time consuming process before an agreement as to positive action is reached. The tendency of the human animal is to delay, and in central banking this delay often proves fatal. When the Reserve Banks, the Open-market Committee, and the Board must all be reconciled and committed to a change of policy the situation may well get out of hand. For example, in 1929 for months before the crash the New York Bank was urging higher rates, but the Board and other Federal Reserve banks were unconvinced, and instead dabbled around with ineffectual efforts to keep funds out of speculative channels. Undoubtedly a greater centralization of control and responsibility is needed.

Along this line, Fortune for May, suggests that control be placed in the hands of professional central bankers, like the late Governor Strong of New York, with as a logical successor his protege, Governor Harrison.

Powers to Control Deflation.

Here again the major controls are rediscount rates and open-market operations. Again speed seems essential, especially in the purchase of governments in order to provide the banks with plenty of funds and thus relieve pressure of deflation. Of course, here again delay is now inevitable. However, Federal Reserve control of deflation appears to me much less effective because banks usually go into depressions with indebtedness at the Federal and this is paid off first if funds start to accumulate (even if the funds come from Federal Reserve action in purchasing governments). Also runs and outflows of gold in the past have intensified liquidation. Deposit issuance and gold export prohibitions may diminish the influence of these factors in the future.

Moreover, after depression, conditions and pyschology are far advanced, Federal Reserve action has negligible effect.

To lower rediscount rates means nothing with short-term money on almost a no-yield basis, and with opportunities for so-called sound loans unavailable banks receiving new funds as the result of Federal open-market purchases will allow them to pile up as excess reserves. In other words, the Federal Reserve can give the banks funds, but it cannot force them to lend them.

Treasury action and Government spending in many ways exert central banking functions and have a tremendous effect upon the monetary base. I think a supplementary memorandum upon these operations might interest you?