To: Mr. Eccles

From: Woodlief Thomas October 10, 1950.

Attached for your confidential information is a summary or brief of principal points with reference to recent Federal Reserve policies and the Government securities market.

W. T.

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Confidential October 10, 1950

FEDERAL RESERVE POLICIES AND GOVERNMENT SECURITIES

Nature of Problem

1. Grave inflationary dangers are presented by the defense program, because of

   (a) Increase in national income resulting from additional Government expenditures without increase in goods available to consumers.

   (b) Possible shortages and rising prices give stimulus to increased buying financed from accumulated savings or borrowing as well as from increased income.

2. Limited program does not require comprehensive harness of rationing and price controls, but general limitations of buying power through vigorous fiscal and credit restraints, as stated in President's Midyear Economic Report

   > "First of all, for the immediate situation, we should rely in major degree upon fiscal and credit measures. These general measures can be helpful not only in restraining inflationary pressures, but also in reducing the civilian demand for some specific products, such as automobiles and housing, thus making available for necessary military use a larger proportion of an already short supply of some critical materials. The more prompt and vigorous we are with these general measures, the less need there will be for all of the comprehensive direct controls which involve the consideration of thousands of individual situations and thus involve infinitely greater administrative difficulties and much greater interference with individual choice and initiative."

   Also stated by Senators Douglas, Fulbright, and Flanders in the Report of the Senate Banking and Currency Committee on the Defense Production Act of 1950

   > "The primary method of dealing with inflation should be the coordinated use of proper monetary, credit and fiscal policies, which can actually prevent inflation. Higher taxes, on personal and corporate incomes, and excess profits taxes should be given an opportunity to work their effect, preferably before the country is placed in the economic strait-jacket of another OPA, or at least simultaneously with such controls.

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> Credit should be restrained by controls on installment buying, real estate credit, and general bank credit; and these controls should be coordinated with each other. The Treasury's debt-management policies should be reexamined, especially in view of the new situation, and they should be coordinated with the duties of the Federal Reserve Board to restrain credit."

3. Credit restrictions are important because great expansion can occur, and is occurring, before fiscal and other measures begin to operate.

   Bank loans increased 4 billion dollars in third quarter - unprecedented for period.

   Money supply--deposits and currency--increased 2.3 billion, about same as in inflation year, 1947.

   Turnover of existing money supply has also increased.

   Reflected in sharp and continued rise of prices.

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4. Means of credit restraint

(a) Selective controls - restraints already applied and Board is under pressure to make very restrictive.

	(In billions of dollars)	
	Amount Outstanding	Yearly Increase
Consumer credit (Reg. W)	21.0	4.5
Installment credit	(13.0)	(3.4)
Real Estate credit (Reg. X)		
Nonfarm mortgages	41.0	6.0
Security loans (Reg. T)		
Debit balances at brokers	1.2	.5

(b) General controls over supply and cost of bank reserves.

Much more important, broader in scope, and more basic. Affect commercial banks, which are ultimate source of all credit and money supply.

	(Estimates)	
	Sept. 30 Outstanding	Yearly Increase
Loans & investments, total	123.8	+5.2
Loans	48.9	+7.2
U. S. Government obligations	63.1	-3.6
Other securities	11.8	+1.6
Reserves with F. R. Banks	16.7	+ .7
Required	15.9	+ .7

Applied through -

(1) Rediscount rate on advances to banks, now 1-3/4 per cent

(2) Reserve requirements - now near legal maximum - average about 16 per cent of deposits

(3) Open market operations - buying and selling Government securities

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5. Principal source of increased credit arises from sales by banks and others of short-term securities to the Federal Reserve.

   (a) Traditionally source was member bank borrowing at rediscount rate from Federal Reserve, supplemented by occasional open market operations.

   (b) Because of great importance of public debt in the economy, however, Federal Reserve has responsibility to maintain orderly market, and must buy or sell regularly.

   (c) But to buy at fixed rate of interest below prevailing rates in market encourages banks to sell Government securities in order to make other loans.

   (d) Purchases by Federal Reserve increase bank reserves, which provide basis for six-fold expansion in bank credit.

   (e) Process illustrated by events since May 3 -

   Treasury attempted to refund issues maturing June 1 and July 1 and again September 15 and October 1 with 13-month notes at 1-1/4 per cent, which was below prevailing market rate.

   Refunding made possible only by Federal Reserve purchases. In August and September System bought 8 billion of maturing issues, added to 2.4 billion previously held, out of 13.6 billion of total issue. Cash redemptions were 2.4 billion. Purchases partly offset by sales of other issues and by gold and currency outflow.

   Changes in reserve position were as follows:

	May 3 - Aug. 16	Aug. 16 - Oct. 4
Federal Reserve holdings of U. S. securities		
Treasury bills	- .1	-2.9
Certificates and notes	+2.0	+4.8
Bonds	-1.4	-0.9
Total	+0.6	+1.0
Other principal factors affecting reserves		
Gold stock	-0.3	-0.5
Currency in circulation	+0.1	-0.2
Member bank reserves		
Total	+0.3	+0.3
Required	+0.4	+0.2
Excess	-0.1	+0.2

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6. Federal Reserve can not restrain credit while it continues to expand reserves in this manner.

    (a) Limitation on purchases would result in rise in short-term interest rates,

        If banks continue to try to sell to obtain funds to lend.

    (b) Higher rates (lower prices of securities) would have following results -

        (1) Discourage bank sales of securities.

        (2) Rise in rates would bring in buyers other than Federal Reserve - no increase in reserves.

        (3) Rise in interest might also discourage borrowers.

7. Increase in reserve requirements

    Force banks to sell some of Government securities to Federal Reserve to obtain additional reserves required.

    Would reduce bank's supply of liquid secondary reserves.

        Discourage selling more securities to make loans.

    More restrictive if short-term interest rates were permitted to rise first.

    Remaining power permits increase of 2 to 2-1/2 billion in required reserves.

        Member banks hold over 40 billion of short-term Government securities, from which to meet increase.

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8. Relation of short-term and long-term rates.

Would rise in short-term rates depress long-term bond prices below par? Probably not.

(a) Short-term rates very low relative to long-term rates.

Usually in periods of active credit demands, short-term rates have been higher.

(b) Long-term rates have been tending to decline.

Persistent investment demand.

(c) Temporary fluctuations of speculative nature would be moderated by Federal Reserve support to bond market.

(d) System would limit rise in short-term rates if it tended to depress bond prices.

(e) Higher short-term rates should not diminish demand for savings bonds.

Rates are not in question.

Buyers should prefer them to marketable issues because of protection against price fluctuations.

Willingness to buy savings bonds affected more by confidence in value of dollar (avoidance of inflation) than by market prices of marketable securities.

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9. Effectiveness of recent Federal Reserve policies

(a) Since adoption of more restrictive policy bank credit has continued to expand at unprecedented rate.

(1) Partly seasonal

(2) Partly based on earlier commitments

(3) Various powerful stimulants--due to defense program--could not be stopped but may have been retarded.

(b) No genuine test of policy

(1) System continued to buy maturing issues at low rates to assure success of Treasury refunding.

(2) Had to sell other issues to absorb increased reserves - more difficult and less effective than refraining from buying.

(3) Rate rise very small so far - only 1/8 of one per cent.

Bill rate from 1.18 to 1.33
One-year rate from 1.23 to 1.35
Bonds declined slightly in price

(c) Policy should be continued if credit is to be restrained.

(1) No longer necessary to support refunding.

(2) Banks again are selling one-year securities at current rates to obtain reserves.

(3) Rate structure in market is distorted - rate for 3-month bills (1.33) too close to supported rate on one-year notes (1.35) and below unsupported rate on one-year bonds (1.46) - should be permitted to adjust to normal relationships.

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Division of Responsibilities

Treasury function is to finance Government in most economical manner possible, with due regard to short-run and long-run effect on general economic growth and stability.

Should establish terms and rates on securities in accordance with market demands.

Does not have power to determine what rate of interest investors are willing to receive - rates in market are determined by supply of funds available and existing demands for them - also by anticipations.

Unlimited Treasury borrowing at artifically low rates only possible if Federal Reserve creates additional money and bank reserves--inflationary policies.

Government should avoid accusation of "rigging the market" for its own securities - will affect confidence in bonds.

Federal Reserve is responsible for regulating supply of credit and money in accordance with needs of commerce, industry, and agriculture with view to economic growth and stability.

Federal Reserve can create money and can to a considerable degree determine the level of interest rates.

Cannot, however, maintain a rigid level or structure of rates regardless of market forces of demand and supply, without causing either inflation or deflation.

Should not be called upon to buy any amount of Government securities at rates below those determined by market forces.

Inevitable result, in a period of strong credit demand, would be inflation.

Federal Reserve, nevertheless, has responsibility under existing conditions for maintaining orderly market for Government securities.

Should moderate market fluctuations, especially if caused by temporary or speculative forces, but should not eliminate them.

Should also for present prevent decline in long-term bond prices.

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Problems of credit policy and debt management are partly technical, concerning

Relationships between different parts of market

General market psychology

Appraisal of various short-run and long-run factors.

Federal Reserve can advise Treasury of its judgment as to market conditions, which Treasury should take into consideration in determining debt-management policies. But if Federal Reserve is required continuously to support prices that are contrary to market forces, inflation will result.

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