FEDERAL RESERVE BANK
OF NEW YORK

New York 45, N. Y.,
May 1, 1951.

To Member Banks in the
Second Federal Reserve District:

As directors of the Federal Reserve Bank of New York, elected by you, we have had in mind repeating the experiment of last September, when we tried to give you a report on our stewardship which went somewhat beyond the regularly published reports of the bank. The period of public discussion of Treasury and Federal Reserve policies since our first letter might have seemed a good time for such a second attempt. Our position as directors of one of the Federal Reserve Banks made it appropriate, however, for us to refrain from discussing these matters in this way while the Treasury and the Federal Reserve System were adjusting their differing views as to the means and methods of fighting inflation in the area of debt management and credit policy. And now that these differences have been resolved in the accord announced March 4th, the implementation of the agreement is more a matter of coordinated action than of exposition by us. We do feel that it may be helpful, however, to review with you the broad range of credit policy problems which now face us, in the light of the new circumstances growing out of the Treasury-Federal Reserve agreement.

The agreement has encouraged us to believe that we in the Federal Reserve System are in a better position than before to discharge our responsibilities and to combat inflationary pressures. Since the outbreak of the war in Korea, last June, a number of actions have been taken by the Federal Reserve System to restrain bank credit expansion. In individual credit areas where inflationary pressures were greatest, or promised to become troublesome, selective controls were imposed or made more severe. They had as their purpose restricting the further growth of consumer instalment credit, real estate mortgage credit, and credit to finance the purchase of securities. In the field of general credit control, where the object of action is to make access to reserve funds (which banks must have to support a further expansion of loans and investments) more difficult and costly, the Reserve Banks increased their discount rates and, during January, the Board of Governors increased the reserve requirements of all member banks of the System.

As bank credit continued to expand at an unprecedented rate during most of this period, however, it became clearer that further steps should be taken to restrict the acquisition of additional reserve funds by member banks. This could be accomplished only by limiting the sale of Government securities, by these banks or by other investors, to the Federal Reserve Banks. Unless the

Federal Reserve System could regain some initiative in its open market operations, other measures to restrain credit expansion were severely handicapped if not nullified.

The essence of the agreement between the Federal Reserve System and the Treasury is the restoration of the necessary degree of initiative to the System in its open market operations, with which is combined the continuing responsibility of maintaining conditions in the Government security market which will enable the Treasury to meet the Government's refunding requirements, and its requirements for new money if needed. These objectives are now being worked out on a cooperative basis, both in terms of credit policy and of debt management. The Federal Reserve System continues, of course, to recognize and discharge its responsibility for the maintenance of orderly conditions in the Government security market.

Limitation of the supply of reserve funds through restored initiative in open market purchases of Government securities by the Federal Reserve Banks may do more than give effect to official policies; it may also give a necessary boost to the Program for Voluntary Credit Restraint. As you know, under the Defense Production Act of 1950, committees of commercial bankers, investment bankers, and life insurance representatives—with participation of Federal Reserve officials—have been appointed and are starting to function throughout the country, assisting lenders of various kinds in their determination to avoid making non-essential loans, and to hold less essential loans to a minimum. So long as reserve funds were readily and freely available at the Reserve Banks, and so long as competition for new business within and between financial groups was so keen, the odds against the success of a program of voluntary credit restraint were great. Now that the availability of reserve funds is under some control again, and now that measures of voluntary credit restraint have legal sanction, this undertaking of the financial community can be a useful supplement to the general control measures of the monetary authorities.

For the year as a whole the goal should be no increase in the aggregate volume of credit extended by all banks of the country. A decrease in the use of credit for ordinary personal and business purposes should, if possible, offset the increased use of credit for defense purposes. Any substantial increase in total bank credit would, in the end, only create more dollars to compete for a limited supply of goods. We do not predict scarcities or shortages, but there is no getting around the fact that the civilian economy will have less real goods and services at its disposal over the next year or two than it would have if so much of our productive capacity did not have to be channeled into defense requirements.

It may be, of course, that the crest of the wave of bank credit expansion has passed, for the moment. In so far as this expansion was based on swollen inventories, signs are not lacking that liquidation has begun, at least in some lines, and this should be reflected in a decline in the volume of bank credit. We cannot rely on this, however, nor would it wholly solve our problem. Another potential, if not actual, inflationary force has appeared which also complicates a program of general credit restraint. This is the problem to which the national Voluntary Credit Restraint Committee recently turned its attention in its Bulletin No. 2 urging restriction of business capital expenditures, where such expenditures will not tend to increase output essential to the defense effort.*

The direct demand for bank credit, growing out of business capital expenditures, may not be too great. To the extent that such expenditures are not financed out of internal resources, they pre-

* This bulletin was sent to you on April 20, 1951 by the Second District Commercial Banking Voluntary Credit Restraint Committee.

sumably will be financed by insurance companies, and in the capital market. But if expenditures for capital investment exceed the total of corporate and individual savings during the remainder of the year and if, in addition, substantial amounts of such savings have been committed in advance for confirmed projects, the indirect effects on credit policy could be disturbing. They would be particularly disturbing if institutional holders of Government securities should seek to sell a large volume of such securities in a short time, in order to obtain funds with which to take up past commitments or to finance new commitments for capital expenditures. Coming at a time when the Treasury will be in the market with substantial refunding offerings, and may be faced with the need for new borrowing, such selling might disrupt the Government securities market. Yet for the Federal Reserve Banks to purchase these securities could put reserve funds into the banking system when general credit policy pointed in the opposite direction. It is our hope that the counsel of the national Voluntary Credit Restraint Committee, to curtail non-essential or postponable capital expenditures, will be followed by both borrowers and lenders, as well as by business concerns which do not need to borrow. As the Committee points out in its Bulletin No. 2, there is undoubtedly a substantial amount of anticipated capital expenditures which could be postponed without detriment to the defense effort, and in the interest of reducing inflationary pressures and conserving labor and materials. These expenditures include, for example, those to improve the competitive position of individual producers of non-essential goods, to expand and modernize facilities for distribution or service which is not defense supporting, and to expand and modernize the manufacture of consumer goods not related to the defense effort.

There is one other aspect of the fight against inflation which we would like to stress. There will be a growing need, as defense requirements bite into the supply of goods available for civilian consumption, to promote saving by the public and to channel these savings into economically desirable uses. It seems clear that incomes of individuals will increase, in the aggregate, during the rest of the year and that, despite actual and prospective increases in taxes, the volume of purchasing power thus becoming available will be in excess of the supply of goods and services currently being produced which can be shared by the civilian economy. If this gap is not closed by a wise savings program, attempts to spend available income (or accumulated liquid reserves) will renew and enlarge the upward pressure on prices without being able to bring forth an increase in production.

It is not possible to make a hard and fast listing of desirable uses of savings which will fit all individual situations, and which will meet all the fears of those who are concerned about the future purchasing power of funds presently saved. Nevertheless, in these critical times when the financial needs of defense are so great, there are compelling national reasons for placing a considerable volume of these savings in United States Savings Bonds. There are two kinds of financial hazard which particularly confront the individual planning a savings program under present conditions. One is the general hazard of a decline in the purchasing power of the dollar, which will affect the future purchasing power of money currently saved. No sure defense against this hazard is available to the individual, although our whole anti-inflation program, including restraint of credit expansion and promotion of savings, is directed toward this end. The second hazard is individual misfortune involving financial demands beyond the capacity of current income. Money invested in United States Savings Bonds will help to meet such contingencies; money spent will not. In our opinion the banks of the district can continue to perform a constructive service by promoting the sale of Savings Bonds, and by making known their views as to how the savings program can be improved and enlarged, so that it will better meet the challenge of the times.

This letter has been confined to an expression of our views on certain financial aspects of the anti-inflation program. It is still true as it always has been, of course, that this is only part of the problem. There must be action in other areas. Taxes sufficient to pay the increased cost of Government must be levied, and levied so that they will impinge on spending rather than saving. Nonessential Government expenditures at all levels of Government should be eliminated. Direct control of those forces in our economy which raise costs without compensating increases in productivity, must be made effective. Increased production must be a continuing goal. All of these things are essential to a broad and consistent effort to combat inflation. Credit policy can complement action on this whole front and, in turn, will be supported by such action. We deem it highly significant that credit policy has now been freed sufficiently from past inhibitions to enable it to do this job.

Sincerely yours,

JOHN C. TRAPHAGEN, *Class A director*
Elected by banks in Group 1

BURR P. CLEVELAND, *Class A director*
MARION B. FOLSOM, *Class B director*
Elected by banks in Group 2

ROGER B. PRESCOTT, *Class A director*
JAY E. CRANE, *Class B director*
Elected by banks in Group 3

Robert T. Stevens, *Chairman,* William I. Myers, *Deputy Chairman,* and Robert P. Patterson, Class C directors appointed by the Board of Governors of the Federal Reserve System, are wholly in accord with the views expressed above by the elected directors of the Federal Reserve Bank of New York.