



prices of between 25 and 30 per cent. Mr. Sproul tries to diminish the importance of this difference by referring to a "normal" long-term growth in the ratio of money to total value of product. This is a specious and misleading theory that has gained considerable prominence in academic circles. Long-term trends are simply a mathematical measure of very broad movements in the past. They are the resultant of a great variety of forces and conceal wide and important fluctuations. They have no logical significance unless they can be related to some force that provides a plausible explanation of the trend of events.

Of greater importance from the standpoint of monetary policy directed toward maintaining a reasonable degree of stability in the economy are the variations from the long-term trend and the causes for those variations. It is known that in the 1920's the ratio of demand deposits and currency to total national product was much less than in the 1930's. This was because the 1920's were a period of expansion both in investment and consumption, with an active demand for money. It is more reasonable to expect that economic developments in the next decade will be more nearly like those of the 1920's than like the 1930's. In 1929 the ratio of demand deposits and currency to gross national product was 26 per cent. On this basis there is still a tremendous potential for a further rise in prices, especially in view of the limited capacity for growth in production.

In his analysis of the inflation potential in the existing money supply, Mr. Sproul fails to mention the tremendous growth in the volume of Government securities held by individuals and businesses and the possibility of their conversion into money, particularly as long as the Federal Reserve maintains support of the Government securities market. If allowance is made for this factor, the inflation potential becomes almost infinite. The problem is one which previously existing instruments of restraint cannot be relied upon to handle.

Mr. Sproul states that "we have never substantially reduced the money supply without concurrent serious decline in production and employment which . . . no one would wish to contemplate now . . ." This argument is appealing but does not bear analysis, nor is it a correct statement of the problem. In the first place, the present situation is not comparable with the past periods in this country, when any serious reduction in the money supply was accomplished by forced liquidation of private credit. Under present conditions the result could be accomplished by Government surpluses and retirement of public debt. With a progressive tax system and possibilities for some flexibility in fiscal policy, such measures are likely to be more readily adjusted to economic needs. The second criticism of this statement is that several other countries have brought about drastic downward readjustments in redundant monetary supplies with beneficial, rather than disastrous, results. Finally, it should be kept clearly in mind that the issue is still one of preventing further expansion in bank credit and money even though nothing is done to reduce the existing supply.

Overemphasis of effectiveness of recent policies. This last point Mr. Sproul recognizes and indicates that recent policies have been effectively directed toward that objective. By selection of figures, however, he overstates the results obtained. He compares the level of adjusted demand deposits plus money in circulation at the end of March, a seasonal low point after heavy tax payments, with figures for the end of December, the seasonal high point just before such payments. If comparison is made between March 1948 and March 1947, increases rather than decreases are shown. The increase in the past year occurred notwithstanding withdrawals from the market of some 10 billion dollars by the Government. The System and the Treasury should take credit for what has been done but should not be satisfied with the results. It cannot be ignored that prices rose by more than 10 per cent in the period -- an indication of continued excessive demand.

Although Mr. Sproul recognizes that the main factor, namely, the Treasury surplus, that has kept down over-all monetary expansion in the past year, will not exist in the coming year, he does not seem to be alarmed about the prospect. This is because he apparently expects a gradual decline in private capital expenditures and hopes for some success in the campaign to sell more savings bonds. In view of the continued tremendous shortages in plant and equipment among public utilities and railroads and the needs of State and local governments, not to mention the growing obsolescence of much industrial equipment that has resulted from new developments and expansion, hope for a decline in capital expenditures seems to be a weak reed to lean on as a means of bringing inflation to an end this year. There continues to be abundant evidence of demand in excess of supply.

Reliance on higher short-term rates. With reference to monetary policy, Mr. Sproul recognizes the need for some measures of restraint. He would place almost complete reliance upon raising short-term interest rates while continuing to maintain the peg on the long-term 2-1/2 per cent rate. He is unquestionably correct in the view that the System should not endeavor to maintain a wide differential in the structure of interest rates. Experience has clearly demonstrated that the policy of support of the Government securities market should be directed toward one end of the pattern. The other end and intermediate rates should be determined by market events. The System should act to maintain orderly market conditions but leave a high degree of flexibility to the market itself. Any other policy is bound to result in shifting by holders from one issue to another in accordance with market developments and thus the sale to the System of more securities than would otherwise occur.

In my opinion, Mr. Sproul is also correct in his view that higher rates on short-term Government securities would be an influence in keeping banks and others from seeking private loans and investments and would thus help to reduce potential credit expansion.

Two qualifications should be made regarding this policy of permitting short-term rates to rise. First, there is some question as to how far the market forces themselves would raise short-term rates as long as the long-term market is pegged. Mr. Sproul suggests that in the past short-term rates have often been above long-term rates. This has occurred, however, only at a much higher level of long-term rates than that now existing. As the short-term rates approach the longer ones, there will be a greater tendency for holders to shift out of long securities in order to acquire the increased liquidity offered by the short securities. Thus, too high a short-term rate might induce debt monetization from the other side of the pattern. This has in fact already been occurring to some extent in recent months. In other words, it is questionable whether a peg of 2-1/2 per cent on the long-term rates will permit short-term rates to rise sufficiently to be an effective restraint upon lending to private borrowers who can readily pay much higher rates.

The second question that may be raised about the policy of permitting short-term rates to rise freely without other measures of restraint is whether it is desirable to require the Treasury to pay a higher rate of interest upon liquid short-term securities held by banks, or for that matter other investors, if restraint on credit expansion can be more effectively accomplished by other means than by reliance solely upon the rise in short-term interest rates. This brings us to the special reserve proposal, which Mr. Sproul says would be clumsy and ineffective. Admittedly that proposal would involve more adjustment in the operations of banks than would a rise in short-term rates, but analysis of the position of individual banks and adequate recognition of the powers of the System do not indicate that this adjustment would have to be clumsy.

Presumed ineffectiveness of special reserve proposal. As to the effectiveness of the special reserve proposal, it is difficult to understand why anyone can say that a rise in short-term interest rates would be an effective means of restricting credit expansion while the immobilization of a certain amount of bank assets would not be. The increase in interest rates would not deprive banks of any ability to sell their Government securities in order to expand other types of credit. It would rely solely upon the profit motive as an inducement to that end. The special reserve requirement, on the other hand, would definitely reduce the amount of assets that banks could sell and in particular would take away from the banks' holdings of liquid secondary reserve funds. Banks would unquestionably have to be more careful in extending private credit. It is true they would continue to hold a substantial amount of medium- and long-term bonds which they could sell, but this would also be the case in the event of a rise in short-term interest rates.

Need for powers to change reserves. Notwithstanding Mr. Sproul's criticisms regarding the clumsiness of increasing reserve requirements as a means of credit policy, he subsequently recommends that the System should have additional power to make such increases. This power will be needed to take care of further additions to reserves resulting from the gold inflow. (He might also have mentioned the possibility of a return flow of currency from circulation and the continued sale of Government securities to the Federal Reserve as sources of expanding reserves.) In this connection, Mr. Sproul mentions the need for a fundamental revision in the method of fixing reserve requirements. This is certainly desirable but it should not in any way be thought of as a means of dealing with present inflationary pressures. The danger is that such a proposal is likely to be used as a "red herring" to divert us from the trail of the real problem.

Mr. Sproul suggests that the whole problem of reserves needs careful study. This is a question that has been carefully studied by the System for many years and it is doubtful whether any more light can be thrown on the problem than we are now able to bring to bear. He proposes some sort of "ceiling" reserve plan, that is, higher reserves on expanding deposits as a means of increasing reserve requirements in the future. This particular proposal, which has been carefully analyzed within the System, is theoretically sound but administratively exceedingly difficult. I am sure that it would not be understood by the banks and would meet with vigorous objection. It could not possibly be legislated in time to give the System power to deal with the current emergency.

Centralized administration of the System. With respect to Mr. Sproul's views as to the organization of the System and the focus of responsibility, it is important always to recognize and to point out the unique character of the Federal Reserve System in enabling persons actively engaged in banking and business to participate in the formulation of governmental policies. It is doubtful, however, whether recent developments toward the assumption of greater responsibility by the Board or by the Open Market Committee as a centralized agency should be considered as a move away from the original purposes of the Federal Reserve Act. It is more likely that the domination of the System during its first 15 or 20 years by powerful banking personalities was the real departure and that recent developments have been a return to the aims of the Act.

It is also questionable as a matter of public policy and the development of public support of the System whether even the semblance of greater control by special interests, as against control by officials appointed for the protection of the broad public interest, would be to the long-run advantage of the Federal Reserve System and of the country in general.

W. J.