FEDERAL RESERVE BANK

OF NEW YORK 7

April 25, 1946.

PERSONAL

Honorable M. S. Eccles, Chairman,
Board of Governors of the
Federal Reserve System,
Washington 25, D. C.

Dear Marriner:

Thinking over your forthcoming appearance before the Advisory Committee, to discuss anti-inflationary measures, they seem to me to line up about as follows, and somewhat in this order of importance:

1. Increased production.

2. Avoidance of development of wage-price spiral.

3. Keeping budget in order which, in present circumstances, should mean balance or a surplus, which means keeping up taxes, in the aggregate.

4. Checking further increases in supply of money - purchasing power - through credit channels.

5. Maintaining controls, while and where abnormal shortages exist, to prevent speculative abuses.

6. Debt management - sales of government securities to non-bank investors and paying off banks.

The failure of the Sixth Report of the Director of War Mobilization and Reconversion lay in its concentration, to the exclusion of almost everything else, on increased production and the continuance of price controls. Important as these are, the first takes account only of the supply side of the equation which also has a demand side, and the second deals with symptoms, not causes.

In our own bailiwick I do not think any of us believe that we can get tough----that is, resort to a substantial increase in interest rates and a substantial decrease in the money supply as anti-inflation weapons. Even if it were politically possible, it would not be economically or socially desirable, because the consequences would probably be more drastic than we should want or intend. What we can do, however, is to try to prevent further increases in the money supply not related

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to increases in production, so as not to throw the demand supply equation further out of balance. For the rest, we shall have to depend on gradually growing up to money supply, meanwhile avoiding creating or encouraging fears of the soundness of our money and the Government's credit.

Enclosed is a memorandum prepared here which may be of some use to you.

Yours sincerely,

Allan Sproul.

Encl.

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SIXTH REPORT
BY THE DIRECTOR OF
WAR MOBILIZATION AND RECONVERSION

It is not quite true that this report has nothing to say about the causes of inflation (see page 7), and on page 8 it says, "The Government must attack the problem with all available means, including fiscal measures ...." However, the preponderant emphasis in the report is on the continuation of price control, and other "available means" are not even listed. Under the heading of "Weapons against Inflation," the only one mentioned is prompt renewal of stabilization legislation.

This approach to the restraint of inflationary tendencies has been criticized with some justice as an effort to hold down the temperature recorded by the thermometer without doing much about the causes of its rise. The question is whether enough effort has been made to use "all available means" to get at the causes of inflationary pressures.

Since the problem is conceded to be the result of a high level of demand backed by the ample purchasing power, on the one hand, and insufficient supply, on the other, a well-rounded program would seem to divide itself logically into two main parts: the one directed to dampening demand; the other directed to stimulating the growth of supply. A good deal has been said about the second part, but very little about the first. That is not surprising since it is a great deal more difficult to do much about the demand side of the problem, in view of the unsatisfied demands that have accumulated during the war and the coincidental accumulation of purchasing power with which to satisfy them. Furthermore, patriotic motives to which appeal could be made with some degree of success in curtailing spending during the war have lost much of their force. Nevertheless, the difficulty of the problem is no excuse for failure to do all that can be done.

The demand side of the inflation problem

Since the monetary aspects of the situation are our particular responsibility, a representative of the System might reasonably be expected to start with consideration of what can be done in this field. But since monetary policy is inextricably tied in with fiscal policy and debt management, the System can hardly avoid consideration of those closely related aspects of the problem.

Most of us would agree that there is no such automatic and immediate relationship between the quantity of money and the general level of prices as may at times have been assumed. Public attitudes toward spending and investing, influenced by economic or political trends or other developments, often affect greatly the relationship between the money supply and the price level at any given time. Yet, in the long run, there seems to have been a general correspondence between major changes in the money supply relative to the physical volume of production and trade, on the one hand, and the general level of prices on the other. It can at least be said that, given a public attitude favorable to spending and investing, an ample money supply is important in making the demand effective and in determining the level of prices.

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For that reason, the general theory of central banking has been that a central bank should exercise its powers to check the growth in the money supply, or even to bring about some contraction in the supply, in periods when inflationary pressures are prevalent, and to ease the credit situation when deflationary tendencies appear. Unless convincing reasons for abandonment of this theory can be found, the general direction of the policies which the System should pursue in the existing circumstances is clearly indicated.

The efficacy of any particular policy at any given time, however, is always subject to debate. For example, at the present time it is said that if the System were to keep a tighter rein on the banks, that would not deter nonbank investors from selling or redeeming their Government securities if they had made up their minds to do so and to spend the proceeds; that as long as a substantial part of the existing huge money supply is held idle, it has no inflationary significance; and that there is no good evidence to support the idea that any moderate rise in interest rates would have appreciable effects in stimulating saving and deterring spending. It is not necessary to deny or debate those points to find ample grounds for a restrictive credit policy in an inflationary period, however. The need for such a policy may be based upon a number of other considerations, among which are the following:

1. Inflationary movements dangerous to the stability of the economy are not limited to the commodity markets, but occur with equally disruptive effects in the capital markets, especially the stock and real estate (farm and urban) markets.

2. Declining interest rates lead directly to price rises in the capital markets and set in motion speculative movements in which capital gains tend to become the primary objective, rather than current income.

3. Unlimited access to Federal Reserve credit enables the banks to compete with other investors for the available supplies of Government and other high-grade investments, forcing prices up and yields down to the point where other investors are practically forced to shift to lower-grade investments, and many are induced to engage in speculative operations in the effort to employ their funds profitably.

4. Easy speculative profits tend to stimulate current spending.

5. Easy credit conditions facilitate business inventory accumulation, and so tend to promote inflationary pressures in the commodity markets in periods of heavy consumer demand; if unaccompanied by direct controls, they also facilitate expansion of consumer credit, and thus tend to accentuate the unbalance between demand and supply.

These considerations strongly suggest that, under existing conditions, the policies of the Federal Reserve System should be directed to combating a further decline in interest rates and to curbing credit expansion. At the same time, however, credit restraints should not be so indiscriminate and so rigid as to interfere with the financing of needed expansion of production.

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Some steps have already been taken by the Federal Reserve System along these lines -- the elimination of margin trading in listed securities, the maintenance of wartime restraints on consumer credit, and the elimination of the preferential discount rate. But these measures can be only partially successful in a situation in which a huge money supply has already provided the purchasing power required for large-scale spending and speculation, and in which the banking system can obtain any amount of reserve funds it desires by selling short-term Government securities which the Reserve Banks will have to buy as long as stability of short-term interest rates outweighs other considerations. The need for more general restraints is clearly indicated, but is inhibited by the difficulty of applying them without affecting interest rates.

To be most effective, a Federal Reserve policy of restraint on credit expansion would need to be supported by appropriate fiscal and debt management policies. In the fiscal field, some further tax adjustments may be desirable to relieve certain groups or industries which are now subject to disproportionate tax burdens, but as a general policy tax reductions which would tend to stimulate public spending should be avoided, and unnecessary or postponable Government expenditures should be eliminated or deferred as long as inflationary pressures persist. Debt management policy can be helpful in dampening consumer demand by encouraging substantial savings out of current incomes and retention of previously accumulated savings through promotion of purchases by the public of savings bonds and other appropriate types of Government securities. It can be helpful also in checking the decline in long-term interest rates and the shifts of funds to the more speculative capital markets by making available, in connection with refunding operations, suitable types of securities for employment of the funds of savings institutions and other institutions and investors and using the proceeds to retire bank-held debt.

Such a policy of restraint on credit expansion, and a debt management policy of the sort suggested, will involve some increase in service charges on the public debt as bank holdings of low-coupon securities are replaced by investor holdings of higher yielding obligations. The suggested debt management policy would involve some shift from short-term to long-term debt, with consequent increase in interest charges, and it is very doubtful whether a firmer credit policy can be effected without causing some rise in short-term interest rates, although this need not affect the general level of rates. On the other hand, the fiscal policy suggested would facilitate further reduction in the principal amount, and hence in the aggregate interest cost, of the debt.

Supply side of the inflation problem

Efforts to promote rapid conversion to peacetime production naturally took the form, first, of removal of restrictions on the availability of materials and equipment, prompt settlement of war contracts, removal of Government-owned equipment and materials from the premises of private industries, etc. In some cases where supplies of materials were limited, it developed that the available supplies were not flowing to the points of most urgent need, and reimposition of controls proved to be necessary. On the whole, however, the steps taken have been quite effective in promoting rapid reconversion.

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Subsidies may be regarded as an alternative to higher prices in stimulating production of essential commodities. Removal of price ceilings would probably be fully as effective in most cases -- perhaps more effective in some cases -- but would involve the danger of promoting a price-wage spiral, with the likely accompaniment of wage disputes which might lead to widespread work stoppages and consequent loss of production. The disadvantages of subsidies are, first, that they tend to become habit-forming, and, second, that they tend to stimulate demand by keeping commodity prices lower than they otherwise would be. On balance, however, it seems desirable to continue the use of subsidies in cases where essential production could not otherwise be obtained in adequate volume without price increases which might disrupt the whole anti-inflation program.

Price ceilings can hardly be classified as an instrument either of dampening demand or of stimulating production. They represent an attempt to avoid the natural consequences of unbalance between demand and supply at a given price level, and their perverse effects on both demand and supply in an inflationary period can be justified only on the grounds that, if successfully administered, they may avoid or at least dampen materially an inflationary spiral and the accompanying disruptive influences which usually end in a "boom and bust."

But in a period of high demand, when the inhibitions of wartime are lacking, there is constant temptation to legal evasion or circumvention by the more scrupulous, and to illegal and flagrant violation by the unscrupulous. The successful administration of price controls in such circumstances requires an extraordinary degree of competence and wisdom. This is well illustrated by section IV of the report of the Director of War Mobilization and Reconversion on Textiles and Clothing. The revision of pricing policies in this field, which is reported in this section, illustrates the necessity of flexibility if price ceilings are not to become serious obstacles to badly needed production. In a sense, the measures announc may be regarded as belated recognition of the evils of over-rigid price policies. It does the consumer no good "to hold the line" on prices of standard merchandise if the result is to make such merchandise unavilable, and force him either to pay high prices for goods of questionable superiority or to go without. The result may be to hold down price indexes which are based largely on standard goods, but actually to increase the cost of living to the bulk of consumers.

In view of the difficulties of administration, therefore, the immediate policy should be to concentrate attention on the most important goods and services, and to administer the control in such a way as to encourage production of essential goods and discourage shifts of production to costly substitutes. The ultimate objective should be to eliminate the control of prices of particular goods as rapidly as a reasonable balance is reached between the bargaining position of producers and consumers.

Wage policy also can have substantial effects on production, particularly when taken in conjunction with price policy. In cases where output is restricted because of inability of employers to obtain sufficient help at current wage levels, a flexible wage-price policy may be essential to obtain needed production. However, if a liberal wage policy is coupled with a severe price policy the employer is very likely to allow his plants to be closed by strikes, perhaps for a protracted period rather than run the risk of operating at a loss or an extremely narrow profit margin indefinitely. The wage-price policy announced in the fall of 1945 appears to have had serious shortcomings in this respect -- it promised the employer a review of

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his selling prices after six months' experience with higher wage costs, but evidently did not carry conviction that the price adjustment granted at the end of that period would be sufficient to make up for losses sustained in the meantime as well as assuring a reasonable profit margin for the future. It is still too early to judge how successful the new policy announced in February will prove to be. On the whole, the wage policies followed to date have probably stimulated consumer demand, and whether they have stimulated production more than they have deterred production (in conjunction with price policies) is questionable. Yet it is only fair to say that a hands-off policy by Government would probably have resulted in a much more rapid rise in prices, and a severely restrictive wage-price policy might have led to much more serious work stoppages and conflict.

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