FOR CIRCULATION:

GOVERNOR RANSOM

GOVERNOR SZYMCZAK ✓

GOVERNOR DAVIS ______

GOVERNOR MCKEE ✓ 8/1/38

GOVERNOR DRAPER EQD

Please return to
Mr. Thurston's office

FEDERAL RESERVE BANK

OF NEW YORK

May 20, 1938.

Dear Chairman Eccles:

Last November I sent you two letters with supplementary memoranda setting forth our views about the depression and possible recovery programs. Since that time, the directors and officers of the bank have had many further discussions of these problems. We think it may now help to clarify our own ideas, and be of some possible assistance to the Board of Governors, to review the course of events during the past six months and to comment on the recovery efforts which have been made and the problems still before us.

The decline of the Board's index of production by about thirty per cent between last August and December was probably unprecedented, for so short a period. Since than the index has fallen more moderately, the figures being 117 for August, 84 for December, and 77 for April. The marked fall in security prices which accompanied the great decline in production came to an end in November and was followed for several months by a sidewise movement. But in March stock prices broke through the November low point. This renewed fall was variously interpreted. It was probably due in part to a growing realization that there would be no upturn of business this spring. By the advocates of a new spending program it was interpreted as confirmation of their fears that without such a program the decline of production and employment would be resumed. By the advocates of a policy of rapprochement between government and business, it was interpreted as the result of a growing conviction in the business community that no such cooperation could be expected.

On April 14 the President announced his recovery program consisting of a large increase in excess reserves by reducing reserve requirements and desterilizing the gold held in the inactive account; loans to industry by the Reconstruction Finance Corporation; continuation of work relief expenditures at the current level; and a renewed and enlarged program of public works. The policy of balancing the budget, which had been announced a year previously and repeated last October, was definitely abandoned.

It is difficult to measure what the immediate response has been to the announcement of this program or to estimate what its later effects will be. From the low point of March 31, there has been a recovery in common stocks of about 20 per cent, and this has been accompanied by a rise in prices of lower grade bonds, as well as prices of government and other high-grade securities more directly subject to monetary influences. But a day-to-day analysis would seem to suggest that much of the rise may have been in response to events not related to the monetary and spending program. On the other hand, the announcement of the program may have had some general effect by creating a mild inflationary expectation for the more distant future. The behavior of commodity prices has been much less encouraging. They have not shared in the recovery of security prices but have established new lows for the depression.

As I pointed out in my letter last November, our view has been that there are substantial reasons for hoping that this depression need not be a repetition of the last. The banking situation is stronger, though in need of constructive treatment as regards bank examinations and the capital position of banks along lines which both we and the Board have favored. There ought not to be a repetition of the credit collapse and the hoarding which were the main causes of the deflationary debacle of 1931-33; and it is interesting to note that the index of production is now down to about the point from which that collapse dragged it to much lower levels. The speculative condition in the security markets is also much better than in 1929. Probably most important of all, the outlook for potential need and demand for some kinds of durable goods, provided it can be made effective, appears to be better than in 1929. For these reasons we continue to believe that, even though, as now seems very probable, there may be some further contraction of production in coming months, a recovery movement could be begun from roughly the current level if proper measures are taken.

The first question, therefore, is how effective the President's program is likely to be and how soon the effects will occur. On the purely monetary parts, I shall reserve further comment until later. As to the lending and spending features, one important question is whether the figures announced, aggregating over $4,500,000,000 including the R. F. C. program already authorized, may not create an undue expectation, not only in the country but also in Washington, as to the amount of stimulation which can be given to the economy by these measures. How fast can this program be made effective? How much money, for example, will actually be spent or lent through these channels in the next year? Of the $1,500,000,000 authorized to be loaned by the Reconstruction Finance Corporation, some authorities estimate that the actual loans made in the next year may not amount to more than $300,000,000 to $500,000,000; and judging by past experience, the public works program, despite the new device of non-interest loans, may not, within the next year, absorb over $500,000,000 of the increased authorization.

There is thus a real possibility that the amount of stimulation toward recovery provided by this program during the next twelve months may not be very great. It is, of course, very probable that with the continuance of depression the budget would become further unbalanced, beyond these sums, by the further increase of relief expenditures and the decline of revenue. But the decline of revenue will occur mainly next year rather than in the present year. And concerning relief expenditures, the question may be raised whether they are not mainly a response to depression, rising only as depression deepens and employment declines, and serving thus more as a brake upon the forces making for further contraction of national income than as a positive expansive force.

The occurrence of this new depression has thrown significant light upon the use of fiscal policy as a compensatory mechanism. One lesson, which accords with experience in the monetary field, though presenting much more difficulty, is the importance of proper timing. The tapering of budgetary deficits should have begun sooner than it did, as we argued in the memoranda sent to the Board in the summer of 1936, and it should have occurred more gradually. The payment of the bonus in 1936 is, of course, the sort of occurrence which upsets all technical calculation, though it does show the difficulties of operating this kind of policy in a democracy; but quite apart from the bonus, there is the significant fact that no substantial reduction of expenditures was undertaken until the spring of 1937, when the boom was already over. Reliance was placed almost entirely upon the increase of revenue. Then there is the further complication that the social security taxes, which quite clearly had been devised without reference to their relation to the compensatory fiscal policy, have been permitted to operate in the new depression as a major deflationary force. At the present juncture, we face a new timing difficulty, in that the new spending program cannot act fast enough to provide an early corrective for depression.

One further important lesson from this new depression is that fiscal policy can be nullified by the behavior of prices and wages, and that indeed it tends to intensify, unless adequate preventive steps are taken, the price and cost movements which defeat it. We therefore welcome the President's proposal for a thorough study of monopoly practices and tendencies in industry, but think it ought clearly to include equally a study of similar tendencies in organized labor. The rise of wages and prices in these sectors of our economy in the winter and spring of 1936-37 seems to us a major cause of this depression.

For reasons such as these, the difficulties of timing changes in policy and of achieving results with sufficient promptness, the effects upon costs and prices, the limitations imposed by the political processes of a democracy, and the limitations imposed by the effects of deficit financing upon the interest rate structure and upon the character and composition of bank assets to which we have referred in our previous memoranda, we are increasingly inclined to believe that too much reliance ought not to be placed upon compensatory fiscal policy as the single or main corrective for depression.

It therefore appears to us, and this was the chief point of my earlier letters, that the main problem is still that of finding the means of providing more direct encouragement to private enterprise and investment, in part through specific measures, and in part by creating an atmosphere more conducive to business confidence. Indeed, whatever may be the merits or the limitations of the program announced by the President last month, I think it is increasingly recognized that it must be supplemented by, and must in large measure be dependent for its success upon, a program which will further encourage private initiative and employment.

Some progress has already been made. The Amendments to the Federal Housing Act appear to have had a moderately helpful effect on residential construction, which may be increased later on under more favorable economic conditions. The tax revisions, as finally agreed upon in Congress, will, we think, have a salutary, though probably not an immediate, effect upon business and investment, partly because of the nature of the revisions themselves and partly because they represent a concession of the kind which the business community itself has most strongly and uniformly emphasized as necessary to its proper functioning.

The President's call upon all parts of the community to cooperate for recovery, his recognition that such cooperation is essential to the success of the new program, the evidences which have since appeared that there are important forces in both government and business seeking to promote a better understanding of mutual problems, and finally the indications that a way may be found to clarify the relations between public and private industry in the utility field are all, it seems to me, encouraging signs that this kind of solution is now being sought. In connection with the utility problem, it would seem important that care be taken that the solution being sought is not nullified by P.W.A. grants to municipalities under the new spending program.

There is no need to attempt a formal outline of a recovery program of this nature. Its elements, I believe, are now fairly generally known and agreed upon. Those already mentioned and some others were referred to in my letters last November. There is still needed, I think, some important revision of our tax system, including the placing of social security taxes on a pay-as-you-go basis, reduction of the schedule of surtax rates on incomes, and the removal of tax exemption on government securities as has already been recommended by the President. These revisions we regard as of more fundamental importance than those already made.

There is need for a clearer and more equitable determination of the responsibilities which should be imposed, upon labor as well as management, in collective bargaining. There is also a grave question whether the Wages and Hours Bill may not represent a serious confusion between reform and recovery considerations, so that provisions which from a longer run standpoint may be socially and economically desirable, may have harmful short-run effects. From this point of view may this not prove to be one further expression of the fallacy, which has never been clearly faced, that we can increase national income and employment by raising costs of production faster than efficiency and volume of production.

There is obviously a need, as we said in November and as has become increasingly more apparent, to find a solution of the railroad problem. In this industry, which constitutes a major segment of our economy, conditions are now worse than in the worst quarters of 1932 and '33, and it is becoming increasingly difficult to see how we can have a real and lasting recovery so long as we disregard the need of a thorough-going attack upon its problems, which appear to involve such fundamental questions as financial and physical reorganization, abandonment of non-essential mileage, equitable conditions of competition with non-rail transportation, a revision of the technical rules and conditions of work which have apparently become a serious obstacle to operating efficiency, reductions of wage rates as you suggested in your Atlantic City address, and even probably of the numbers employed, and a thorough reconsideration of the tax burdens now resting on the industry.

Finally we think it very desirable to continue to explore, as I know you have been specially interested in doing, the waysin which government may offer financial aid, not in the form of a pump-priming program intended to work through consumers' incomes, but in the form of assistance to housing, railroads, utilities or other major industries, or in the form of economically desirable public investments of a kind which would not compete with private industry but on the contrary, would encourage that recovery of private investment upon which our economy fundamentally depends.

I have left to the end the consideration of purely monetary policy. In my statement last November I expressed the view that excess reserves were already adequate and that no change of monetary policy was called for. When the President announced the recovery program in April, excess reserves amounted to approximately one and a half billion dollars; there had been an upturn in bank deposits following the moderate decline which occurred in 1937, the quantity of deposits and currency was substantially above that of 1929, and interest rates subject to monetary influence were at a very low level. In these circumstances there did not seem to be any occasion for increasing excess reserves except possibly as a means of creating inflationary sentiment; and in this respect, as I have already stated, the effects do not appear thus far to have been very great. On the other hand, for the sake of this doubtful advantage, we have recreated some difficult problems for the future.

The new program will have the effect of increasing excess reserves to approximately $3,800,000,000, which is well in excess of the previous high point. The immediate problem which this action presents is the rise in the prices of government securities and other highest quality obligations. Some Treasury bill issues are now on a no-yield basis, while prices of longer notes and bonds have been bid up in some instances to new record highs. There is thus presented the danger that at some later time we may have to face a renewal of the difficulties which appeared in the government security markets last spring. Mention must surely be made of the fact that even prior to this program increasing excess reserves, the Open Market Committee was endeavoring by switches in the portfolio to curb the rapid rise in government securities, which even then had been going on for some months. It was in the hope of making this policy more effective that I recently proposed to the Open Market Committee that, in view of the new program, authority should now be given to vary the size of the portfolio in order more effectively to exert our influence toward orderly conditions in the government security markets. Our responsibilities as a central banking system are just as great during a period of advancing security prices as during a period of declining prices. Too rapid or too prolonged a rise will surely increase the size and difficulty of the problem of central bank management on the subsequent decline, not to mention the problem of capital losses by member banks which will result from any substantial decline in the bond market.

Looking to the longer future, I think we must recognize that the handling of these large excess reserves will present much more difficult problems than those which had existed previously, problems, both of methods of control and of administration and jurisdiction, which raise too many questions for treatment in this letter but about which I hope to write you at some time in the future. But our immediate problem is clearly that of recovery from the depression in which the country now again finds itself, and it is in the hope that we may make some contribution to the solution of this problem that this letter is sent.

Faithfully yours,

George L. Harrison

George L. Harrison,
President.

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