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December 1, 1950.

The revival of discussion of a proposed Capital Issues Committee, embraced in the Research Staff's memorandum of November 20, 1950, presented by Mr. Young, emphasizes the desirability of early determination of the program of further steps that should be taken to implement the general policy agreed upon unanimously by the Board of Governors and the Federal Open Market Committee on August 18, 1950.

The Board and the Committee announced at that time that they were prepared to use all the means at their command to restrain further expansion of bank credit consistent with the policy of maintaining orderly conditions in the government securities market, and added that the Board was also prepared to request the Congress for additional authority should that prove necessary.

Since then, as pointed out in the proposed communication to the President in regard to his State of the Union message and economic report to the Congress, Federal Reserve discount rates have been raised, the shorter-term yields in the government securities market have risen somewhat and the price of the longest term bond has dropped slightly, Regulation W was promulgated and subsequently its requirements stiffened, Regulation X has gone into effect, and programs of voluntary cooperation of banking institutions directed towards restraint upon unnecessary credit expansion have been initiated.

The use of a Capital Issues Committee, as a further means of dampening, and exercising desirable discrimination in, the flow of capital funds during the rearmament period would be an additional step, the pros and cons of which are discussed extensively in the staff memorandum. Such a plan would involve the necessity of formulating criteria upon which to base approval or disapproval of particular issues; the question of the sources from which would be derived funds for approved issues and the extent and desirability of diversion from other uses would arise; as a matter of course, the purposes for which the funds would be used would be essential considerations, along with their effectiveness and the cost to the borrower as well as return to the investor; and considerable responsibility would be assumed by the government which heretofore has been left to the borrowers and lenders in accordance with the principles of the private enterprise system which we have kept in mind in the determination of policies up to this time. It would be a step towards rationing and direct controls.

The memorandum points out that even if it were possible to devise objective criteria adequate for judging proposed security issues a capital funds authority would be beset with pressure groups and politicians seeking to influence the committee in favor of local projects, both corporate and municipal, that this would be an important argument in favor of impersonal general monetary controls, and that it is generally agreed that monetary and fiscal controls are preferable to direct wage, price, and rationing controls for curbing inflation in any situation short of total mobilization. Monetary measures are more impersonal and less arbitrary than direct controls, they are more easily and more flexibly administered, and they are less subject to political pressures in favor of particular groups.

We have continued to utilize open market operations following the general rise in discount rates, but we have reached a point where there is reason to believe that we have merely established a new pattern in the government security market, with little or no observable deterrent effect upon the expansion of credit, which has proceeded at an unprecedented rate. It is evident to me that if we continue to use open market operations to restrain the further expansion of credit, we shall do so slowly and cautiously and intermittently. It is also evident to me that we shall not, under present circumstances with world conditions such as they are and the possibility of all-out war, increase the long-term rate of government bonds. The best we can hope for is a slight increase from time to time in the short-term rate in government securities. That kind of operation in the open market is not really restrictive of the further expansion of credit. It is helpful, but it is not sufficient. We need to do more. To increase the short-term rate to the long-term rate is also a good theory and possible of realization under other circumstances, but not under the present circumstances. It would require too long a time to effectuate that relationship between the long and short term rates. In the meantime, credit would be expanding and prices would be increasing.

Although the selective credit controls have been unquestionably useful, each of them deals only with a portion of the credit field and leaves open other avenues of credit such as that embraced in the Capital Issues proposal, with increasing administrative difficulties.

The opposition to the effective use of selective controls is such that it eventually destroys the effectiveness of the controls themselves because it destroys the ability of the monetary authority to act in sufficient time and with sufficient effect. If, however, the Federal Reserve does act in sufficient time and with sufficient effect in the selective credit field, it destroys its ability to obtain from Congress additional necessary selective or general instruments to meet its responsibility in the money and credit field. In other words, it becomes too unpopular to become entrusted with additional necessary powers.

Such methods, moreover, tend to obscure the merits of the direct approach to the source of credit, the supply of money in the banking system, which has been left relatively free from control. What is more, selective instruments, including capital issue proposals obscure the efficacy of the source of credit which is the supply of money in the banking system.

It, therefore, seems to me that we should increase reserve requirements as soon as possible immediately after the December and January refunding has been completed. We should at once begin a review of the special reserve proposal and place that on the docket as early as possible for discussion by the Board so that we can make up our own minds and then contact the Federal Reserve Banks and other governmental agencies, particularly the Treasury, as well as banking associations, so far as possible and expedient. I think we should increase margin requirements shortly after an increase in reserve requirements. I think we should move further in the open market from time to time in the direction of a flexible short-term interest rate so far as that will be possible under present circumstances.

In essence, I think the use of a proper combination of both general and selective instruments is indicated. I do not oppose a study of the capital funds proposal--I recommend it, and I suggest that the staff continue the study under a committee of three Board Members. This committee should then make its recommendations to the Board at an early date, not only as to its proposal on capital funds restrictions, but also on the question of legislation if it is deemed advisable by the committee to seek legislation in this area.

While further developments in Korea may require more drastic treatment, the purpose of the foregoing observations in the meantime is to direct the attention of the Board again to the reasons and the necessity for prompt formulation of the Board's views, policy, and proposals with respect to the further and more effective regulation of the reserves of the banking system while expansionary developments are continuing at a rapid pace.