November 6, 1947.

Mr. Allan Sproul, President,
Federal Reserve Bank of New York,
New York (45) N. Y.

Dear Allan:

I have your letter of October 24 regarding the proposed increase in the discount rate. I agree that the action need not be taken at this time. The present program of Treasury retirement of Federal Reserve holdings by use of its cash balance and accumulating surplus promises to exert considerable pressure on the market for the next month or so. We can probably wait at least until an issuing rate of 1-1/8 per cent on certificates has been announced.

The increase in the discount rate should be made when further restraint seems necessary. If banks persistently borrow in order to increase their reserves, or even to maintain them, rather than sell securities for the purpose, then there would be a strong case for increasing the discount rate.

As to the amount of the next raise in the discount rate, I think the rate should not be kept as close to the current certificate rate as you suggest. It seems to me that the discount rate should be designed to discourage banks from borrowing and, therefore, should be somewhat above the prevailing rate for Treasury certificates, which now seem to afford the most popular current market instrument for the investment of liquid funds.

You state that "the discount rate of the Federal Reserve Banks is now in approximate balance with other rates in the money market, including the rates on Treasury bills and certificates." For many months, however, the discount rate was 1/8 per cent above the prevailing rate on Treasury certificates. I believe that a difference of 1/8 or 1/4 is proper. If the discount rate is the same as the current market yield on certificates, then banks needing additional reserves will find it more profitable to borrow than to sell the certificates. Sales and subsequent repurchases involve some cost because of the spread between buying and selling prices, commissions, etc. To equalize the two alternatives — borrowing or selling certificates — a somewhat similar cost should be imposed on borrowing by a higher discount rate.

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If banks do not want to hold certificates when the discount rate is above the current certificate rate, they have three choices: (1) They can sell their certificates to the Reserve System and hold excess reserves; (2) they can sell certificates and buy bills; (3) they can sell certificates and endeavor to purchase longer-term, higher-yielding securities. You mention only the last of these choices.

In the case of the first choice, if banks prefer to hold excess reserves in order to be prepared to meet current demands without the necessity of borrowing, the restrictive effect is the same as if they hold certificates. In either case the funds are not being used for current lending. It is simply a question of whether the commercial banks or the Reserve Banks hold the certificates; no more or no less private credit is in use. It is true that excess reserves are more readily usable, but if they are reduced the bank will impair its liquidity position and probably will want to restore it to the desirable point.

For banks to sell certificates to the Reserve System and purchase bills would, I believe, be a desirable development. This might happen if the bill rate rises until it reaches a lwvel in relation to the issuing rate on certificates at which banks would prefer bills to certificates. If the System held more certificates and less bills and current bids by banks determined the bill rate, the market for bills would be much more flexible. As a means through which to effect temporary reserve adjustments, an active and free market for weekly bill issues is better than the use of certificates that have fixed coupon rates and mature quarterly. At the same time investment of a larger portion of the System's holdings in certificates would reduce the volume of unnecessary rollovers.

I see little reason to be alarmed about the possibility of banks shifting from certificates to higher-yielding securities if the discount rate is only slightly above the certificate rate. In view of the fact that the amount of such securities available for purchase by banks is limited, any attempt on the part of the banks to purchase them would raise the price and reduce the current market yield. It seems doubtful that banks would want to follow this course in view of the general expectation of rising short-term rates and the consequent danger of the loss of premiums on longer-term securities. If they do follow it, the case would be stronger for bringing about a further rise in the certificate rate in order to discourage such shifting.

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Your fear about banks purchasing longer-term securities instead of certificates is not entirely consistent with your aversion to bringing about a "sledge hammer adjustment." We cannot by the same action cause banks to shift from certificates to bonds and also put excessive pressure on the bond market.

For these reasons, when an advance in the discount rate is made, I would favor an increase to a rate above the then current issuing rate on certificates rather than to the same level. The timing of the action should depend on the need for imposing further restrictions on bank credit expansion.

It seems to me that during the next few weeks our aim should be to keep the banks under enough pressure to discourage further expansion in bank credit. Our powers to prevent such expansion are limited by the need for maintaining a reasonable degree of stability and orderliness in the Government securities market, which is today of such great importance in our financial structure. Nevertheless, under the existing economic situation we should not be held back by fear of bringing the boom to an end by curtailing capital expenditures.

At the present stage some curtailment in expenditures is vitally important. Overall expenditures -- for consumption, capital purposes, and to meet foreign requirements -- are in excess of the productive capacity of our existing industrial structure and labor force and seem to be increasing more rapidly than production can possibly be increased. Further expansion in the volume of bank credit and in the velocity of the existing money supply can only add to the pressure of expanding expenditures on the limited supply of goods and services and result in further price rises. Heavy capital commitments at this time not only contribute to inflationary pressures but also threaten serious problems of adjustment for the future when more normal relationships between demand, supply, and prices are restored. We should not worry too much at this stage about bringing a downward pressure on prices. In fact some decline would be beneficial.

There are three general lines of action that might be brought into use for checking inflation. The first of these, applied with a high degree of effectiveness during the war, is the use of direct controls. While there may be a few strategic points at which such controls may now be applicable, I am sure you will agree that, in general, imposition of an effective harness of direct controls at this time is not feasible.

Fiscal measures afford the second means of approach to the problem. Again, while all possible pressures should be exerted toward maintaining a high level of taxes and reducing expenditures for avoidable or deferable purposes, we must recognize that there is little hope for measures in this field that will be sufficiently restrictive.

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In the monetary field some additional restrictions, admittedly of limited effectiveness, can be imposed. We need not be fearful about bringing the boom to an end. Further expansion of bank credit will help to extend the boom unduly and to create serious problems for the future. The purpose of action should be to end the boom, which is now of dangerous proportions. The quicker it can be ended, the more chance there is for avoiding an aftermath of prolonged and disastrous depression.

This discussion is out of focus with the importance of the subject of this letter, namely, whether the discount rate increase should be 1/8 or 1/4 per cent, but it has a bearing on our attitude toward all policies that may be followed in the monetary field in coming weeks. For this reason I am setting forth my views at some length.

Sincerely yours,

M. S. Eccles,
Chairman.

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