

**FEDERAL RESERVE BANK**  
**OF NEW YORK 45**

November 12, 1947.

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

Dear Marriner:

My letter of October 24th, to which you replied in your letter of November 6th, was addressed primarily to two questions affecting discount rate policy in the immediate future -- namely, the timing and the extent of a possible increase in rate. I wrote my letter following a telephone conversation with you, and it was really an extension of that conversation, setting forth views which were then developing in my mind. It was obviously not an attempt to discuss either credit policy in its entirety or the much more complex and difficult problem of fighting inflation under present conditions. I am not going to attempt the latter task now, but I would like to carry forward a little further the more limited discount rate discussion.

We now seem to be pretty well agreed on the timing of future action, and the criterion you suggest as a guide to action is a useful one -- namely, that "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."

On the question of the amount of the increase, we still differ. You want to move immediately, when we do move, to a rate which will be a penalty rate in terms of the then existing coupon on one-year Treasury certificates of indebtedness, and I wish to approach this position cautiously and gradually so that we may observe the effect of our actions on the tendency of banks to borrow, and on the market for Government securities. Yours is the more orthodox view but, in my opinion, it does not fit present-day conditions, and your arguments against what I have proposed seem to overlook one of the main features of my proposal. I say that what you are advocating does not fit present-day conditions because if we make borrowing too unattractive, banks can easily resort to alternative methods of obtaining additional reserves, and because we cannot act today without regard to the effect of our actions on the Government security market and the refunding operations of the Treasury. I say that you have overlooked one of the main reasons for my proposal, because I want to encourage the banks again to make use of the discount window so that we may have the advantage of their reluctance to borrow for extended periods, and of the influence of the fact of borrowing upon their willingness to expand their loans and investments. If a tendency to abuse our discount facilities should develop, it could be readily discerned and relatively easily corrected. This is not the case, as you know, when banks obtain additional reserves by selling short-term Government securities which we ultimately buy.

FOR VICTORY



My predilection for some bank borrowing probably explains why I am not impressed by the argument that the cost to the banks of selling and subsequently repurchasing certificates should have its counterpart in a penalty discount rate, in terms of the yield on certificates. And my concern for our continuing responsibility with respect to the market for short-term Government securities leads me to reject the argument that our experience when the discount rate was 1 per cent and the coupon rate on one-year certificates of indebtedness was  $7/8$  of 1 per cent, is an adequate guide to action now. In the earlier period we were still maintaining most of the fixed wartime pattern of rates and we were not openly and aggressively seeking to exert pressure on the reserve position of the banks by all the means at our disposal. Now that we are defrosting short-term rates, have taken the certainty out of the rate structure, and started to use all the weapons of credit control which are available to us, we have created a very different situation in the market for short-term Government securities, and the effects of our actions are showing definite signs of being cumulative. We have a very uncertain Government security market on our hands at the moment and, if we act intemperately or unwisely, we might precipitate such a volume of selling of Government securities (and therefore Reserve Bank buying) as would knock any credit control program into a cocked hat.

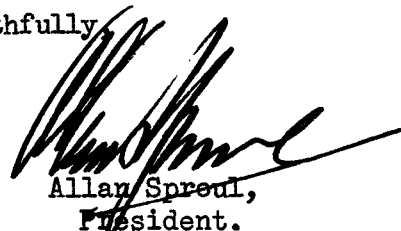
The exposition which takes up page 2 of your letter, and sets forth the alternative courses of action which are open to banks which do not want to hold certificates when the discount rate is above the current certificate rate, does not seem to me to meet the issue. It is stated, first, that the banks can sell their certificates to the Federal Reserve System and hold excess reserves. Recent experience indicates that when banks embark on this course they frequently go beyond meeting their immediate requirements or immediate needs for reserves, and raise cash for other uses. Second, it is suggested that the banks can sell certificates and buy bills. There are indications that this is taking place to some extent, probably as a hedge against a further rise in the certificate rate, but only a small part of the funds obtained by the banks, through our purchases of certificates, is being used in this way. A real and continuing incentive to do this would appear to be lacking unless the bill rate is above the rate for short and intermediate certificates -- an unlikely circumstance except in this period of change. Third, your letter mentions the choice I also mentioned -- namely, selling certificates and seeking to purchase longer term, higher yielding securities. I think you have unduly emphasized this suggestion of mine. I did not say that the banks would aggressively seek to shift from certificates into longer term securities, but only that they might show a preference for the latter type of obligation. It is true that recent weakness in the Treasury bond market has discouraged bank purchases of longer term securities, as we hoped it would, but they still prefer to sell certificates (or notes) when they wish to raise funds -- not the medium or long-term bonds which they hold. That tendency might well be accentuated if the reluctance of banks to incur indebtedness at the Federal Reserve Banks is reinforced by making borrowing costly, and if the signal for another increase in the certificate rate has been given by an increase in the discount rate above the existing certificate rate. My reference to a sledge hammer adjustment did not refer particularly to this aspect of the discount rate problem; that was a phrase in the closing paragraph of my letter referring to the whole range of monetary action as part of a general anti-inflation program.

11/12/47.

This disclaimer leads me into a brief comment on the latter part of your letter, which concerns itself with the broader problems of combatting inflation, rather than with the relatively minor problem of the discount rate. This was evidently written, in some measure, in response to my statement that "we are not seeking a sledge hammer adjustment designed to end a boom by curtailing capital expenditures, production and employment, thus bringing downward pressure on prices. Ours is the more delicate task of restraining a further increase in bank credit, and in the velocity of use of existing purchasing power while giving every encouragement to high, or higher, production. The major attack on inflation will have to be met by means other than drastic overall credit restrictions." We are agreed, then, that we should do whatever we can to discourage a further expansion of bank credit, and in the velocity of the existing money supply, since under existing conditions such an expansion or increase can only result in further upward pressure on prices. That is a pretty difficult assignment by itself, given our present necessary involvement in support of the Government security market, which may at any time force us to put a substantial amount of reserve funds into the banking system. I should hate to see the System, because of an excessive desire to play an important part in the present anti-inflation program, assume or seem to assume what appears to me to be the impossible task of checking the present inflation by monetary measures alone, and I suggest that it would be unwise, or even reckless, for the System to talk about "ending the boom" by credit controls. At the present time, when there are such urgent needs for our products abroad and such large unfilled accumulated demands at home, we cannot contemplate credit restrictive measures which would cause a serious slump in production and substantial unemployment; which would bring down food prices, take the steam out of demands for higher wages, and pry open bottlenecks (by reducing the flow of goods) in steel and transportation and elsewhere. And that is the kind of credit restriction which, by itself, would be necessary to "end the boom".

We can make a modest contribution to a program of stabilizing our economy at a high level, however, by following the path we have now laid out for ourselves in cooperation with the Treasury. The measures of credit control and debt management which we are using, and a restored control over consumer credit, will supplement whatever fiscal and other non-monetary measures are adopted to check inflation. Altogether they may exert enough downward pressure on consumer demand and on postponable capital expenditures to accomplish our purpose of preventing a further rise in prices, with all its train of evil consequences.

Yours faithfully,



Allan Spruell,  
President.