January 15, 1948.

Dear Allan:

Your letter of January 13 to Senator Taft is timely and excellent and I am very glad that you sent me a copy of it. It is of such interest to the other members of the Board that I am circulating it for their confidential information.

Copy given to each Board member 1/16/48

Since you wrote the letter the President's Economic Report has gone to Congress and may possibly project the question of market support into the arena of political debate. In any case, I would be interested to know what you think of it when you have had an opportunity to look it over, particularly pages 48 and 85 dealing with credit regulation and debt management.

Sincerely yours,

Mr. Allan Sproul, President,
Federal Reserve Bank of New York,
New York 45, New York.

ET:b

FEDERAL RESERVE BANK

OF NEW YORK 45

January 13, 1948.

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

Dear Marriner:

Enclosed is a copy of a letter which I have written to Senator Taft and which I thought might be of interest to you.

Yours sincerely,

Allan

Allan Sproul.

Encl.

MISC. 140A—80M—1-47

FEDERAL RESERVE BANK OF NEW YORK

January 13, 1948

Honorable Robert A. Taft
United States Senate
Washington, D. C.

Dear Senator Taft:

I listened to your talk on the radio last Thursday evening and was, of course, "professionally" interested in your brief comment on credit policy. It awakened in my mind echoes of what I had seen reported in the New York Times about a press conference you held in Kansas City late in December, which disturbed me as did your statement over the radio.

What particularly disturbed me was your statement that "the Administration let bank loans increase in a year by $5,000,000,000, creating that many more paper dollars, and failed to use the powers it always had to restrict bank credit". And at Kansas City you were reported to have said that "Every banker thinks that they have full power and have had full power to regulate business credit under the traditional methods of selling Government bonds and raising the rediscount rate and that authority has existed right along. They have had it and they have not used it".

I recognize very well that there are usually two sides to every question and that this one has many facets. I would like to place before you a point of view, however, which I have already expressed before the Banking and Currency Committee of the Senate (copy of my testimony is enclosed), and which I believe has validity in the present situation. I was brought up on the use of the discount rate and open market operations to control the use of bank credit, and through control of bank credit to try to help control the swings of business and of prices. That training would predispose me now to the use of the discount rate and of sales of Government securities as a check on inflation, but I don't think these weapons can now be used in the way you imply — that is, all out and to the extent necessary to "stop inflation in its tracks" as one writer has phrased it.

Since July 1947 we have been following a modest program designed to bring about some increase in interest rates and some decline in bank reserves and we have had a modest measure of success. Although in both of your statements you have said that "the administration (I do not accept your identifying the administration and the Federal Reserve System as one and the same) let bank loans increase in a year by $5 billion", the more important figure from the standpoint of inflationary pressures is how much the money (currency and demand deposits other than Government and interbank deposits and cash in bank vaults) belonging to the public has increased. During 1947 this sum rose from $110 billion to $113 or 114 billion (estimated), not a very large factor, I should say, in the inflationary developments of the year. With respect to interest rates, three months Treasury bills which were at 3/8ths of one per cent now earn nearly 1 per cent, one year Treasury Certificates of Indebtedness are issued at 1 1/8 per cent instead of 7/8 per cent, long term restricted (not eligible for bank investment) Treasury bonds yield 2.48 instead of 2.33 (and a low of 2.12 per cent in 1946), present rates on other Government securities have risen at least proportionately, rates on state and municipal securities and on corporate securities have risen substantially, and bank lending rates are up somewhat.

The amount of Federal Reserve credit in use, which determines whether we have added to or subtracted from bank reserves, declined from $24,375,000,000 at the beginning of 1947 (January 8th) to $22,320,000,000 at the beginning of 1948 (January 7th). Since we began giving support to the long term Government security market in November 1947, an operation which coincided with the most recent period of heightened interest in inflation, and which has drawn critical comment from some bankers (not every banker by any means) and others, we have actually shown a net reduction of $368,000,000 in our total holdings of Government securities (we sold or redeemed more short term securities than we bought long term) and the total amount of all Federal Reserve credit outstanding has changed from $22,689,000,000 to $22,320,000,000. In other words, we have been taking funds out of the market and exerting a restraining pressure on the banking system. This has been possible because of a coordinated credit and debt management policy designed for this purpose. In my opinion, we are doing as much as a delicate situation will allow toward imposing reserve pressures, by using Treasury surpluses to retire reserve bank holdings of Government securities and by lessening the support price levels (increasing the yields) of Government securities. It seems to me that we should have the greatest chance of success if we are able to continue this program, and that it is much more important, therefore, that there continue to be a substantial amount of Treasury funds available to retire Federal Reserve held debt than that we take all-out monetary action (aggressively raising discount rates and selling Government securities).

I would agree that by exerting aggressive pressure on bank reserves we could set in motion forces which would bring about deflation. Experience suggests that if we chop into this situation with a meat axe we could also start a depression, and this despite the existence of what appears to be an almost insatiable domestic and foreign demand for our products. To use our existing powers as your statement seems to imply we might have used them, would mean that our action would have to be drastic enough to lower the money income of a large segment of the consuming public. To accomplish this by overall monetary or credit action would mean a serious decline in production and employment. Otherwise the policy, by hypothesis, fails or else our present modest program stands approved. It seems to me, therefore, that you may be chiding us for not having used powers, which we would be foolish to use — which are not really available to us in the present state of domestic and international affairs, and in the face of a Federal debt exceeding $250 billion and interwoven into our whole economy.

This latter point suggests a subsidiary question which may be in your mind and which I know is in the minds of some bankers, insurance executives and others. Why should we support the long term Government security market at the 2 1/2 per cent level and to that extent circumscribe our powers and our actions to control the volume of credit? To me it is not primarily a question of cheap money or low interest rates so far as the Government debt is concerned, although it is sobering to calculate how big an increase in the cost of servicing the debt would be involved if short term interest rates rose, say, to 2 or 3 per cent (a not impossible level if an aggressive credit contraction policy were pursued). It is primarily a question of what good can be accomplished in the present situation by a vigorous aggressive policy of over-all credit contraction and what are the risks. Our critics say that if a drastic fall in market values of Government securities is the price we must pay to bring about deflation now, and prevent a worse "bust" later, we should pay it. I say we can't bring about deflation by general credit action unless we bring about such an indiscriminate reduction in consumers' disposable income as to threaten the disaster we are trying to avoid. To illustrate, the food situation is near the root of much of our present troubles and continued high or rising prices for food makes much more likely another round of wage increases and so on. But how can we expect a reduction in the aggregate demand for food (or other scarce materials) to follow a policy of allowing Government security prices to seek their own level — or forcing them down by System sales to contract credit — unless the policy were so vigorous as to reduce substantially production and employment and, therefore, consumers' disposable income. We are all a little enchanted, of course, with the idea of a modest downturn which would relieve some existing pressures and forestall worse disturbance later. But no one has yet found out a sure way of bringing just a little depression, and I think our present program of modest restraints involving a combination of debt management and credit policy is the best course to follow in trying to achieve that objective in so far as credit policy can be the cure — which isn't too far in my opinion.

It might still be argued, I suppose, that abandoning our support of the Government security market could be encompassed within our modest program and that only moderate declines in prices would occur, that Government securities would reach a "natural" level, and that everything would then be much better. With markets as delicately balanced as our contacts and experience indicates the present markets to be, I cannot agree with this opinion or judgment. Without our support, under present conditions, almost any sale of Government bonds undertaken for whatever purpose (laudable or otherwise) would be likely to find an almost "bottomless market" on the first day support was withdrawn. A rapid descent in prices going far beyond any question of the Government's credit (which is still high) or relative interest rates would be most likely. Uncertainty would almost surely persist for a considerable time after such a development, the Government's necessary refunding operations would be made very difficult, and private security markets would be seriously affected. In such circumstances, there could easily be a flight of "cash" out of both markets, and price changes so erratic as to make new financing almost impossible for some time, with what ramifications I do not like to contemplate. In the face of a Federal debt of over $250 billion dollars, in all sorts of forms held by all sorts of holders, and with a high consumption high employment economy, in which there are already severe stresses and strains, we can't treat the Government security market as we might a $50 million issue of the XYZ corporation. I am not a believer in more and more Government controls, certainly, but this is one control which I would not want to try to let go, voluntarily, under present circumstances.

I have written you at this length because of my concern that there be understanding of our present policy of credit administration and debt management, and because of my respect for your ability to plow through and inform yourself about the many problems with which you must be concerned.

Yours faithfully,

Allan Sproul

Allan Sproul
President

Enclosure

AS:DHF:rs