FEDERAL RESERVE BANK

OF NEW YORK 7

January 12, 1946.

Hon. Marriner S. Eccles, Chairman,
Executive Committee, Federal
Open Market Committee,
c/o Board of Governors of the
Federal Reserve System,
Washington 25, D.C.

Dear Marriner:

Elliott Thurston called me the other day to tell me that you expected to be back in Washington on Monday, and that, meanwhile, it would be helpful if I would prepare an aide memoire discussing Secretary Vinson's letter on the preferential rate. I enclose two copies of such a memorandum. My idea is that we should have an early meeting of the Executive Committee of the Federal Open Market Committee and should then have a talk with Vinson.

Yours sincerely,

Allan Sproul, Vice Chairman,
Executive Committee,
Federal Open Market Committee

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Federal Reserve System at the Crossroads

Secretary Vinson's letter of December 29, 1945 raises much larger questions than the question of the preferential rate on advances to member banks collateraled by government securities maturing within one year, which was the subject of Chairman Eccles' letter of December 13, 1945. It requires consideration of monetary policy and debt management in the transition from war to peace, and in the subsequent period of more normal economic conditions, and it requires consideration by the System as to whether its responsibilities do not compel it to take independent action if agreement cannot be reached with the Treasury. These are matters which can only be resolved in discussion with the Secretary, and this memorandum is intended to provide a possible basis for such discussion.

The first point to be made is that a do-nothing policy is a policy of further decline in interest rates and of further increase in the volume of bank credit. During the war it was the policy of the System to supply all of the reserves needed by member banks to enable them to provide the Treasury, directly or indirectly, with the funds necessary to finance the war effort, after taxes and sales of government securities to non-bank investors. This policy was supplemented and implemented by maintaining a "pattern of rates" in the government security market, which effectively transferred the initiative in credit control from the System to the member banks, and set in motion a steady decline in yields and rise in prices of government securities. If this policy and practice is continued, now that the war is over, there is every reason to believe

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and every indication that the decline in interest rates from this point forward will be accelerated, and considerable likelihood that the volume of bank credit will further increase. Even though the latter contingency is not realized, it seems highly probable that the downward pressure on interest rates (and the upward pressure on prices of all kinds) will be intensified by an increase in the velocity of money. We have now a highly favorable combination of circumstances for such a development and there are unmistakable signs that it is under way. We have a redundant money supply, a presently restricted supply of goods and services, and a favorable business outlook for the next few years. It has been repeatedly demonstrated that when we have this combination the effects are felt in all markets and inflationary developments are likely. As gilt edge securities, both public and private, rise in price under pressure of the abundant money supply, funds flow over increasingly into lower grade securities and equities (and into the commodity, real estate, and other markets) under the pressure of rising expectations of profit and the minimizing of risks. The stage was never better set for another demonstration of this character. The question to ask the Treasury, therefore, is whether it approves and is requesting us to follow a policy of making monetary conditions even more conducive than they now are to inflationary developments.

To promote an inflationary boom at this time would be a poor prologue for the maintenance of full production and high employment in the post-transition period. Even if this were not the case, it may be sharply challenged whether it is desirable, as a more or less permanent

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policy, to have interest rates lower than they are now. Interest is itself an element of the national income, and, as the interest rate declines a point is reached where the loss of income from old investment may exceed the gain of income from new investment, because the inducement to invest will diminish as the interest rate, already low, declines further. At the same time the further decline in rates progressively disorganizes the whole financial and social structure of a country, and raises the question of whether considerable segments of the community do not have to be subsidized in one way or another. Carried far enough it would undermine insurance companies, the savings banks, all endowed institutions, and the great host of people affected by the condition of all such institutions. Carried far enough, it could force socialization of thrift, compelling the complete substitution of public security for private saving. Nor would it be healthy for the private enterprise economy on other grounds, since as interest rates decline lower and lower, the scales are progressively tipped further in favor of public investment and against private investment, from the point of view of the lender. A point is reached where no investment is justified that involves any risk, and the government is the only riskless borrower.

A further decline in interest rates and a further increase in the money supply would be highly dangerous in its implications for the short run or transition period, and undesirable in preparation for the longer run peacetime economy of high production and employment. If we do nothing now we are adopting a policy of lower interest rates and, probably, of increased supplies of bank credit.

What do we propose to do; what positive steps can be taken?

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First, it should be understood that we do not believe that monetary controls can cope singlehanded with the inflationary aspects of the current situation. Nor do we believe that they can be a major weapon of anti-inflation policy, if by monetary control is meant a substantial upward adjustment of interest rates and a substantial restriction of the money supply. What we propose is to combat a further decline in interest rates and a further increase in the money supply, and in that way to discharge our responsibility for promoting economic stability, and to support measures taken by other agencies to curb inflationary tendencies.

The immediate proposal is the elimination of the preferential discount rate. This, in and of itself, is a small matter, but under present circumstances any change affecting monetary policy and debt management may have important repercussions. Everyone is watching for a sign. We must argue, therefore, that the effects of what we propose to do can be held within reasonable limits. A convincing argument can be made.

Initially, if the elimination of the preferential discount rate seemed to be having an undue effect on the market, aggressive support could be given through open market operations, particularly in the certificate market. As the effect of the elimination of the preferential discount rate wore off, however, the purpose of that action would be defeated if the System continued to supply the banks with all the funds they desired, through open market operations. At this later stage the System would probably find it desirable to reduce gradually its support of the short-term market, and the result would be some rise in the short-term rate. The amount of the change needed to accomplish the purposes in view would be slight, and with proper handling through Treasury debt policy and open market operations, (and perhaps some public explanation) could be held within the intended limits. The purposes, serving the main purpose of checking the further decline of

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one, to make short-term securities somewhat more attractive to banks and thus to lessen the inducement for them to reach out for longer-term securities, and, two, to reinforce this change by re-introducing into the interest rate structure some modest element of unpredictability, so that the banks would no longer have such complete assurance that the higher yielding securities are just as safe as those of lower coupon and, therefore, the better buy. Our problem is to get back this necessary minimum of unpredictability in interest rates, to give the money market, and especially the banks, some inducement to operate again on the basis of this unpredictability, and at the same time to avoid any general rise in interest rates. In view of the volume of government securities outstanding and the newness of the problem, the money market will be very sensitive to any change in policy. But instead of being paralyzed by fear of the consequences of any action we might take, we should turn this to our advantage since this sensivity would probably guarantee that such minor changes as we have in view would produce the desired effects, and make reasonably certain that we could prevent the effects from being greater than we had intended. Particularly would this be so if, as is contemplated, the long-term rate were held at two and one-half percent. It is most unlikely that short rates would move very far under these conditions. Furthermore, it should be noted that this mildly restrictive policy would be continued only so long as the general economic situation made it desirable, and under such conditions the national income and tax yields would be relatively high, so that no undue burden on the Treasury (and therefore on tax payers) would be involved.

It seems improbable that this moderate program would materially alter the cost of the debt to the Treasury or the earnings of the banks. But even if it should, those are surely secondary considerations, and if it is really desirable to reduce the cost of the debt or the earnings of the banks these problems should be attacked more directly, and not allowed to paralyze action directed towar

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promoting economic stability. In this connection, it is worth noting that most of the benefit of the decline in yields on outstanding government securities, and all of the benefit in the case of the longest-term securities, has gone to secondary sellers in the market, not to the Treasury. In fact, the result has been, during recent war loan drives, to increase the interest charge on the public debt, as buying of new issues shifted increasingly to the longer-term securities, which have offered the greatest profit to the buyer at the greatest cost to the Treasury.

If the Treasury will not agree to such a policy and such a program, we are truly at the crossroads. We must decide whether our own responsibilities do not compel us to take action. The Federal Reserve System has stated that its primary responsibility is to exert its influence so as to promote economic stability, at as high levels as can be maintained over an extended period in a growing economy. Compared with this objective, all other considerations are secondary. This is a matter to be discussed seriously and soon with the Secretary of the Treasury. To do nothing now is to adopt a policy which runs directly counter to the achievement of our main objective. The immediate elimination of the preferential discount rate will do no more than give us a breathing spell, while we are formulating a longer range policy, and devising some means of resolving disagreements which must inevitably arise, from time to time, between the Treasury and the System.

A.S.
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