BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 24, 1948.

To Chairman Eccles

Subject:

From Mr. Carpenter

Attached is a copy of a letter sent to Mr. Szymczak by Mr. Sproul with respect to (1) future System credit policy and, (2) the date for the next meeting of the executive committee.

Mr. Szymczak called Mr. Sproul today to discuss with him the suggested date for the next meeting of the executive committee but found that he was home with a cold. Since Mr. Szymczak will be away from Washington early in April and you are slated to go before the Joint Committee on the Economic Report on April 7, the meeting of the executive committee probably will be held, as Mr. Sproul suggests, on the 13th or 14th of April.

Attachment

FEDERAL RESERVE BANK
OF NEW YORK

New York 45, N. Y.

March 22, 1948.

Dear Matt:

I am addressing you as the Board member of the Executive Committee and in the light of our telephone conversation this morning. I have been surprised that so little was said last week, in the various statements, about the cost of a program of immediate mobilization and subsequent increased preparedness. If recent estimates of what will be needed to develop and maintain a dominant air force, and the ground forces and naval forces to supplement and support it, and to obtain advanced bases for it, are anywhere near the mark, we are in for a large increase in our military budget over the next two or three years. (I assume that not much will be accomplished in the way of squeezing out of the budget less essential expenditures.) Tax reduction now, which seems politically assured, will accentuate the situation.

This will call for a new appraisal of the outlook as far as credit policy and debt management are concerned. The risk we run is that of placing on top of the inflationary pressures growing out of the financing of the war new inflationary pressures which might grow out of the financing of a peace offensive. It seems to me necessary that we pay as much of the bill as we can through taxation and, if and when we come to deficit financing, we should mobilize the savings of the country so far as possible. Nevertheless, I am sure there will be residual bank financing, if tax reduction and large increases in expenditures are combined. That will mean that control or restraint through credit policy and debt management will be pretty much out the window. Other controls -- prices, wages, and profits -- and allocation of materials will again have to be considered.

If these conditions are developing, what should be our objective? My present view is that we should decide upon a rate structure with which we are going to ride out the storm; that it should probably involve a short rate of sufficient attractiveness to enable us to do all of our bank financing -- refunding and new money -- with bills and certificates; and that for the rest we should offer nothing but savings bonds, savings notes, and long term "bank ineligibles" at 2 1/2 per cent to sop up available savings. There would be no notes or intermediate bonds eligible for banks, and to that extent playing of the pattern of rates would be minimized. The narrower the spread between certificate rates and the 2 1/2 per cent long rate, and therefore between the certificate rate and the rates on presently outstanding obligations, the less incentive there would be for pattern playing also. It looks to me, therefore, as if it would still be desirable to get the certificate rate up to 1 1/4 per cent by June 1st and perhaps we can prepare the market for this by allowing the rate on outstanding bills and certificates to move up between April 15th and May 15th. The Treasury suggested this as a possible alternative to our proposal of an 11-months 1 1/8th per cent certificate on Aptil 1st, but it isn't a firm commitment.

These are all first impressions. I think we should have a meeting of the Executive Committee of the Federal Open Market Committee some time between April 5th and 15th to review the whole situation. (I suggest April 13th or 14th.) Meanwhile, it is somewhat ridiculous to have the fiscal and monetary authorities seemingly in the dark as to just what is going to happen to the budget, as a result of political and military decisions. I hope that before our next meeting the committee's staff will be able to get some new figures for us to look at.

Yours sincerely,

(Signed) Allan Sproul

Allan Sproul, Vice Chairman,
Executive Committee of the
Federal Open Market Committee.

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

P. S. For your information I am enclosing some notes on what I said at the Treasury when Marriner and I met with Secretary Snyder, Undersecretary Wiggins, and Mr. Bartelt on March 11th.

PP.S. I am sending a copy of this letter, but not of the enclosure, to Al Williams at Philadelphia and also to Tom McCabe for his information.

A. S.

Enclosure

March 11, 1948.

Statement at Treasury
Secretary Snyder, Under Secretary Wiggins,
Messrs. Bartelt, Eccles, and Sproul

1. Inflationary pressures still strong. Too early to say whether they have been seriously checked and certainly too early to say they have been reversed.

2. In helping to fight inflation through credit and debt policy we have had two major opposing forces to combat. First, there was the steady downward pressure on long term interest rates which we stopped during the first half of 1947. Second, there was the rapid rise in bank loans which got under way in the second half of 1947, and which was largely out of control because gold imports and our support of the Government security market supplied banks with the reserve funds they needed.

3. In the first quarter of 1948 heavy net Treasury receipts and retirement of Federal Reserve held debt with the proceeds, plus the shock to public psychology of the sharp February decline in agricultural prices, have held bank credit in check.

4. Now we are going into the critical second quarter. Treasury expenditures may be in excess of receipts, and gold will continue to flow in adding to bank reserves. We have conserved some ammunition in the form of War Loan deposits which can be withdrawn, but probably not enough to combat an excess of Treasury expenditures, continued gold imports, and further sales of Government securities by nonbank investors. Meanwhile, direct and vigorous Federal Reserve action will continue to be inhibited by our responsibility for support of the Government security market.

5. To help prevent a further upsurge in bank credit, to give maximum support to the efforts of the bankers themselves to restrain credit expansion, we should sop up reserve funds as fast as they become available to the banks, and to do this we should sell the banks short governments. To increase our chances of being successful in this necessary manoeuver we should clear the way now for a further increase in short term interest rates, so that -- risk, maturity, and liquidity considered -- the attractiveness of short governments relative to long term bonds or long term loans will be increased.

6. To put ourselves in position to exercise this moderate influence we can't wait until the June 1 financing. The situation can get away from us by then.

7. An 11-month 1 1/8 on April 1 will clear the way for some increase in bill and short certificate rates during the next two months and for a 1 1/4% 1-year certificate on June 1 -- which will be anticipated by the market. It will also get rid of a small isolated issue by consolidating it with the March 1, 1949 maturities, and free our hand with respect to another increase in discount rate.

8. But suppose the pressure for an increase in bank loans abates during the coming quarter. An increase in the short rate would still be desirable because then, with renewed confidence in the level of long term prices and yields, the temptation to play the pattern of rates would reassert itself if the spread between short and long rates is too wide. We would have to sell long securities to try to hold prices down and Treasury costs would go up just as they will with an increase in the short rate, with no offsetting improvement in the rate structure.

9. It is only if it becomes clear that there has been a reversal of direction in our economy, and that a depression is under way, that we should not want to complete the program now contemplated over the next three months. In that case, if we act now, and conditions change, we should have the added advantage of being able to reverse our recent action, with all the psychological influence that might have.

10. It seems to me we have little to lose and a great deal to gain by acting now -- that the bold approach is also the cautious approach, and that we shouldn't let the initiative slip out of our hands for the next two months.