

February 20, 1951.

Dear Mr. Webb:

I am enclosing the material which I discussed with you on the telephone yesterday and again today. I hope it may serve your purpose and be of some assistance to the Senator in the preparation of his reply.

Sincerely yours,

M. S. Eccles.

Mr. Charles Webb,
Assistant to the
Hon. John W. Bricker,
United States Senate,
Washington, D. C.

2/24/57
Pamphlet

Governor Vardaman's letter makes it appear that because the Reserve System has given rigid support to the Government bond market ever since we entered World War II any decision to change that support now is arbitrary and unreasonable. His letter totally ignores the vast difference between the situation at the time we entered the war and thereafter, as contrasted with the economic picture now. Prior to World War II we were still in a depression with excessively low interest rates, millions of unemployed and unused productive capacity. Pearl Harbor froze us into that too easy credit structure because it was not possible to finance the huge Government deficits which immediately became inevitable without assuring the Treasury of a fixed pattern of rates. Huge deficits cannot be financed on a falling bond market and a rising interest rate structure. That condition prevailed throughout the war. When the war ended many Government economists erroneously believed that we would have a sharp deflation. Moreover, Treasury financing, instead of being inflationary, began in postwar years to exert a strongly deflationary force, particularly to the extent that the surplus was used to pay off bank-held debt. For the calendar year 1945, for instance, the cash deficit was \$43.7 billion. There was a small cash surplus in 1946, a surplus^{of} \$5.7 billion in 1947, and \$8.1 billion in 1948. Also, while A. L. M. Wiggins served as Under Secretary of the Treasury the interest rate on Treasury certificates was permitted to rise from 7/8's per cent in 1947 to 1-1/8 per cent at the beginning of 1948 and to 1-1/4 per cent in the fourth quarter of that year. The Treasury bill rate was similarly freed from pegging operations and was allowed to adjust to the certificate rate, rising from 3/8's per cent in mid 1947 to one per cent by the year end,

and to 1-1/8 per cent in the latter half of 1948. By thus allowing short-term rates to rise the spread between these rates and the long-term 2-1/2 per cent/^{rate} was narrowed. This had the effect of inducing more investment in the shorter term maturities and of relieving pressure on long-term Government bonds which had driven them up to high premiums with a corresponding loss in yield.

At the same time the Reserve System increased its discount rates and the Board was able to report that at the end of 1948 "the net result of all factors was a small decline in bank deposits and in currency held by the public -- the first decrease for any year since 1947." Thus, it is plain to see that the situation was vastly different from that prevailing today when bank loans have been and still are expanding at an unprecedented rate and such minor flexibility in short-term rates as the Federal Reserve has been able to effectuate has been accomplished despite strong resistance from the Treasury.

Today we are again embarking on enormous defense expenditures for an indefinite period. Fortunately, the Treasury does not have to go to the market for new supplies of money for some months. If, in the interim, the Federal Reserve is still frozen into a rigid pattern of rates, as Vardaman advocates in his support of the White House and the Treasury,

then there will be no chance of avoiding more and more credit inflation. The time is short. Unless action comes promptly to adopt more realistic rates that will attract true investors and cause them to hold Government securities, inflationary expansion of bank credit will mount higher and higher and will break through any dam of price, wage, and like controls which are set up.

It is the urgency of the problem and the necessity for more realistic debt management policies that Vardaman overlooks in arguing that there is no reason not to carry on with policies which are destroying the confidence of the dollar. In the postwar years, when Vardaman implies the Reserve System should have broken out of the shackles of pegged rates for Government securities, there were widespread expectations that the postwar boom would play itself out, as in fact it was beginning to do before the Korean situation touched off the present inflationary spree.

Vardaman states that the "Board has never asked the Congress for relief from its implied obligation" to support Government securities. Of course the Board never asked for such a thing. It never was proposed to abandon support. Actually, beginning with its Annual Report for 1945 and in subsequent reports and in repeated statements before Committees of Congress the Board has asked the Congress to review the situation and to give the Reserve System additional, or supplemental, powers to deal with bank credit.

The record of the Federal Reserve System is clear. On December 31, 1940, nearly a year before the outbreak of war, the Reserve Board, the Presidents of the twelve Reserve Banks, and the twelve members of the

Federal Advisory Council joined in a special report to the Congress. The report pointed out that the large defense program upon which the country was then embarking would have severe inflationary consequences. The report called attention to the fact that the banking system held a huge volume of excess reserves on which increases in the money supply could be based. The report said: "The Federal Reserve System finds itself in the position of being unable effectively to discharge all of its responsibilities. While the Congress has not deprived the System of responsibilities or of powers, but in fact has granted it new powers, nevertheless, due to extraordinary world conditions, its authority is now inadequate to cope with the present and potential excess reserve problem." A five-point program was recommended in the report. The first and major proposal was that Congress grant the System authority to double the statutory reserve requirements and to make them applicable to all banks receiving demand deposits regardless of whether or not they were members of the Federal Reserve System. Had Congress seen fit to grant this authority the reserve requirements against demand deposits could have been increased from the previous statutory maximum of 26 to 52 per cent for banks in central reserve cities, from 20 to 40 per cent for banks in reserve cities, and from 14 to 28 per cent for so-called country banks. Unfortunately, nothing was done at this early date to deal with the anticipated problem of inflationary overexpansion of bank credit.

In its first postwar report to Congress in 1945, the Board reviewed the monetary situation which had resulted from the war and again called attention to the inadequacy of the System's powers to deal with

this same problem. That report stated: "The creation of unnecessary bank credit by the commercial banking system is the particular concern of those charged with monetary responsibilities. It cannot be a matter of indifference that at present the country's central banking mechanism lacks appropriate means, that may be needed, to restrain unnecessary creation of bank credit". The Board advocated increases in short-term interest rates and suggested a number of supplemental measures to deal with bank reserves. None of these measures was authorized by the Congress.

Again in its Annual Report to Congress covering the year 1946, the Board recurred to its dilemma, pointing out that the need for the System to support Government securities and maintain an orderly market left it without adequate means of restraining bank credit expansion. The Board stated that while an increase in short-term rates and a greater degree of flexibility would be desirable, it would not suffice of itself "to prevent the shifting by banks from holdings of Government securities to private loans or corporate securities, if attractive loans or investments were available. On the basis of such shifts the banking system would be in a position to create reserves and to engage in uncontrolled credit expansion."

In its Annual Report for 1947, under the heading "Inadequacy of Existing Monetary Instruments", the Board again called attention to its dilemma. This report stated:

"Inflationary potentialities latent in the postwar monetary situation and limitations of the Reserve System's statutory powers for exerting an effective anti-inflationary influence under conditions brought about by the war were first pointed out in the Board's Annual Report for 1945. Developments since that time have emphasized the dilemma of the System in undertaking restrictive action within the existing framework of its authority while maintaining a responsibility for the orderliness and stability of the Government securities market. The Board believes that it would be unwise to set aside this responsibility in view of likely adverse effects on financial institutions, on the Government's fiscal and debt-management operations, and on the financial position of business.

"After extensive study of the problem of bank credit restraints, the Board concluded that, in order to be in a position to meet further contingencies of inflationary bank credit expansion without abandoning support of the Government securities market, some workable addition to the System's existing authority may be needed, at least on a temporary basis. Rapid bank credit expansion during the second half of 1947 clearly indicated that existing restraints are not adequate for these objectives. In response to a request from committees of Congress, in a session called to consider emergency measures to aid European recovery and to cope with inflationary developments in the economy, the Chairman of the Board of Governors presented an analysis of the credit situation and the Board's proposal for legislation to permit the imposition of more effective restraints."

Congress granted a limited, temporary authority applicable only to member banks and this authority was drawn upon to help restrain further bank credit expansion during most of 1948. In its 1948 Report to the Congress, the Board said: "With a large Government debt which is likely to be a dominant part of the debt structure for many years, the Federal Reserve has to cope with the dual problem of maintaining an orderly Government securities market and exercising control over the volume of bank reserves."

The report added:

"In its Annual Reports and other public statements since the end of the war, the Board of Governors has stressed the limited effectiveness of the traditional instruments of credit policy in the general monetary situation created by war finance.

In August 1948, the Congress granted temporary authority for increasing the reserve requirements of member banks. This temporary authority expired on June 30, 1949.

"In his Economic Report for 1949, the President pointed out that the monetary authorities should at all times be in a position to carry out their traditional functions of exerting effective restraint upon excessive credit expansion in an inflationary period and conversely of easing credit conditions in a time of deflationary pressures. The powers of the Federal Reserve to exert effective restraint on credit expansion are limited by the obligation to support the market for Government securities. In order to be in a better position to discharge its responsibility for maintaining sound credit conditions, the Board requested continuation of the temporary authority to apply a supplemental reserve requirement to member banks, and the extension of the requirement to all insured banks.

"The Board recognized that the proposed supplemental reserve requirement was not the perfect or final way of providing the Federal Reserve with adequate means to perform its primary function. It was proposed as an interim authority that could be used, if necessary, without making drastic changes in existing practices, until a more fundamental solution could be provided."

This report urged the Congress to review the situation, including adoption of such measures as might be appropriate to deal with the continuing problem. Nothing came of these recommendations.

The year 1949 marked an abatement of the intense inflationary pressures which had dominated the postwar economy. However, the Board, in its Annual Report to the Congress, said:

"Throughout the year 1949, the general and selective instruments available to the Federal Reserve authorities were coordinated in a flexible program for adjusting the availability and cost of credit to the changing needs of the economy. As downward trends in business activity, employment, and prices appeared early in the year, the Board of Governors shifted the emphasis of credit policy from restraint to ease. Toward the end of the year, after increasing evidence of economic recovery, the open market operations of the Federal Reserve permitted short-term money rates to rise in response to growing demand for credit.

"As the Board has repeatedly emphasized, beginning with its Annual Report for 1945, the Reserve System lacked adequate means of restraining excessive credit expansion during the early postwar years. In striving at that time to moderate inflationary dangers, the System used such measures as it had at its disposal, including margin requirements, regulation of consumer instalment credit, discount rates, reserve requirements, and moderate increases in short-term money rates. Nevertheless easy money conditions with relatively low rates prevailed throughout this period of acute inflationary pressures."

Throughout these years the Treasury failed to support, or actively opposed, the granting of supplemental authority to deal with the reserve problem. When the Korean situation touched off another inflationary splurge, the Board was again left without adequate means of carrying out its responsibilities in the credit field.