



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON 25, D. C.

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

Mr. Milton Friedman,
Department of Economics,
University of Chicago,
Chicago, Illinois.

Dear Mr. Friedman:

I enjoyed very much reading the fine statement of February 1, 1951 on the "Failure of the Present Monetary Policy" issued by yourself and your colleagues of the Department of Economics at the University of Chicago. I also enjoyed very much listening to the University of Chicago Round Table in which you and Les Chandler participated.

I think that the statement of February 1 is as excellent an analysis of the price-credit relationships in the current situation as has come to my attention, and the policy recommendations are, of course, theoretically sound. That I have reservations about the unequivocal application of these policy recommendations, you will understand, stems in part from the all-important practical considerations involved, and, in part, from the fact that it is not possible in some circumstances to apply such action at all.

On page 4 of the statement you say that the "failure to tighten bank reserves since Korea is a consistent part of the financial history of the last decade." Further on the same page it is stated that "this weapon (open market operations) has not been used effectively throughout the last ten years because the Treasury and the Federal Reserve System between them have been unwilling to let one particular price, the interest yield on Government bonds, rise more than fractionally."

These statements, I think, overlook the fact that for the first five years (war years) of the last ten years the problem was mainly fiscal rather than monetary. Had we financed the war in greater part from tax receipts both our war and post-war problems would have been substantially reduced. But once the decision was made by the Government to finance the war in large part by deficit financing the Central Bank could not deny the banks the necessary reserves required to make this program successful. Neither this or any other Central Bank could or would want to deny or take any action which had the effect of denying the Government money with which to wage a war of survival. With respect to the war-time freezing of rates

it must be remembered that you cannot engage in large-scale deficit financing with a fluctuating interest rate pattern. This observation holds with respect to our past experiences and will undoubtedly be true in the future.

The insistence of the Treasury on carrying over into the post-war period and into the defense period the same ~~artificially~~ ^{unavoidable during} low and frozen interest rate pattern that was ~~justified by~~ World War II conditions is, of course, very unfortunate. In the early months after the war there was justification for a go-slow policy on significant rate changes since the belief was widely held that the adjustment from war to peace would be much more difficult than it turned out to be. But once the strength of the inflationary forces in the country became evident it was time to take appropriate monetary action. However, while there are no real substitutes for credit control through open market operations a combination of partial substitutes would be of real benefit as the Board has been pointing out since 1940.

You may recall that on December 31, 1940, the Board of Governors of the Federal Reserve System, the Presidents of the Federal Reserve Banks and even the Federal Advisory Council recommended to the Congress that reserve requirements be changed so that maximum requirements under existing law would become the minimum requirements and that the Open Market Committee be authorized to increase these by 100 per cent. I suggest that our post-war experiences would have been somewhat different had this authority been granted.

In 1945 the Board again asked for additional authority and since 1947 the Congress has had a bill before it authorizing the Board to require a special reserve of banks in the form of certain kinds of short-term Government securities.

In view of the prospect, however, that the central bank ^{may} be faced again with large-scale Government deficit financing without full-scale war, and in view of debt management ~~policy~~ ^{problems under these conditions}, I no longer think that the special reserve is the best answer to the problem. I would suggest rather that

- (1) the Board be given authority to raise substantially the primary reserves of all banks;
- (2) short-term interest rates should be made flexible;
- (3) the long-term rate should be permitted to rise to 3 per cent; and
- (4) that maturing E, F, and G bonds should be refunded at 3 per cent.

I believe that the threat of significantly higher reserve requirements would cause banks to value liquidity more highly in order to meet potential increases in required reserves. This would be a powerful deterrent to increased bank lending. Flexible short-term rates would be a further deterrent, since they would raise the cost of reserves to banks in everyday operations. In addition, flexible rates could result in a penalty on banks if they met statutory increases in reserve requirements through the sale of short-term Government securities. The increase in the long-term rate should be incentive enough for long-term investors to hold Government securities but, in any case, it provides for a penalty in the form of capital losses if they do not hold them.

Again let me say that I enjoyed the statement and the radio broadcast very much. I think both were a distinct contribution to public understanding of these very serious issues.

Very truly yours,

M. S. Eccles.