Confidential

February 7, 1951

My dear Mr. President:

You as President of the United States and we as members of the Federal Open Market Committee have unintentionally been drawn into a false position before the American public -- you as if you were committing us to a policy which we believe to be contrary to what we all truly desire and we as if we were questioning your word or defying your wishes as the chief executive of the country in this critical period. We would betray our duty to the country as well as to you if we failed to do all in our power to clear up these misunderstandings.

In your recent meeting with us you clearly stated as your objective one which underlies Federal Reserve operations -- the maintenance of confidence in the integrity of the dollar and therefore in Government securities. In your recent economic report to the Nation you said: "If inflation continues to gain cumulative force it will multiply the cost of the defense program. It will undermine production, destroy confidence, generate friction and economic strife, impair the value of the dollar, dissipate the value of savings and impose an intolerable burden upon fixed income groups. This must not happen."

We propose to do all in our power to prevent it happening. We are dedicated to the preservation of the purchasing power of the dollar. Any policy which eats away this purchasing power -- which increases the cost of living -- at the same time and to the same degree undermines confidence in the credit of the United States. The credit of the United States Government in the final analysis rests with the American people. It depends upon the public's willingness to buy and hold Government securities.

The heart of the problem which confronts us is this: How can we stop the decline in the purchasing power of the dollar? How can we curb the dangerously rising tide of credit which is adding to the country's supply of dollars at an unprecedented rate? How can we arrest the flight of dollars into hedges against inflation when the supply of dollars is growing so fast? How can we best encourage people to hold and increase their savings and to spend less so long as inflationary dangers threaten?

Without confidence in sound financial management, this flood of newly created dollars in the form of credit cannot be controlled. It will overwhelm whatever price, wage, and similar controls, including selective credit measures, that may be contrived. This problem was not present in the mobilization period preceding World War II. Then the country had an abundance of unused plant, materials, and manpower. Savings had been depleted. Liquid assets were low and the public did not fear rising prices or shortages of goods and therefore did not anticipate the possibility of inflation.

Today our concern and our responsibility is with the basic problem of bank reserves which continue to generate a rising tide of money. In the face of existing inflationary pressures there is no effective way of stemming this tide that will not reflect itself in interest rates. It merely confuses the issue to charge that the Open Market Committee favors higher interest rates per se. We favor the lowest rate of interest on Government securities that will cause true investors to buy and hold these securities.

Today's inflation is not due to deficit financing by the Government. It is due to mounting civilian expenditures largely financed directly or indirectly by sale of Government securities to the Federal Reserve. You have taken a courageous and forthright stand for increased taxes to finance the defense effort on a pay-as-we-go basis. If the additional taxes which you have recommended are enacted, little or no new Government borrowing will be needed. The experience of the past year, however, has clearly demonstrated that a balanced budget alone cannot stop inflation. We shall still need to deal with inflationary threats arising from civilian spending based largely upon the present excessive money supply, augmented by the liquidation of Government securities by the banks and other holders.

It continues to be, as it has always been, the policy of the Federal Reserve System and of its Federal Open Market Committee to adapt credit policy to the needs and requirements of the Government as well as of the country. Our support of Treasury financing in time of war and in time of peace has given clear proof of this policy.

However, in inflationary times like these our buying of Government securities does not provide confidence. It undermines confidence. The inevitable result is more and more money and cheaper and cheaper dollars. This means less and less public confidence. Mr. President, you did not ask us in our recent meeting to commit ourselves to continue on this dangerous road. Such a course would seriously weaken the financial stability of the United States and encourage a further flight from money into goods. It would not be consistent with our responsibility to the Congress and to the people of this country to follow such a program.

In your meeting with us you mentioned the experience of returned veterans and other small holders with Liberty Bonds after World War I. As you know, the Savings Bonds of today are specifically designed to avoid a repetition of this experience. The Liberty Bonds were marketable securities subject to market fluctuations in price. These fluctuations were excessive following World War I, particularly because a large volume of Liberty Bonds were not purchased out of savings but with bank-borrowed funds. Later many of these were dumped on the market to repay loans. As a result, in the absence of any provision for support to maintain orderly conditions in the market, they reacted excessively in price.

The Savings Bonds of today, unlike Liberty Bonds of World War I, are redeemable on demand at specified values. The holder of Savings Bonds need not be concerned with market fluctuations because he will always get back dollars he has put into such bonds with a stated amount of interest.

In our open market operations we are concerned only with the marketable issues, which are largely held by banks, other financial institutions, and experienced market-wise corporate and individual investors. We have maintained, and plan to continue to maintain, orderly conditions in these issues. These holders are accustomed to changes in prices of securities and to shifting their investments in order to take advantage of more profitable opportunities. Today they are able to sell their Government bonds to the Federal Reserve at a premium, whereas the owners of Savings Bonds, in which savings of the mass of the people are invested, must accept a lower interest return if they redeem their bonds before maturity.

In accordance with our assurances to you, we shall seek to work out with the Secretary of the Treasury as promptly as possible a program which is practicable, feasible and adequate in the light of the defense emergency, which will safeguard and maintain public confidence in the values of outstanding Government bonds, and which at the same time will protect the purchasing power of the dollar.

Finally, at this critical time, when the cooperation of every one is desperately needed, we sincerely trust that the decisions which are made will be for the best interests of the people of the United States.

With warmest regards,

Sincerely,

(Signed) Tom

Thomas B. McCabe,
Chairman.