UNITED STATES SENATE
Committee on Banking and Currency

November 3, 1947

Honorable Marriner S. Eccles, Chairman
Board of Governors
Federal Reserve System
Washington, D. C.

Dear Governor Eccles:

I received in today's mail a letter from an official of a large and successful American company, offering several suggestions for controlling the present price spiral through the Federal Reserve.

Two of the recommendations are quite unique, and while I think the Administration would hesitate some time before adopting them, I would like to have your views as to how effective and practical you think they would be.

From his letter to me I quote:

"I have always understood that one of the principal reasons for the existence of the Federal Reserve was to control such situations; i.e., put the brakes on in a boom, and encourage expansion in a depression. I suggest that the following action by the Federal Reserve would be effective in the present situation:

(a) Require all member banks to carry larger deposit reserves with the Federal Reserve, thus mopping up excess reserves. (This will require legislation by the Congress.)

(b) Announce that the Federal Reserve will make no further purchases of Government bonds from any member bank for the purpose of enabling the member bank to increase the total of its loans and investments beyond the present level. (This would still permit the member bank to exercise discretion in varying from time to time the proportions of various type loans and investments. For example, a member bank could increase the proportion of consumer type loans by making a corresponding reduction in commercial, industrial, agricultural, and real estate types of loans.)

(c) If the action taken in (a) and (b) did not bring the credit expansion to a halt (although I think that it would), then the Federal Reserve should start to sell Government bonds, of which it now holds $22 billion.

You will, no doubt encounter objections to the above proposal.

It will be said that the inevitable result of such action will be to harden interest rates and thus increase the cost to the Government of carrying its huge debt. My answer to this is that such a result is undoubtedly likely, but that we have to measure this increased cost against the alternate cost to the people of this country if the Federal Reserve does not take action. For example, an increase of 1% in the carrying charge on the Government debt would result in an increased gross interest payment by the Government of $2.5 billion per year; however, the Government would promptly recover perhaps 40% of this in taxes, leaving a net additional interest cost to the people of this country of $1.5 billion. As against this additional cost however, it might well be that the cost-of-living savings would aggregate $10 billion as a result of bringing the price spiral to a halt. A saving of $1 a bushel on wheat alone would amount to $1.4 million.

Furthermore it will be said that the proposed action will depress Government bond prices. This undoubtedly would be true, but here again in assessing the damage we have to differentiate between a bookkeeping loss based on market quotations of the moment and ultimate actual losses to the bond owners. Large numbers of holders would suffer no actual ultimate loss. For example, Government agencies, insurance companies and banks who have invested in the bonds can hold them to maturity and suffer no loss of principal. Corporations who hold tax certificates would suffer no loss of principal. Individual holders of the E, F and G type bonds would suffer no loss of principal. In fact, no one who is prepared to hold his bonds to maturity would suffer any loss of principal.

It has also been suggested that if the individual holders of large numbers of E,F and G bonds should see market quotations for Government bonds falling, they might deluge the Treasury with requests for payment of their bonds, to which they are entitled under the contracts. My reaction to this is that they would be less likely to present these bonds for payment if the price level is stabilized or receding than they would be if the price level keeps rising. In this latter event, as they see the purchasing power of their dollar bonds being reduced, they may be more interested in cashing the bonds and converting the proceeds to something more tangible.

To conclude, everyone seems to agree that we are in a dangerous inflationary situation. In trying to bring this situation under control we are not making full use of the most effective tool at our disposal, namely, Federal Reserve action to halt further credit expansion. We are avoiding full use of this tool because of what I would call "compartmentalized" thinking, which sees merely one side of the result of such action, i.e., higher cost to the people of carrying the Government debt; but fails to consider the much larger offsetting saving to the people which will result from halting the price spiral."

With kind regards,

Sincerely,

(Signed) C. D. Buck

November 13, 1947.

Honorable C. Douglass Buck,
United States Senate,
Washington, D. C.

Dear Senator Buck:

This is in response to your letter of November 3, 1947, quoting portions of a letter from a correspondent who suggested certain courses of action by the Federal Reserve which he believes would be effective in the present situation.

It is evident that he has given unusual thought to the monetary aspects of the problem but that he may not have seen the Board's Annual Reports for 1945 and 1946 in which we reviewed the inflationary aspects of the situation which have developed since the war and the existing limitations on Federal Reserve authority. These reports outlined for legislative consideration some measures which might have corrective value. I am enclosing copies so that if you wish you may send them to your correspondent for his further study with special reference to his first proposal, relating to reserve requirements. We are hopeful that the forthcoming session of Congress will give thoroughgoing consideration to the question as to what additional powers in this field might properly be vested in the Federal Reserve System.

In this connection, I might say that it requires "compartmentalized thinking", as your correspondent put it, in order to come to the conclusion that Federal Reserve powers could be successfully used to combat the inflation. The Federal Reserve System can work toward economic stability through its influence on the flow of money but manifestly there are limitations on the effectiveness of such influence, because of the non-monetary factors affecting prices and business activity which cannot be controlled by monetary action. The goal can only be obtained through the coordination of the major policies of Government in the domestic and foreign field which influence business activity, including particularly those with respect to taxation, expenditures, foreign trade, agriculture and labor. These subjects will of course receive active consideration at the forthcoming session.

With respect to your correspondent's second proposal, that the Federal Reserve make no further purchases of Government bonds from any member bank for the purpose of enabling the member bank to increase the total of its loans and investments beyond the present level, this suggestion is predicated upon an incorrect assumption. The Federal Reserve does not make purchases for this purpose, and in practice they are not made directly from the individual member bank. They are made in the market from recognized dealers for the purpose primarily of maintaining stable conditions or of increasing the general supply of funds in the market when needed. The purpose he has in mind could only be accomplished through some such method as those outlined in the Board's Annual Reports.

As to your correspondent's third suggestion that, if the operation of his first two suggestions did not bring the credit expansion to a halt, then the Federal Reserve should start to sell Government bonds, the adoption of such a course of action would not only create difficult market problems for the Treasury in refunding its maturing and called securities but the price declines might be so sharp that they would be seriously harmful to the holders of outstanding long-term Government bonds and might have unfavorable repercussions on the functioning of many organizations such as insurance companies, educational institutions, trust funds, and others dependent upon their investments in Government securities. It is not an altogether sufficient answer in such cases to say that they might hold their investments through to maturity. Circumstances and situations frequently arise in which they must be able to liquidate or to readjust their investments to some extent.

In this connection you will be interested in knowing that one of the results of the policy which is being followed by the Treasury in refunding maturing obligations is that through the issuance of shorter-term obligations, even though at slightly higher rates than have prevailed heretofore, there is a substantial reduction in the overall cost to the Government of carrying its debt. This is due to the fact that a large volume of maturing obligations were securities originally issued for longer terms which have carried higher rates than the short-term securities into which they are being refunded. It has not been intended that the refunding policy should have the effect of increasing the rates carried by the longer-term issues of the Government. However logical may be the reasoning advanced by your correspondent, it is not believed that the Treasury or the Congress would willingly accept the budgetary consequences of a course of action which would result in raising these rates. We must find some other way.

I am glad to have the opportunity to consider and to reply to the proposals quoted in your letter. I hope that this reply will be of some assistance to your correspondent in his further study of the problem.

With kindest personal regards,

Sincerely yours,

(Signed) M.S. Eccles

M. S. Eccles,
Chairman.

Enclosures