Form F. R. 511(a)

TO Secretary to Secretary Snyder

FROM Governor M. S. Eccles

COPY

REMARKS:

I will appreciate it if you will see that Secretary Snyder personally receives this immediately in order that he may have an opportunity to read it before he goes before the Douglas Committee this morning.

Thank you.

12/2/49

GOVERNOR ECCLES' OFFICE

December 1, 1949.

Dear Mr. Secretary:

For your information, I am enclosing herewith a copy of a letter which I have written to Senator Paul H. Douglas in connection with my appearance before his Committee on November 22 and in response to some of his questions.

Sincerely yours,

M. S. Eccles.

Honorable John W. Snyder,
Secretary of the United States Treasury,
Washington, D. C.

December 1, 1949.

Dear Senator Douglas:

In connection with my testimony presented on November 22 before your Committee, I indicated that I had not attempted to include in my statement some important matters which may be helpful to the Committee. You granted me the privilege of filing a supplementary statement should that appear desirable.

In the course of my testimony you asked if it would serve a useful purpose if Congress were to instruct the Treasury further as to the policies to be followed in debt management where they are dependent upon the monetary policies of the Federal Reserve System. You also stated that you would appreciate it if you could get some suggested standards of an instruction that might be given to the Treasury by Congress with reference to Treasury relations with the Federal Reserve. Since presenting my testimony I have given a great deal of thought to this subject. In reading over the record of my remarks, it was apparent to me that I had not responded as fully as I could have to some of your questions. Therefore, I should like to take advantage of the privilege of making a supplementary statement.

A very fundamental dilemma confronts the Federal Reserve System in the discharge of the responsibilities placed on it by Congress. The System has by statute the task of influencing the supply, availability, and cost of money and credit. In peacetime, the objective is to do this in such a way that monetary and credit policy will make the maximum possible contribution to sustained progress toward goals of high employment and rising standards of living. Federal Reserve System powers for carrying out this responsibility are at present basically adequate. But the System has not, in fact, been free to use its powers under circumstances when a restrictive monetary policy was highly essential in the public interest. It has been precluded from doing so in the earlier postwar period in part because of the large volume of Government securities held by banks, insurance companies and others who did not view them as permanent investments. Reasons for supporting the market under these conditions I have already presented before your Committee.

This policy of rigid support of Government securities should not be continued indefinitely. The circumstances that made it necessary are no longer compelling. But the Federal Reserve would not be able to change these policies as long as it felt bound to support debt-management decisions made by the Treasury, unless these were in conformity with the same objectives that guide the Federal Reserve. The Treasury, however, is not responsible to Congress for monetary and credit policy and has had for a long time general easy-money bias under almost any and all circumstances. As long as the Federal Reserve policy must be based upon this criterion, it could not pursue a restrictive money policy to combat inflationary pressures.

Decisions regarding management of the public debt set the framework within which monetary and credit action can be taken. As the size of the debt grew through the period of deficit finance in the 'thirties and particularly over the war period, Treasury needs came to overshadow and finally to dominate completely Federal Reserve monetary and credit policy. When the Treasury announces the issue of securities at a very low rate pattern during a period of credit expansion, as it did last Wednesday, the Federal Reserve is forced to defend these terms unless the System is prepared to let the financing fail, which it could not very well do. To maintain a very low rate pattern when there is a strong demand for credit, the System cannot avoid supplying Federal Reserve credit at the will of the market.

Under these conditions it can hardly be said that the Federal Reserve System retains any effective influence in its own right over the supply of money in the country or over the availability and cost of credit, although these are the major duties for which the System has statutory responsibility. Nor can it be said that the discount rate and open market operations of the System are determined by Federal Reserve authorities, except in form. They are predetermined by debt-management decisions made by the Treasury. This will be true as long as the System is not in a position to pursue an independent policy but must support in the market any program of financing adopted by the Treasury even though the program may be inconsistent with the monetary and credit policies the System considers appropriate in the public interest.

The Federal Reserve System was established by Congress primarily for the purpose of determining and carrying out credit and monetary policy in the interest of economic stability and is responsible to Congress for that task. There is a seven-man Board of Governors, appointed for 14-year terms with approval of the Senate. The Board is assisted by an experienced and highly qualified staff of experts. There are twelve presidents of the Federal Reserve Banks, each with a staff of specialists, and each Federal Reserve Bank has a Board of Directors composed of leading citizens in its district drawn from professional, business, farming, banking, and other activities. There is also the Federal Advisory Council, composed of a leading banker from each of the twelve districts, established by Congress to advise the Board. All of these supply information and advice and many participate in formulation of monetary policies appropriate to the needs of the economy.

Under present circumstances the talents and efforts of these men are largely wasted. Views of the Federal Reserve Board and Open Market Committee regarding debt-management policies are seldom sought by the Treasury before decisions are reached. The System, however, has made suggestions on its own initiative to the Treasury in connection with each financing, but very often these have not been accepted. Decisions are apparently made by the Treasury largely on the basis of its general desire to get money as cheaply as possible.

In a war period or a depression, there is reason for financing a deficit through commercial bank credit -- that is, by creating new money. The Federal Reserve System has supported such financing at very low rates by purchasing government securities in the market at such rates, thus pumping the needed reserves into the banking system. In the early postwar period some support was desirable, especially for the 2½ per cent long-term bonds, but it should not have been as inflexible as it was for short-term rates.

The outlook at the present time is for an expanding economic activity with high employment. We also now anticipate a government cash deficit of over 6 billion dollars in the calendar year 1950. It would be inexcusable to finance this deficit at very low rates of interest by creating new money should inflationary pressures resurge. But if the Treasury, under these conditions, insists on continuation of the present very low rates, the Federal Reserve will have to pump new money out into the economy even though it may be in the interest of economic stability to take the opposite action. In making a cheap money market for the Treasury, we cannot avoid making it for everybody. All monetary and credit restraints are gone under such conditions; the Federal Reserve becomes simply an engine of inflation.

With respect to the problem of how future monetary and credit policies are to be established, it seems to me Congress must choose from the following three general alternatives if the present dilemma confronting the Federal Reserve System is to be resolved.

(1) Congress can permit the present arrangement to continue. The Treasury would control in effect the open market and other credit policy as it does now by establishing such rates and terms on its securities as it pleases, with the requirement that the Federal Reserve support them. It should be recognized that under this course, limitations over the volume of bank credit available both to private and public borrowers, and accordingly limitation over the total volume of money in the country, would be largely given up. Such credit and monetary restraint as might be required from time to time to promote economic stability would be entirely dependent upon the willingness of the Treasury to finance at higher interest rates, and in the past the Treasury has been resistant to doing this. If this alternative is followed, which is the present arrangement, Congress should recognize that the responsibilities for monetary and credit policies are with the Treasury and not with the Federal Reserve System and that the principal purpose of the

Federal Reserve System is then to supply additional bank reserves on the demand of any holder of Government securities at rates of interest in effect established by the Treasury.

(2) The Congress could provide the Federal Reserve System with a partial substitute for the open market and discount powers which debt-management decisions of the Treasury have rendered and can continue to render largely useless for purposes of credit restraint. Some measure of control over the availability of credit under inflationary circumstances could be regained if the System were given substantial additional authority over basic reserve requirements of the entire commercial banking system. With such authority, the System could, if necessary, immobilize new bank reserves arising from a return of currency from circulation, gold inflows, and System purchases of securities from nonbank investors and thereby prevent the multiple expansion of the money supply. In addition, the System would need authority to require banks to hold a special reserve in Government bills and certificates. This would be necessary in case banks entered upon an inflationary credit expansion through the sale of Government securities to the Federal Reserve or in the event it was necessary to assist the Government to finance large deficits without creating additional bank reserves which serve as a basis for multiple credit expansion.

(3) Congress, if it wishes credit and monetary policy to be made by the Federal Reserve System in accordance with the objectives of the Federal Reserve Act and the Employment Act of 1946, could direct the Treasury to consult with the System in the formulation of its debt-management decisions in order that these decisions may be compatible with the general framework of credit and monetary policy being followed by the System in the interest of general economic stability. It is obvious, of course, that Government financing needs must be met and the responsibility of the Federal Reserve to insure successful Treasury financing must continue to be fully recognized. But Treasury financing can be carried out successfully within the framework of a restrictive credit policy, provided the terms of the securities offered are in accordance with that policy.

To sum up briefly my views, I believe that Congress should fix clearly the responsibility for national monetary and credit policy. Although the Federal Reserve System was established as an agency of Congress for determination of monetary and credit policy, as it must function now it is responsible both to Congress and to the Treasury for that policy. These two responsibilities are often conflicting, and both cannot be satisfactorily discharged. The responsibilities and authority of the System need clarification and for that purpose one of three alternative actions might be taken by Congress:

> (1) Recognize in the statute that responsibility for monetary and credit policy is with the Treasury and recognize the Federal Reserve for what it is today — an agent for advising the Treasury and carrying out monetary and credit policy determined by the Treasury;
>
> (2) Give the Federal Reserve System such additional authority over bank reserve requirements as would adequately serve as a partial substitute for discount and open market powers;
>
> (3) Give the System a mandate to determine monetary and credit policies on the basis of guide posts stated in terms of the language of the Full Employment Act of 1946, with the Treasury required to advise and consult with the Federal Reserve and take into account the mandate of Congress in connection with its debt-management decisions.

I recognize that monetary or credit policy by itself cannot assure economic stability. It should be accompanied by a fiscal policy, as well as a bank supervisory policy, in harmony with it.

I appreciate very much having the opportunity to express my views on this matter.

Sincerely yours,

M. S. Eccles.

Honorable Paul H. Douglas,
United States Senate,
Washington, D. C.