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FEDERAL RESERVE BANK  
OF  
PHILADELPHIA

April 24, 1947

Board of Governors of the  
Federal Reserve System  
Washington 25, D. C.

Dear Sirs:

At recent meetings of our Board and its Executive Committee, the Directors gave special attention to current business, banking and credit developments in this district and in the country. They have expressed increasing concern about the inflationary forces in the economy. This concern came to a head at the meeting of the Executive Committee April 10 when the Directors decided to formulate their views because of the responsibility of the Reserve System in curbing inflationary pressures through the control of the supply of money. At the meeting on April 17, 1947, the Board asked me to convey to you the views that the members have formed as a result of their discussions.

Current developments give cause for apprehension to all of us. Leaders of both parties and of public thought, such as President Truman, Senator Taft and Mr. Baruch, have emphasized that inflationary possibilities are the most serious threat to maintenance of a high level of peacetime activity.

The recent behavior of prices, including the cost of living and the consequent effect on the purchasing power of the people, is a continued manifestation of inflationary pressures. It foreshadows further difficulties. While evidencing some restraint, organized labor is again driving for higher wages in order to offset the effects of price advances since the last general rise in wages. But unorganized workers and the large number of people depending upon fixed income are being squeezed anew between rising costs and lagging incomes. It is clear that we are in the spiral of inflation, with its harmful results - immediately to consumers, and presently to business and all of us.

Since before the end of the war, emphasis has been placed, as it should have been, on increasing production of goods and services as the primary way to diminish inflationary pressures. We still believe that increased production is a paramount necessity. It is apparent, however, that even the phenomenal records we have achieved in production have not

yet, except in certain commodities, produced the balance between the supply of goods and spending power that all of us had hoped would be reached within two years of the end of the war. Moreover, it is unlikely that still further increases in output, except in some spots, can be sufficient in the immediate future to catch up with demand.

We are impressed, therefore, with the importance of immediately attacking the problem with courage and vigor on other fronts, especially on the side of demand. The Reserve authorities have primary responsibility for regulating the supply of money or total means of payments, which is one of the vital factors in the total demand for goods and services. The policy of the System in facilitating wartime financing was to give the banks access to Reserve Bank credit at fixed rates announced in advance. The effect of this policy was to shift the control over the total volume of money from the central banking system to the market. Probably this policy was appropriate and tolerable during the war but it would seem that the time has come for the System to exercise its statutory authority over the volume of credit.

Under the wartime policy of the System, the market has taken the initiative in using these facilities for a tremendous expansion of the money supply, thereby adding to the intensity of inflationary pressures. In order to carry out the intent of Congress in bringing about and maintaining "sound credit conditions", the System should take the necessary steps to discontinue its commitment to provide reserve funds to the market at guaranteed rates. Emphasis should be shifted from maintaining the pattern of rates to controlling the spiral of expanding credit.

The present process of credit creation continues to add fuel to inflation and may result in social costs far surpassing the relatively small savings to the Treasury through lower interest rates. It seems to us that control over the volume of money is a paramount and urgent issue before the System. Such control cannot be regained through actions whose primary effect is not on volume but on the method of extending Reserve Bank credit - for example, to shift the means from bills to certificates of indebtedness. It is our considered judgment that steps should be taken now to give the System freedom of action in exerting its influence over the volume of money supply.

We recognize that timing is a most important element in a major policy change of this character, as is the extent or degree of such a change. The psychological factors, as measured in the probable public reaction, are also important considerations. But, if we are to cooperate with President Truman in the efforts to bring about a better balance in the economy, a matter of utmost concern to the entire nation, the System should promptly exercise its authority. Appeals to business men to reduce prices will fall on deaf ears unless it can be shown that each agency of the Government, as well as each private group, is doing everything possible to check inflation.

Very truly yours,

THOMAS B. MCCABE (signed)

Chairman.

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May 28, 1947

Mr. Thomas B. McCabe, Chairman,  
Federal Reserve Bank of Philadelphia,  
Philadelphia 1, Pennsylvania.

Dear Mr. McCabe:

Your letter of April 24 addressed to the Board of Governors has now been circulated to all of the members and on their behalf I wish to convey to you and your Board our views in this connection. The questions of policy which the letter discusses are within the jurisdiction of the Open Market Committee and not of the Board as such. No doubt we could all agree upon the broad objectives stated in general terms in your letter.

The economy is or at least has been in a spiral of price inflation reflecting the excess of war-created buying power over the supply of available goods and services. It has not been possible to expand production sufficiently to meet all of the existing demands arising from the huge accumulations of savings combined with a record peacetime high level of current income. It was not possible by any practicable means, except higher taxes, to contract either current income or accumulated buying power in the form of liquid asset holdings. With the abandonment of the harness of controls, including allocations of basic materials, building permits, price and wage ceilings, and the excess profits tax a rise in prices was inevitable.

In other words, we have already had a large degree of inflation. It seems to us surprising and late in the day to suggest that now the instrument of increased interest rates should be invoked "to check inflation" for when the generalities in your letter are translated into terms of practical action, that is the only means that the System could use theoretically as an anti-inflationary weapon. It is all the more surprising because Mr. Williams as well as Mr. Sienkiewicz have been familiar with and have participated in open market policy discussions from time to time. Mr. Williams was a member of the Open Market Committee from March 1945 up to March 1946. This is the first intimation we have had that the directors of the Philadelphia Bank believed that the interest rate weapon should or could be invoked. In fact, the Open Market Committee has been unanimous in all of its major recommendations to the Treasury and no member has proposed abandonment of the fundamental policy of supporting the Government bond market at levels satisfactory to the Treasury.

We have indicated that some aspects of present Federal Reserve and Treasury public-debt policies are conducive to further

credit expansion and declining long-term interest rates. It should be recognized, however, that during the past year, while the Treasury has been following its program of debt retirement, these undesirable tendencies have been largely in abeyance. The inflation that has occurred has been largely the result of wartime creation of money, although perhaps a small factor has been expansion in private credit, which, however, could not have been checked by any practicable change in Federal Reserve policies.

Recognizing that earlier tendencies toward monetization of the public debt and declining bond yields will possibly recur, we are considering measures for counteracting them. It is doubtful, as stated in the Board's 1945 Annual Report, whether present powers of the System are adequate for this purpose and we have proposed legislation which would fill this gap in the System's power.

Meanwhile we have suggested a change in the mechanism of handling Treasury bills that would serve to restore the bill as a market instrument. There has been discussion of the possibility of some increase in the low rate now maintained on Treasury certificates. While such action would help to correct any tendency for bond yields to decline and is desirable as a means of restoring a properly functioning money market, it could not be used as a strong anti-inflationary weapon, especially in the immediate situation. At best, any such change would have to be brought about gradually and without opposition by the Treasury.

Your letter suggests, however, that something more immediate and more effective is desirable and possible. It would be interesting to know just how the System, assuming that it should "properly exercise its authority" regardless of the Treasury's interests, could "check inflation." Would your Board propose that the System, in order to control the "spiral of expanding credit", discontinue "its commitment to provide reserve funds to the market at guaranteed rates" by refusing to purchase Government securities at all? How high would rates at which the System might buy have to go in order to discourage banks from making loans or borrowers from seeking loans when money can be profitably used?

Every member of the Open Market Committee is aware of the disastrous consequences that would follow if the System were to attempt to force rates up to levels that would be effectively restrictive on private borrowing. Such a policy would drive the price of all outstanding marketable Government securities held by banks, insurance companies, pension and trust funds, and other fiduciaries far below par. The Treasury, with its very large monthly maturities, would have no idea of the cost of refunding these maturities and hence of the kind of refunding issues that could be put out. It would increase enormously the charge on the budget for servicing the debt. If the Secretary of the

Mr. Thomas B. McCabe - (3)

Treasury were confronted with any such consequences as would be produced by the System's abandonment of support of the Government bond market, he would no doubt take the issue directly to the President who, in turn, would take it to the Congress if the Open Market Committee remained adamant. There can hardly be any doubt as to what the result would be. The "System's freedom of action" would in all probability be promptly terminated.

While the letter of your directors is couched in general and diplomatic language, its import is one of criticism of Open Market Committee policies. It is for that reason that we felt impelled to reply very frankly. Instinctively and by reason of your practical experience in important Government affairs you have a realistic and constructive approach to public problems. It is hard to believe that after you have considered carefully the practical application of the generalized proposals in the letter you would favor taking the actual steps necessary to make them effective. Such a remedy would be far worse than the disease.

It would be most unfortunate if responsible people in the Federal Reserve System were to create the impression publicly that the System itself could have prevented or could at this late hour materially diminish inflationary forces. The problem is not so simple that it could be dealt with effectively by monetary policy. Outside of the monetary cranks, no one at all informed on the subject would suggest that in the great complex of economic forces there is some simple monetary device that could preserve or restore economic equilibrium.

Sincerely yours,

(Signed) M. S. Eccles

M. S. Eccles,  
Chairman.

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