See Personal file on King

May 14, 1951.

Mr. Edward A. Rumely,
205 East 42nd Street,
New York 17, New York.

Dear Mr. Rumely:

Let me thank you for your kind letter of April 3, 1951, and for the draft of Dr. King's very interesting study "Why Not Apply Science to the Nation's Monetary and Peace Problems?" I shall be very glad to pass on to you my comments on Dr. King's proposals.

Dr. King has proposed that each commercial bank (including those that are not presently members of the System) be required to maintain at all times, in the form either of cash or of reserve balances at its Reserve Bank, reserve assets equal to 100 per cent of deposit liabilities. Thereafter, the private banking system as a whole could not create money through the expansion of its loan, investment, or other assets. Dr. King has correctly pointed out that credit creation for the economy as a whole would be a function solely of the monetary authorities under his plan.

However, Dr. King assumes that the procedure would be fully automatic and would take care of all changes in the volume of trade, a point with which I cannot fully agree. A predetermined price level would be established which would correspond to par. Whenever prices rose above or below par, the Federal Reserve Board would sell or buy Government securities in the open market in order to influence the lending power of the commercial banks and the quantity of money. These changes in the quantity of money would then be transmitted to the price level and would be capable of influencing precisely the level of business activity according to Dr. King's plan.

I should like to make several points in reply to Dr. King. (1) The Federal Reserve Board has on several occasions asked the Congress to grant it additional monetary powers, of a similar but more limited type than those recommended by Dr. King. These powers might include, first, the limited authority to increase primary reserve requirements or, second, the broader authority to require

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all commercial banks to hold an adequate percentage of their deposits in a special reserve in Government securities. Use of these powers would doubtless help the Federal Reserve to control the volume of bank lending and monetary expansion and, therefore, the level of business activity.

I cannot agree, however, that there is any mechanistic relationship between the quantity of money and the price level, which would permit a scientific determination of prices at all times on this basis. We cannot control the economic fluctuations in the same way that we can split the atom. Too many human considerations are involved in the social sciences which prevent the development of any precise scientific mechanisms in this field.

(2) I have always believed that inflationary pressures arise whenever the combined demands of businessmen, consumers, and Government exceed the current supply of goods and services. Similarly, deflation occurs when these combined demands are not sufficiently great to take from the market all of the goods and services currently being produced by our tremendous productive facilities.

It is quite true that unchecked monetary expansion can be a powerful, and in some cases the major, factor contributing to an excessive demand for goods and services and, therefore, to inflationary pressures. However, monetary policies alone cannot effectively regulate total demand in relation to the current production of goods and services. The use of appropriate tax and expenditure policies, which react directly upon the spending stream itself as well as upon the quantity of money, is necessary in order to check both the boom and the depression.

(3) You are making a real contribution in the present fight against inflation in pointing out its destructive long-range effects and in stressing the desirability of taking appropriate monetary measures to fight inflationary pressures. I agree with you that the dollar already has been permitted to depreciate too far, and that its consequences have worked a grave injustice on great masses of our people. I feel, however, that the Committee and Dr. King might point the discussion even more in the direction of specific monetary and particularly fiscal measures which should be adopted at the present time to prevent even further depreciation of the dollar. There is not enough discussion in the paper, for example, of why an effective pay-as-you-go program of financing defense expenditures is absolutely essential in restraining inflationary pressures at the present time.

(4) In conclusion, let me quote several paragraphs from the April 1939 issue of the Federal Reserve Bulletin which are particularly appropriate in connection with Dr. King's proposals.

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"The Board of Governors is in complete sympathy with the desire to prevent booms and depressions, and has always considered it its duty to do what it could to help accomplish these results.

"Experience has shown, however, that (1) prices cannot be controlled by changes in the amount and cost of money; (2) the Board's control of the amount of money is not complete and cannot be made complete; (3) a steady average of prices does not necessarily result in lasting prosperity; and (4) a steady level of average prices is not nearly as important to the people as a fair relationship between the prices of the commodities which they produce and those which they must buy.

"Steady prices and lasting prosperity can not be brought about by action of the Federal Reserve System alone, because they are affected by many factors beyond the control of the Federal Reserve System."

Very truly yours,

M. S. Eccles

ERH:dm

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