FEDERAL RESERVE BANK

OF CLEVELAND

CLEVELAND 1, OHIO

October 14, 1949

The Honorable Paul H. Douglas
Chairman of Subcommittee of
Joint Committee on the Economic Report
The United States Senate
Washington, D. C.

Gidney

Dear Senator Douglas:

Pursuant to your request of August 22, I am submitting herewith my views on the issues raised in your questionnaire, E-1, of August 1949. For general reference, I enclose a document entitled "Draft Replies to Questionnaire Addressed to the Presidents of the Federal Reserve Banks by the Subcommittee of the Joint Congressional Committee on the Economic Report."

When your questionnaire was received by the Presidents of the Federal Reserve Banks, the Chairman of the Conference of Presidents, Chester C. Davis, Federal Reserve Bank of St. Louis, after consulting with the other presidents, appointed a special committee consisting of Allan Sproul, Federal Reserve Bank of New York (Chairman), Alfred H. Williams, Federal Reserve Bank of Philadelphia, and H. G. Leedy, Federal Reserve Bank of Kansas City, to consider preparation of a general report that could be used as background by all the presidents in preparing their individual replies. The Special Committee of Presidents appointed a special Research Committee composed of economists from seven of the Federal Reserve banks to assemble factual information and draft replies which, in its opinion, would express the consensus of the Federal Reserve bank presidents. Considering the shortness of the time available for dealing with the many fundemental issues raised by your inquiry, I think that the Special Research Committee has done an effective job in submerging individual differences and developing a well-rounded and reasonably coordinated position.

I am in substantial agreement with most of the position taken in that report and shall confine my personal replies to those questions on which I disagree or on which I believe some modification in viepoint or emphasis to be desirable. The numerical and alphabetic reference to questions in my replies is the same as that used in the Draft Replies.

I. - 3. Cite the more important occasions when the powers and policies of the System have been inadequate or inappropriate to accomplish the purposes of the System.

On the whole, I agree with the Draft Reply and even with the statement that "the power of the System to absorb actual or potential excess reserves has been inadequate because *** use of open market operations and discount rates was inhibited by a desire to avoid interference with the management of the public debt and adverse effects on the public's appraisal of Government obligations."

I believe the statement to be a correct representation of the facts with regard to the attitude of a majority of those in the System charged with responsibility for policy but I am not fully in sympathy with that position because, as I indicate in my reply to question II. - 1. below, I believe more determined steps could and should have been taken to absorb some of the excess reserves through use of open market operations and a more flexible policy as to support prices of governments.

II. - 1. Would a monetary and debt management policy which would have produced higher interest rates during the period from January 1946 to late 1948 have lessened inflationary pressures?

I am in agreement with the Draft Reply which states that such a policy would have enabled the Treasury and the Federal Reserve System to pursue a more restrictive monetary and debt-management policy than that which was actually undertaken. I also agree with the concluding sentences that it is difficult to conjecture how effective a policy of further tightness would have been during the three postwar years. In my opinion, some of the steps finally taken by the System should have been taken sooner. How far we could have gone without precipitating the undesirable consequences in the markets that some feared, no one knows. I have been disturbed by the extent to which people in key managerial positions in banks, insurance companies, trust companies, and elsewhere in the financial and business world, to say nothing of the lay public, appear to have accepted the doctrine that an invariable maintenance of Government bond prices at or above par is essential to the financial soundness of the country. To me, this is a doctrine out of keeping with the history of our financial past and unfortunate in the restrictions that it puts on the functioning of our financial machinery. I believe that a tighter policy could have been followed which would have permitted some issues to go moderately below par so that the country could have adjusted its thinking on the matter of money rates, security prices, and financial soundness to changing conditions. I recognize that such a program would have involved certain risks but I believe they should have been taken.

While believing that a tighter policy should have been followed, I am by no means confident that it would have had any materially different effects than did the policy that was actually followed during the first three postwar years. As the Draft Reply states on page II. - 3., a more restrictive policy would have restrained more effectively those expenditures which depended upon the use of borrowed funds. The most important of these expenditures were in construction and real estate and in business itself. Liberality in the use of credit in construction and real estate was fostered by Congressional policy, and more restrictive Federal Reserve action might have resulted in a direct countermandate of the Congress or in Congressional action to provide special governmental financing facilities thus nullifying, at least in part, Federal Reserve action. Business demand for credit grew out of the need for inventories and additional or renovated plant and equipment. While some speculation in inventories may have occurred, most of the increase in the postwar period appeared to be necessary in order to permit industry and trade to function more efficiently. The expansion or renovation of plant and equipment reflected the need of business to expand capacity to meet the large postwar demand for goods and services and we have a record of accomplishment in catching up with these demands which is highly praiseworthy.

A more restrictive monetary and credit policy might have led to a moderation in the rate of capital expenditures. A reduction in the rate of capital expenditures might have resulted in their being spread out over a longer period of time so that they might not have reached such a high peak in 1948 and might not have declined so much in 1949. Had such been the case, inflationary pressures from this source might have been reduced and a more stable employment situation might have occurred. On the other hand, capacity would not have been increased so much and thus the inflationary pressures resulting from consumer demand might have been maintained over a longer period and have been reflected in higher prices. Criticism of our business leadership might also have been more severe because of an alleged slowness in expanding capacity to a point "adequate" to serve the needs of the nation. Only a few months ago the steel industry was under such attack.

III. - 3. a. What would be the principal advantages and disadvantages of restoring circulation of gold coin in this country?

b. Do you believe this should be done?

I am not in full agreement with the Draft Reply to this question. While I realize that it may not be practicable to restore circulation of gold coin in this country immediately when the rest of the world is not on the gold standard and when political and economic uncertainties throughout the world would be conducive to the hoarding of gold coin, I do believe that we could and should liberalize the provisions of law and regulation with respect to the ownership of gold by our citizens. I believe that steps could be taken to permit people to buy, hold and sell gold more freely in this country without endangering our financial soundness.

IV. - 1. a. What changes, if any, should be made in the reserve requirements of member banks?

I am not in agreement with the recommendation contained in the Draft Reply. The present system of reserve requirements is by no means perfect and from time to time the Federal Reserve System has had committees study this question. However, sufficient agreement to justify change has never been secured on any proposal for determing reserve requirements. Recently a technical staff System committee submitted a proposal for a new system of reserve requirements based on type of deposits rather than on location of bank, as at present. The recommendation in the Draft Reply to your questionnaire is essentially that proposal. I do not believe that the particular proposal has been given enough study by the banking system and particularly by parties other than those directly connected with the Federal Reserve System to warrant its consideration at this time. The banking system has adapted itself to the existing method of reserve requirements, and banking relationships have developed around them. The advantages claimed for the proposal do not appear to me to be sufficient either in character or in probability of achievement to warrant the disturbance to the banks that would result in making the change. I would favor legislation permitting member banks to count vault cash as a part of their reserves. This would help to remove some of the present inequities claimed in the system of requirements. Otherwise, I am in favor of letting the entire question of reserve requirements rest unless there can be an approach made to the subject in a manner which would give opportunity for participation by a wide group of interested parties such as bankers' associations, state bank supervisors and others.

IV. - 1. b. What changes, if any, should be made in the authority of the Federal Reserve to alter member bank reserve requirements?

1. c. Under what conditions and for what purposes should the Federal Reserve use this power?

The authority to alter member bank reserve requirements is a clumsy and unsatisfactory instrument of credit control. It affects all banks and requires or permits adjustments which may have unhealthy general effects and be harmful in many individual instances. The use of this authority, therefore, can be justified only in exceptional cases and calls for a degree of discrimination difficult of attainment. As the Draft Reply indicates, requirements should be altered only to take care of those situations in which excessive liquidity or tightness could not be compensated for by open market operations without engaging in purchases and sales of such magnitude as to have seriously detrimental effects on money markets, security markets, and business and Government finance. Such situations would include unusually heavy and sustained imports or exports of gold. I believe, therefore, that the power itself should be used rarely and not as a substitute for ordinary open market operations. On that basis, I do not believe that additional powers or changes in existing powers are necessary. Bankers, generally, would appreciate our giving the matter a rest cure and letting them feel that they have a stable basis of reserves on which to operate.

IV. - 1. d. What power, if any, should the Federal Reserve have relative to the reserve requirements of nonmember banks?

I am in agreement with the Draft Reply to this question. However, I reiterate the position taken in my immediately preceding replies that the whole subject of reserves should be given a rest cure. If legislation should be considered, such legislation should include application of the same general type of reserve requirements to all banks.

IV. - 2. a. Should the Federal Reserve have the permanent power to regulate consumer credit?

I do not believe that the Federal Reserve should have permanent power to regulate consumer credit as I am not at all convinced that it is necessary, wise or practicable thus to police this field of human activity. I am not satisfied that there are advantages to be derived from use of the power sufficient to offset the disadvantages inherent in an irritating interference with normal business transactions.

IV. - 6. What legislative changes would you recommend to correct any such deficiencies? (i.e. in legal power to accomplish Federal Reserve System objectives.)

As indicated in any replies to questions IV. - 1. and IV. -2., I am opposed to the recommendations in the Draft Replies for legislation changing the method of determining reserve requirements and granting authority to the Federal Reserve to exercise control over the volume of instalment credit. While a number of other changes could be suggested which would be conducive to more efficient and more economical operations, they are of minor significance to the achievement of Federal Reserve policy objectives. I believe that the System can do a good job under existing authority.

VI. - 5. a. What changes, if any, should be made in the powers of the Federal Reserve to lend and guarantee loans to nonbank borrowers?

b. Should either or both of these powers be possessed by both the Federal Reserve and the Reconstruction Finance Corporation? If so, why? If not, why not?

I am in disagreement with the position taken in the Draft Reply to the first question. I do not believe that our present authority to lend, or, in effect, guarantee loans to nonbank borrowers needs change at this time. At the Federal Reserve Bank of Cleveland we have been able to operate effectively under the provisions of the act and do not feel that it is unduly restrictive. Rather, we feel that the restrictions now in Section 13b of the Federal Reserve Act are wise and desirable.

VI. - 6. a. What would be the advantages and disadvantages of establishing a National Monetary and Credit Council of the type proposed by the Hoover Commission?

b. On balance, do you favor the establishment of such a body?

c. If so, what should be its composition?

I have reservations about the value, effectiveness or desirability of such a Council and, on the whole, would be inclined to oppose its creation. Should one be established, however, I believe it should be purely advisory and reportorial. For this reason its membership should be inclusive of all Federal lending and supervisory agencies and not restricted to just a few as suggested in the Draft Reply.

I hope that the material herewith submitted will be helpful to your committee and that you will call on me if I can give further information or expression of views.

Sincerely yours,

Ray M. Gidney
President

Encl.