

W. I. King

1921-1922

National Bureau of Economic
Research 1920 - 1921 - (1922)

New York University by 1930

Fraser file

King

76 S. 23d St. Flushing, N.Y. Nov. 13, 1921

ACKNOWLEDGED

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B. S.

Benjamin Strong,
N.Y. City

My dear Governor Strong: -

I have just finished reading your very able and clear cut history of the Federal Reserve system as given before the Congressional Committee. It is a document which every economist should be glad to add to his library.

You requested criticism of your argument. With most of your contentions I am in hearty accord and I am glad to see such a scientific spirit in all of your statements. I presume, however, that no two economists ever agree on everything, hence I am going to take the liberty of raising a question or two.

Do you not think that it would have been a much wiser policy for the Government to have taxed more and borrowed less to finance the war? Would not such a policy have compelled

necessary
 the saving and economy by a better method than
 that actually employed, (pp 451 & 452)? Is it not
 evident that the people did save all the expense
 of the war while the war was going on and that
 credit did not alter this fact in any material
 way?

Is it not true that if the supply of circulating
 medium had been kept fixed that the taxes
 and money borrowed from the people would have
 lessened the demand for consumption goods
 to about the same degree that the demand
 for war supplies was increased? The income
 of the people is relatively fixed and if they spend
 more dollars for one purpose they normally
 must spend less for the other purposes (p. 453)

Is it not true that the injustices and
 injuries wrought by the rise in the price level from
 1914 to 1919 (and its subsequent decline) have
 been far greater than those which were inflicted

by the panic of 1907? If this is true, and if, as I believe, the Federal Reserve Board can almost absolutely control the trend of prices in the United States, are you justified in stating that the business of the Federal Reserve Banks is to deal with credit conditions and not to watch price charts? (p. 622) Understand, I heartily endorse your position of not interfering for the benefit of any class in the nation — I refer to average prices only.

Do you really believe that anything has ever "led the world to a state of production beyond the power of consumption"? (p. 773) Is it not clear that millions are near starvation and that nearly everyone would like to treble his consumption? It appears to me that the crisis must be otherwise explained.

Granting the imperative need of assisting the Treasury under the policy adopted for financing the war, would it not have been desirable in the latter part of 1919

(chart p. 500.) to have raised the discount rates

on paper secured by everything except Government
 notes to any height necessary to prevent the
 enormous expansion in loans that then occurred?
 Could it not have well been held around the
 800 million total throughout? Would such a policy
 have not ^{largely} prevented the price rise and boom of
 1920 and have therefore made the present depression
 much less severe? Is not a vigorous lifting
 of the discount rates the most effective weapon
 against inflation that can be provided to the
 bankers? It appears to me that the time for
 the sharp raise in these rates was the moment
 that the volume of discounts began to climb —
 not later. If the rate had to go to 10% or
 50% why not take it there? I see no object
 in differentiating speculation from business enterprise
 for all business enterprise is largely speculation
 and must be in a competitive system.

If the rates had been kept high in 1919 would
 there not have been abundant leeway and surplus

reserves to have permitted of any desired volume of credit expansion when the decline appeared in late 1920?

Are you not unduly optimistic in assuming (p. 5-05) that prices are being brought to "a new stabilized level". Have we ever witnessed such a condition? Are we likely to ^{do so} soon? Are not costs of production rather the result of a price level than the cause thereof?

"But all that's past is gone, you know" and the main practical question is the future. The last year has proved that "the higher they fly the harder they fell" - may we not soon reverse the adage? Are you sure that the same laissez faire policy followed in 1919 will not lead to another wild rise of prices in 1922-23 with all the disastrous disturbances inherent therein? I feel that the Federal Reserve system has it in its power to prevent such a calamity and

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that it is its patriotic duty to prevent such
a price rise by ~~prevention~~ raising its discount
rates whenever the price level begins to show
symptoms of another rush skyward. The raise
should be enough to stop it - however much
it takes. If not, we are likely to see gold
reserves again reduced to low levels, and if
at that time Europe begins to draw gold from us,
financial panic may be added to the other enormous
evils connected with unstable price levels.

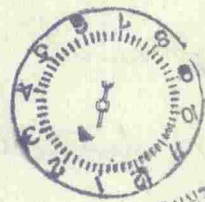
I trust that you will not feel that I am
a carping critic for I assure you that I have
every wish for your success. I have, as you may
know, devoted no little thought to the subject and
I expressed my views in an article in the Economic
Review of which I am enclosing a copy. I may of
course, be wholly wrong but I am as yet unconvinced
of my error.

Again let me thank you heartily for your very
valuable report and assure you of my good wishes.

Very sincerely yours,

Willford D. King

NOV 15 1921



GOVERNOR'S SECY.
FEDERAL RESERVE BANK OF ST. LOUIS

Carbon copy destroyed

FEDERAL RESERVE BANK
OF NEW YORK

November 17, 1921.

My dear Professor King:

When I received and read your long letter of November 13, frankly, my conscience smote me hard in realizing that I had imposed upon you a task of writing such a long letter by hand. It was indeed most kind of you not only to read the statement, but to comment upon it so fully. Your letter certainly deserves an extended reply, but in order that it may be reasonably complete I must ask you to receive and hold its contents in confidence.

First, please bear in mind that the scope of my statement, which necessarily was a very long one, was limited by the time allowed me by the Commission and the necessity for dealing specifically with matters which had been criticised by Mr. Williams and others, and also by two other important considerations which were controlling at that time, but which now would not be so important. One of them was a very dangerous financial situation in New York, which made it necessary for me to deal with certain parts of the inquiry with the utmost caution. The other was naturally imposed upon me by the necessity for loyalty to those with whom I had been associated in the Treasury Department during the war period, and especially the post-war period. I refer specifically to the year 1919 and the policies of that year, with which I was very much out of sympathy during the greater part of the time.

It seemed to me that no argument as to the Treasury's policies of the year 1919 was permitted by me so long as Secretary Glass and Mr. Leffingwell were available to the Commission, and especially, as I explained to the Commission, when I had occupied the position specified in the Federal Reserve Act of being the agent of the Treasury rather than a principal.

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With this preliminary comment, which is necessary to an understanding of my personal position, let me add that almost every question raised by your letter, in order to be accurately answered, requires consideration of the circumstances and of public opinion at the time, and of what is practicably possible contrasted with what is theoretically perfect.

Should the government have taxed more and borrowed less? The answer to that is Yes, had it been possible. My thoughts in regard to the policy of taxation during the war were, I may say, almost entirely controlled by the influence of Professor Adams' book "Public Debts," and his admirable chapter upon Secretary Chase's policy in financing the Civil War. If you will, however, refresh your memory as to the state of mind of the public, the temper of Congress, the difficulty of getting legislation of the character required through Congress, I think you will agree that while more might have been done, what was done was extraordinary when one contrasts the failures of the Civil War period, and the equally disastrous failures of the European belligerent nations. Over and over again the policy of high taxes was urged upon Congress by Secretary McAdoo, and was energetically supported by the managers of the Federal Reserve System. The program for taxation recommended for the year 1918-1919 contemplated revenues of \$8 billions from taxes. The approaching conclusion of the war resulted in a modification of the program to \$6 billions, as was finally adopted.

My own view as to whether the people did save all the expense of the war while the war was going on is slightly different from what is implied by your question. They did furnish all of the services and they did produce all of the materials required for the war during the war period. That is certainly true; but what they did not do was to reduce their own consumption so that what was consumed by the war was ^{less of} ~~not treated~~ ^{had to be paid for} ~~as a part of future payments~~, as would have been the case had taxation ^{more nearly} covered expenditures; but after all, could taxation have covered the entire expenditure?

Theoretically, I admit that it could, and cited the example of warfare in feudal

days to illustrate the point. But on the other hand, what is theoretically possible and what is practicably possible are two very different things, and I doubt whether taxation to the extent required would have been politically and socially possible. This can be only a bare expression of opinion.

This, in a measure, answers your next question as to the limitation of the supply of circulating medium. Leaving out the influence of additions to our gold and the inflationary effect of gold imports, I personally believe that more could have been done after the war ended toward limiting expansion and inflation than was done. Very little, if anything, more could have been done during the period of our belligerency, and under the existing state of the law prior to our entry we were really powerless to do anything. The figures prepared at the bank indicate that the greatest expansion took place before we declared war; the least expansion during our participation in the war; and a considerably greater expansion subsequent to the conclusion of the war, ^{than during our war period.} The first two periods were the most difficult to deal with. The last period could have been dealt with in my opinion by a different policy had the Treasury and Congress been willing to adopt it.

My belief is (and of course I am expressing but my personal opinion) that the risk should have been assumed of a high rate policy commencing in March of 1919. What the consequences would have been can only be surmise. We would have prevented a considerable part of the ^{later} advance in prices, which in fact had considerably declined between January and April in 1919. The arguments of the Treasury against that policy were principally two: One was that the decline in the values of Liberty bonds, as the result of the ^a higher interest level, would cause a demand in Congress for refunding the entire war debt, which was regarded as an impossible operation and one necessitating gross injustice to those who subscribed at par and sold at a discount, and an unwarranted profit to those who had not subscribed at par but who had purchased at a discount. You will recall that the Treasury was borrowing constantly increasing amounts until September 1919. The second argument was that

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we were faced with an imminent and sudden reduction in our export trade, with the possibility of goods piling up at home and causing heavy price declines anyway.

Possibly, writing with more frankness than I should, I might say that neither of these arguments ^{then} have impressed me. I did not expect our export trade to decline, but rather to continue for a considerable period, and I was always willing to take the risk of Congress running away with the situation by passing some big refunding act. I do not think that they would have done it; but again that is just personal opinion.

Commenting upon your question in regard to control of prices. That is, I believe, one of the most difficult and puzzling matters of policy with which the Federal Reserve System deals. I realize not only the imperfections of my statement on that point, but will go further and say that I realize my limitations in dealing with so important a subject; but shall try and express to you just how I feel the attitude of the Federal reserve banks should be toward prices in general.

There are a great variety of considerations which enter into the rate policy of the Federal reserve banks: The state of reserves, whether gold is being imported or exported; whether the country is in a speculative or in an apathetic state of mind; whether prices are advancing or declining; whether there appears to be over-production or under-production; whether the general level of interest rates is much above or much below the discount rates at the reserve banks; &c. &c. When it comes to the question of prices, it seems to me that we should consider movements of prices in their relation to our discount rates, to our volume of discounts, to market rates for credit, &c., as being a reflection of our policy, rather than a primary cause of action. It is difficult to express by dictation, but what I have in mind is that it is the movement or trend rather than the absolute figures of the moment, which should determine our policies. If our discounts are expanding, if our rates are getting below the market, if prices are advancing, if the speculative temper has developed, then rates should be advanced. Not only all of these considerations together, but possibly only one or two would be justification

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for advancing rates. The converse of that is true to some extent as to possibly all of the factors that I have named, excepting declining prices. It should not necessarily be our policy to promptly reduce discount rates just because prices decline; in fact, a declining of prices is likely to reach considerable proportions before actual liquidation of the volume of credit takes place, assuming, of course, that we escape, as we should, a panicky, perpendicular liquidation with a large volume of distress sales of securities and goods. On the whole, I think the policy of the Federal Reserve System will be safer and less liable to political attack if the attention of the country is focused more upon the state of our reserves, the volume of our loans, and the cost of credit, than it will be if we frankly assume to direct our policy toward regulating prices. This is a country of a great variety of economic interests; when cotton is prosperous, cattle may be prostrated; when manufacturing is prosperous, agriculture may be in difficulties. There would always be one class or another to demand that we regulate their prices. In fact, this has been frankly stated to me at the Capitol by those who are thinking sectionally rather than nationally. So, admitting, if you please, the effect of our policy, its reflection in the price level, will it not be safer in the long run to direct our policy toward regulating the volume of credit (certainly in public discussions of the question) rather than to direct our policy to the direct regulation of prices. This argument may seem to you a bit specious, but I can assure you that it is practicable, with my experience with the temper of Congress ^{of} during the past ten months.

As to the world reaching a state of production beyond the power of consumption. I should say that the answer to that is more psychological than actual. We do know that people influenced by fear, propaganda, or for some one or another reason, at times are driven to practice unusual economies, while production continues, and a great surplus of goods accumulates. It is a reflection of a state of mind rather than an economic condition. I believe, generally, that the world

is just about capable of consuming all that it is capable of producing, so long as one admits that the state of society is such as to support a constantly elevating standard of living. In fact, as to that whole line of inquiry, in your letter, I attach much more importance to the influence of the state of mind of the people, than I do to the theoretical possibilities in a theoretically perfectly organized state, where the influence of fear, or the influence of the anticipation of future events, so strongly controls what people do.

Expressing it differently, I think ^{not} all of the losses and suffering in the past two years could have been escaped if two things ^{had been} were possible of accomplishment: One, if the volume of credit and the level of prices could ^{have been} be reasonably maintained at that established in the spring of 1919; and second, if the minds of the people of the country could have escaped the influence of what was happening in other countries, where less fortunate conditions led to the breakdown in Japan in the East, and somewhat later in Europe.

I have answered your inquiry as to the rate policy of 1919, excepting as to the suggestion that rates might have been raised to any heights necessary on all forms of borrowing, excepting those secured by government collateral. There, I think practical experience has completely demonstrated not only to us in New York, but to the managers of the other reserve banks, that these differential rates are wholly wrong and ineffective. Had we established a 7% rate on commercial borrowings, and maintained a 4% rate upon loans secured by government bonds and notes, in the spring of 1919, within two or three months all of our loans would have been secured by government bonds at the 4% rate; and the converse would have been true had we made a 7% rate on government loans and a 4% rate on commercial loans. The banks simply borrow in the cheapest form in which they can. The only differential in rate, which our experience indicates is justified, is that ^{which} applying ^{as to} for the period for which the loan is granted. The enormous volume of the government's borrowings would have afforded ample means to all of the banks of the country to have borrowed all that they wished at the low rate. To escape the 1919 expansion, it would have

Professor King

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It is necessary to have advanced all rates. That is a matter which I believe the Treasury never understood until the spring or fall of 1920.

The object of my statement in differentiating speculation from business enterprise was to remove from the minds of the members of the Commission what I believe was a very erroneous impression of the policy of the bank in New York. Please bear in mind that having been deprived of the opportunity of controlling the expansion of credit by the employment of higher discount rates, it was necessary to do the best that we could do by direct control. The best example that I could give to the Commission was the control which we exercised over the stock market speculation. Of course, I admit that all business contains in a greater or lesser degree some element of speculation, but having found ourselves unable to effect a complete, democratic and universal control by interest rates, we had to take hold of each department of enterprise by the best means we could devise, and in the case of the stock exchange we did it in the way described in my statement. It was a poor plan at best, and I hope never to be called upon to attempt it again.

I agree with you that if expansion could have been prevented in 1919, our policy in 1920 could have been reversed, probably with salutary effects.

It is difficult in a letter of reasonable length to answer your inquiry about my optimism as to prices being brought to a new stabilized level. Some time I hope we can discuss this; ^{as} ~~my~~ ^{an} attempt to describe ^{it as} ~~this is~~ a very spotty development. What I think you may safely imply from my statement is that with the policies of the Treasury no longer controlling, it is at last possible for us to be a greater influence in stabilizing prices and promoting, generally, more stable business and price conditions, than was possible during any of the periods that I described in my statement. Without going too far in the implication, your question might have been framed ^{to indicate} that I was unduly optimistic in expressing an intention to endeavor to accomplish a better stabilization of prices and conditions. It is not an attitude, however, which I would care to emphasize publicly, as I believe it is filled with possibilities of danger to the Federal Reserve System.

This I fear is a very inadequate reply to your rather searching questions, which I hope some day to answer verbally. In conclusion; as to the future, I believe that you and the good men of your profession live in an atmosphere which deprives you of the opportunity of forming judgment on two important aspects of our work: One is what I might describe as the practical manipulation of rates, and the effect of it. We have started a vast and complicated organization, with mixed powers and influences, with very little experience to go by and that of an unusual and extraordinary character, and now that we have achieved a position of greater freedom we must cautiously feel our way along and see what are the practical results of the policies adopted from time to time. They are the problems which I would describe as the operating problems as distinguished from the theories. But another and more important influence is that which relates to the protection and permanence of the System. There is the densest ignorance in Congress, and generally throughout the country, as to what the Federal Reserve System can do and what it can not do, of its purposes and its policies. Selfishness, ignorance and intolerance, prejudiced criticism, with attacks of ^{by} demagogues, political ambitions, and all sorts of influences, which are ^{now} ~~always~~ and ~~will~~ always be in the background of our affairs until the Federal Reserve System has a great tradition behind it and is held in public esteem as being sacred from attack. We must always have in mind that Congress has the power to sweep us out of existence or to change us from what we now are to something that would be monstrous and dangerous. From this you must not gather that I am influenced in the slightest degree by political considerations; they have no part in our policies. But I am, and always will be, influenced by the possibilities of real dangers to the System, and those I can assure you during the past twelve months have been greater than any of our University men have realized. My attitude to the Commission before which I appeared was to leave our critics alone, and to endeavor to lay before the Commission as sound and well supported information as we had at our command on the subjects in which they were interested, and endeavor to get as favorable report as possible. This explains much that is missing from the

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statement, and in general much of my attitude in dealing with the question of the relations between the Treasury and the Federal Reserve System.

One influence which has been strongly in my own mind during the past few months in adopting a policy of lower rates, has been the need for opening our markets to foreign credits. I cannot go into the detail of this situation in this letter, but I think I should say to you frankly that there is gradually looming up ahead of us a new danger, and one with which we must reckon. This country cannot afford to absorb the world's entire gold production, to gather in most of the gold which now serves as bank reserves in Europe, and lock it away without ^{admitting its} performing any function. If the Government of the United States determines to start the collection of interest upon loans made to the Allied governments, we will undoubtedly see further great additions to our bank's ^{gold stock.} international currencies, and all sorts of batten schemes. Such men as Professor Cassel, Senator Hitchcock, Mr. F. A. Vanderlip, and many others, that I could name, are coming forward with plans for the restoration of stable conditions; in other words, for the accomplishment of the impossible. I am only suggesting to your mind what I fear will be the next form of attack upon the Federal Reserve System. There is no danger of abuse of our facilities at the present level of discount rates, and there is the possibility of our facilitating the world's recovery in a sound way, and we have the power and intention, when the need arises, to advance our rates.

Please overlook this very hastily dictated letter, and give me the pleasure of a call at the bank some day when we may have lunch and discuss these matters more intimately.

Yours sincerely,

Professor Willford I. King,
76 S. 23rd St.,
Flushing, N. Y.

BS:MM

~~PERSONAL~~

January 30, 1922.

My dear Professor King:

You must have wondered why you have received no reply to the letter which you were kind enough to write me on November 13. I did dictate a reply on November 17, but a few days afterwards I was obliged to go to the hospital for an operation, and only to-day have returned to the office. In the meantime, having been prohibited from all work I was unable to read over the letter which I had dictated and send it to you, and now it is somewhat out of date.

It will be so much more satisfactory if we could have a talk of sufficient length to cover all the ground dealt with in your letter. I feel so pleased that you should have taken the trouble to write me so fully, and in longhand, that I do not want you to feel that your kindness is not appreciated.

One point only I must refer to in this letter. It bears upon practically every question which your letter raises.

Supposing during the war, or the period immediately subsequent to the Armistice, the managers of the Federal reserve banks, or the Federal Reserve Board itself, should have found what they believed to be just ground for disagreement with the policy of the Secretary of the Treasury, and should have positively declined to develop a policy reasonably synchronizing with the Treasury's policy; what would have happened to the Federal Reserve System? Would we have remained in existence? Would the Federal Reserve Act have been materially modified by legislation? Would the provisions of the Overman act have been ^{re}vo^{ke}d? Would the direction of the Federal reserve banks be under the direct control of the Secretary of the Treasury? Would the members of the Federal Reserve Board have been removed from office and new members appointed? In fact, what would have happened no one can say. But I

maintained at that time, and since have no reason to change my view, that the policy of the Federal Reserve System could not be made practicably and effectively to dominate the policy of the Secretary of the Treasury. I can recall reading in years long gone by, a reference either by Palgrave or Bagehot to exactly similar conditions as those which prevailed in the period dealt with, and in language which I cannot exactly recall, but somewhat as follows:

"When war arises, the sinister hand of the Finance Minister reaches out to the central bank."

So it may seem to be the case with us. But even were it a sinister hand, what was this creature of Congress to do? Engage in propaganda to defeat policies not only sanctioned but made mandatory by Congress and by the various bond bills.

Frankly, I cannot see the force of the argument that "the tail could possibly wag the dog." I recall hearing such a description as this applied to the relation of Austria to Germany by Dr. Henry Van Dyke, who very aptly said that "while the tail cannot wag the dog, this did not necessarily give ground for a feeling of contempt for the tail."

It must be recalled that during the period of our participation in the war, and during the year 1919, Treasury affairs were run by two men of strong character and personality, and who I have always believed exercised discretion, so far as Congress permitted, with the highest minded purposes of doing the best that could be done. When we disagreed with them, we said so frankly. When these disagreements, which naturally arose one time or another, came to an issue, the choices were assent, compromise, or resistance. My own belief was, and still is, that of the three courses resistance was the most dangerous and would have been the most futile. But in point of fact, no serious differences arose between the Secretary of the Treasury and the reserve system management until the year 1919, and then they were of a character most difficult to deal with; and they were in fact dealt with more by way of compromise than by either of the other courses. This was suggested in my statement to the Commission, and I was most anxious that the Treasury's point of view should have been exposed to the Commission by either Senator Glass or Mr.

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Leffingwell. Time not permitting that, I could only introduce Mr. Leffingwell's public statement, Dr. Miller's address, and Professor Sprague's admirable paper. What I was unwilling to do, and am still unwilling to do, is to turn upon my associates of that most difficult and trying time, and charge them with responsibility for decisions which we all should share together, and especially, as in the case of one of our principal critics, make charges of bad faith.

I have written you with somewhat more frankness than I have ever written to anybody on this subject, and am led to do so by the cordial and frank character of your letter, which you took so much pains to write me. You will, however, please consider this letter as quite confidential and personal for yourself. I would rather resign my position than start now to blame those with whom I was associated during the war, even though I disagreed with them at that time and said so.

Will you not at some early opportunity telephone or write me at the bank, and then make an appointment to lunch with me there, and I will find so much pleasure in taking you through the institution and giving you in that way some idea of the immense affair it has become.

With cordial regards, believe me,

Yours sincerely,

Professor Willford I. King,
76 S. 23rd St.,
Flushing, N. Y.

BS.MM

King

ACKNOWLEDGED

FEB 14 1922

R. S.

76 S. 23d St. Flushing, N.Y.

Feb. 12, 1922

Governor Benjamin Strong,
Federal Reserve Bank,
N. Y. City.

My dear Mr. Strong:

I returned recently from
a trip to Washington and found
your interesting letter awaiting
me. I greatly appreciate your
confidence and your frank
statements. I believe I appreciate
your position much better than
before. It had not occurred
to me to look at the situation

in just the way that you picture
it.

It will give me great pleasure
to lunch with you at your
convenience. If you let me know
the date that suits you I shall
try and fit my engagements
to it. My telephone is Watkins 636

Most cordially,

Wilford L. King

King Willford

February 14, 1922.

My dear Professor King:

Thank you for your note of the 12th just received. I shall ask my secretary to make an appointment with you for some day next week, as this week seems to be rather crowded with engagements.

My thought was to arrange, if possible, for you to reach the bank not later than 11 o'clock, as certain of our departments at about that time are at the peak of the load of the day's business. After going through a few of the departments of the bank we can have lunch in the building and have a little discussion of the subject of our recent correspondence.

Yours sincerely,

Professor Willford I. King,
76 S. 23rd St.,
Flushing, N. Y.

BS. MM