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1957

For Release on Delivery

THE PRICE OF STABILITY

Address by

Winfield W. Riefler, Assistant to the Chairman

Board of Governors of the Federal Reserve System

before

The Rochester Chamber of Commerce

Rochester, New York

January 14, 1957

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Federal Reserve Bank of St. Louis

THE PRICE OF STABILITY

The Federal Reserve System is widely held responsible for so-called "tight money," i.e., for the rise in interest rates, for the lower prices at which long-term bonds sell in the securities markets and for the fact that potential borrowers with credit-worthy propositions have to shop for lenders. Now, in a sense, this is true. But it is very important to understand the special sense in which this affirmation is made. It is true in somewhat the same sense that the Courts can be said to be responsible for the increase of injunctions issued. More fundamentally, however, it is the clash of conflicting interests that poses a problem which the Courts must deal with in the public interest, a problem which cannot be solved by looking the other way.

Similarly, in the case of tight money and higher interest rates, the Federal Reserve System could in a technical sense look the other way. It could disregard the effects upon the real value of the dollar, of huge demands for borrowed funds in excess of current savings, impinging on a situation in which prices are already rising and demand is already pressing on industrial capacity. It is within the Reserve System's technical discretion to make sufficient reserves available to the commercial banking system to permit the banks to make loans in much larger volume. This would in effect, however, create money to offset the deficiency of savings. If the Federal Reserve System did this, it would betray its basic responsibility.

Price Trends

In the course of the last 18 months, the prosperity, stability and growth which this country had enjoyed began gradually to turn into a boom. An exuberant optimism developed, serious shortages appeared in key commodities, such as steel, and prices rose over an increasingly wide range of commodities. In the atmosphere of generally active demand, opportunities for employment were brisk and were reflected in increased wages. As costs of both labor and materials rose, they were increasingly passed on into higher prices for final products. Regulated agencies, such as railroads, squeezed by higher costs, requested and were granted rate increases, thus adding further to the cost of doing business. For a long time these expansive developments found only moderate reflection in the general cost of living, partly because our agriculture was going through a basic readjustment and food prices were low. More recently, as food prices first stabilized and then rose, the very general rise in costs and prices which had been gathering headway has been more fully reflected in the index of consumer prices. As this index is used by many of our leading industries to determine when wage adjustments shall be made, we are now experiencing an additional series of cost increases which industry will naturally wish to pass on in pricing intermediate and final products.

These developments are now sufficiently widespread to furnish unmistakable evidence that the mechanism of the spiral of inflation is at work. The spiral can be said to be still an infant in that the total rise in the cost of living is still less than 3 per cent. It is so unmistakably present, however, that it calls for consideration of the dangers involved in such a spiral and the existing means of coping with it.

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Mechanics of Inflation

An inflationary spiral once in operation has strong tendencies to feed upon itself. Because prices generally are expected to rise, the incentive to save is diminished and the incentive to spend is increased. Consumers who would normally be savers are encouraged to postpone saving and, instead, purchase goods of which they are not in immediate need. Businessmen, likewise, are encouraged to anticipate their growth requirements. Thus, spending is increased on both counts. But because the economy is already operating at relatively full capacity, further increases in spending cannot result in corresponding increases in production. Instead, they work themselves out in a spiral of more and more rapidly mounting prices, wages, and costs, in other words, in an accelerated depreciation in the purchasing power or real value of the dollar.

The operations of such a spiral undermine the very foundations of balanced industrial growth. Growth or expansion plans are necessarily concrete and are based on projections of market trends in the demand for specific products. These trends become quite misleading when they reflect not basic demands that may be expected to recur but rather anticipatory buying entered into as a sort of hedge against inflation. Expansion of capacity based on faulty forecasts may lead to serious imbalances in productive capacity and in the credit structure, imbalances that may set the stage for hard problems of readjustment later on.

Brakes on Inflation

Such is the prospect that would lie before us should the incipient spiral of inflation, now in being, gather headway and become first self-feeding and later self-accelerating. This simply cannot happen, however, without increasing supplies of money. As prices and wages and costs mount, more and more money is needed to finance transactions. Some of this financing can be effected by drawing down working capital and by making more intensive use of money already in existence, but there are limits to these expedients. A mounting spiral of inflation, accelerated by feed-back, can never go very far without additions to the money supply. We are safeguarded, therefore, as long as the Federal Reserve System maintains appropriate monetary policies. It is the one institution within our government which is explicitly charged, by the nature of its functions, with concern for the preservation of the purchasing power of the dollar. To be alert to the effect of its operations at all times and to stand adamant against inflation is a primary responsibility of the Federal Reserve System.

Basic Cause of Tight Money

When interest rates rise, as they have risen during the past year, in a context of (1) high-level employment, (2) output pressing on limits of capacity, (3) rising costs and prices, (4) increased velocity of money, and (5) deterioration of bank liquidity and corporate working capital ratios, and when all of these developments occur at a time of continued stability

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and some growth in the money supply, the only real explanation is that plans for investment in the aggregate are in excess of current savings. It follows, also, in this context that money cannot cease to be tight and equilibrium be restored unless either savings increase sufficiently to meet investment demands, or investment plans are scaled down to the availability of savings, or that a balance is achieved by a combination of both.

If the Federal Reserve System should disregard its mandate and release more reserves to the member banks, this would not relieve the situation. Rather, it would accentuate it, for the commercial banks would then lend more to potential borrowers seeking loans. These borrowers, with money in hand, would enter the markets to add their bids for scarce goods and scarce services to bids already there. The effect would be to spark an inflationary spiral and to accelerate the rise in prices, wages and costs. As a consequence, even more money would be needed to finance transactions. When the circle had worked itself out, money still would be tight because the basic economic requirements had not been met, i.e., saving had not come into equilibrium with demands for investment.

Now, the Federal Reserve System has, in fact, mitigated the rise of interest rates during the past year in the sense that it has increased somewhat the volume of reserves made available to its member banks, and, to the extent that increased loans and increased spending were made possible by these releases, the System shares in some part responsibility for the price advances that have occurred. It did not release reserves in sufficient volume, however, to neutralize the economic forces that were the fundamental cause of the rise in interest rates. Throughout the past year, as a result, commercial banks have operated within a general environment of restraint that has helped to temper the exuberance of the boom.

Price of Stability

What then is the price of stability so far as it is affected by conditions in the financial markets? It consists essentially of changes in the difficulty with which money can be borrowed, in the interest rate which must be paid for that borrowing, and in the rewards that accrue to those who save. Naturally many voices are raised in protest.

Loudest is that of the home builder and home buyer who counted on financing his transactions on mortgages subject to an interest ceiling of 4-1/2 per cent. Mortgage lenders, able to lend their money on mortgages of equal quality for 5 per cent or better, are obviously not interested in mortgages yielding less. More distressing yet is the plight of our municipal and school authorities who come to the market to borrow funds to enlarge sadly deficient school facilities. They are dismayed at the impact of higher interest outlays on school budgets that are already strained. Almost equally aggrieved are the small businessmen who complain that they are squeezed unfairly as compared with the giant corporations which not only may be better able to pay higher interest rates but also have wider access to markets in which to find the funds they seek. Most misleading are the voices that maintain that higher interest rates are needlessly swelling the costs of government

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because they apply to our huge national debt and that they are delaying the day when a well-ordered Federal budget will permit long-needed tax relief for our citizens.

Increasingly, voices representing all these points of view demand a reversal of current Federal Reserve policies or some exception to the impact of these policies so far as they affect a particular situation.

Now, the Federal Reserve has no power to favor some groups of borrowers as against others, for example, to favor public school authorities in their quest for borrowed money at the expense, say, of funds for plant expansion. All the Federal Reserve can do is to affect the total volume of funds available to the commercial banks to lend. Since the great bulk of loans does not pass through the banking system at all but is channeled from savers to borrowers directly, or through financial intermediaries such as insurance companies, the Federal Reserve System actually affects only the amount by which the banks augment savings that enter the market from other sources. Thus the Federal Reserve has no means to bring relief to any specific group of borrowers alone. It can only make reserves available to the commercial banking system as a whole, to be loaned in the market under competitive conditions. To increase such reserves under present conditions would, of course, increase the inflation. But would it also bring relief to the affected groups?

Partly in response to tighter money, building costs have been fairly steady over the past few months, but over the past two years they have increased three times as much as the cost of living. How long would home builders be able to develop mass markets if building costs were to inflate further? How many additional schools could, in fact, be built if costs of construction were to resume their recent rate of rise? Would not lower interest rates, if they stimulated a resumption of this rise, compound the problem? The small businessman is particularly vulnerable to unpredictable price movements. He is less able to cope with inflation than the large concern that can employ specialists to deal with the impact of rising costs on inventory, pricing and expansion policies. The budget-maker knows too well how rising costs ruin his carefully prepared itemization of prospective expenditures.

More sophisticated critics point out, correctly, that the huge demands for financing now present in the money markets are not entirely related to current industrial activity but partly to the financing of future activity when labor and material may well be in better supply. Is there not a real danger, they ask, that the current level of interest rates will stifle essential forward planning of our businessmen and set the stage for a recession later on?

There is no question but that this problem is real and that its relative weight must be taken into account in every decision concerning monetary policy. It is probably true that some of the over-exuberance that has characterized the American economy in the past two years had its origin in the very easy credit conditions that prevailed in 1954. We can see clearly now that this is true as to certain important segments of the home building industry.

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Because of the existence of this problem, the Federal Reserve System can never commit itself specifically with respect to its future course of action. It must always be in a position to adjust its policies to the requisites of stability. The balance between saving and spending is subject to many shifts, and the Federal Reserve System must always be in a position to respond flexibly to these shifts. It does this in a minor degree, in fact, almost continuously. Those who care to read the record meticulously will find that on more than one occasion during 1956 the Federal Reserve relaxed somewhat the emphasis with which it applied policies of restraint. On each occasion, a subsequent quickening of inflationary pressures indicated a continued need for restraint.

One generalization that emerges from these illustrations is that, despite the possibility of differential impacts, interest rates high enough to balance saving with investment are a cheap, not a dear, price to pay for stability when the alternative is inflation. Inflation, long continued, corrupts the foundations of society. It reaches into the bosom of the family, erodes savings, and undermines provision for sickness, education and old age.

What about "Mild Inflation"

Yet, there are other voices, urbane and persuasive, to suggest that a little inflation, a controlled inflation amounting to, say, 2 per cent a year, may not be too bad, particularly if the alternative be a deep depression. They suggest (1) that it may be a necessary price for growth and prosperity and insurance against the losses of deep depression, and (2) that workers' real wages are now protected by suitable collective bargaining contracts against the ravages of an annual 2 per cent increase in the cost of living. This view overlooks many pitfalls.

First, the cited alternative of deep depression is completely invalid. Interest costs that contribute to stability by balancing saving with investment do not set the stage for economic collapse. To the contrary, they help prevent imbalances from developing in the economy. If a depression occurs, it will be because these imbalances have actually developed, not because they were avoided.

Second, there is no such thing as a controlled inflation limited to 2 per cent per year. If it were once known that our government consciously embraced or tolerated such a goal, the incentive to save would be sadly diminished and the incentive to spend sharply increased. This in itself would lead to an acceleration of inflationary pressures. It would tend to make them self-feeding and would go far to eliminate any possibility that the pressures could be controlled within narrow limits.

Third, escalator clauses cannot protect the whole economy from inflation. At the best, they insulate a portion of the economy at the expense of the rest. This is the road to internal disruption and social chaos.

Finally, continued inflation, even if it could be controlled to a rate of 2 per cent per annum, would by no means be mild. It would be equal to an erosion of the purchasing power of the dollar by about one half in the

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course of each generation. For example, a worker retiring at age 65 on a pension of $100 per month would have the equivalent of only about $82 per month at age 75, and of only about $67 per month at age 85. If he lived to be one hundred, his pension then would be the equivalent of only $50 in current prices.

These calculations illustrate the tremendous stake that the American worker has recently acquired in stability in the purchasing power of money. Among the outstanding gains achieved by collective bargaining in recent years is the widespread adoption of industrial pension and retirement plans based on the worker's earnings during his active working life. If we should experience merely creeping inflation, those pensions will be seriously deficient in buying power as compared with what the worker had the right to expect. If the inflation should be anything more than creeping, the loss would be disastrous.

Two other important provisions of modern collective bargaining contracts relate to automatic cost of living adjustments and automatic adjustments for increases in general productivity. Where in effect the first clearly protects the worker from inflation so far as current earnings are concerned, it also automatically translates rising consumer prices into rising costs of production. The second diminishes the extent to which growth in productivity may act to cushion inflationary pressures.

Thus, should our government come to tolerate a goal of even mild inflation, these new features of collective bargaining agreements would tend actually to speed the interplay of generally inflating costs and prices upon each other at the same time that the real value of the worker's pension was being dissipated.

No such calamity is implicit in these agreements, however, if our government continues to stand firm for a stable dollar. In an environment where the purchasing power of money is stable, these key provisions that now characterize so many collective bargaining contracts are not mutually inconsistent. Rather, they mutually reinforce each other in promoting the prospects of a widely based and stable prosperity.

Community Response

The last thing I would want to imply is that the Federal Reserve can produce or guarantee sustainable growth or stability or a completely stable purchasing power of the dollar. That happy result depends on mutually harmonious and reinforcing interreactions between all parts of our society. The Federal Reserve does play an indispensable role, however, in the quest for stability. I am certain that stability would be impossible if the Federal Reserve failed in its duty to adopt appropriate policies directed toward sustainable economic growth, high levels of activity and stability in the purchasing power of the dollar.

The adoption of these policies by the Federal Reserve, however, by no means insures their effectiveness. That depends on a constructive reaction by every element in the community. To revert to the earlier analogy, a community in which the citizens were preponderantly law abiding would still be

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lawless should the Courts fail to administer the law. On the other hand, a community that was essentially lawless would remain so no matter how conscientiously the Courts acted on the cases that came before them. Equally, in the problem of achieving and maintaining stability, the Federal Reserve can refuse to fuel the fires from which the inflationary spiral springs. Also, on appropriate occasion such as the present, when saving is vitally necessary to provide the ingredients for growth, it can so operate as to permit market forces to increase the incentives for saving. But sustainable growth will not be forthcoming if the community does not respond to these incentives and does not, in fact, curtail its consumption and increase its savings. In the same vein, the Federal Reserve, when credit demands are expanding at a time of rising prices and excessive demands on our productive facilities, can permit this demand to be reflected in the availability of credit and a higher cost of borrowing. These are signals for all borrowers to see, to heed, and to cause a reexamination of their projected spending plans. The signals will not result in the most constructive outcome, however, if the borrowing elements in the community do not, in fact, review their programs and take steps to postpone or otherwise to economize on less essential outlays.

Stability can only be achieved by the whole community acting in harmonious response to the facts of each individual situation. The potential future before this economy is unbelievably bright, but that potential will not be realized if, as a community, we disregard the plain meaning of facts that are there for all to see. Today the situation calls not for expedients or palliatives to alleviate the impacts of higher interest rates but for constructive response to those rates, constructive in the sense of increased saving and sober review of projected expenditures. Although it is impossible to put a dollar figure on potential demand, the gap to be bridged between saving and projected investment expenditures is probably not very large. It must, however, be bridged, not by panic curtailment but by judicious rescheduling of outlays on the part of all of the major elements of our community--consumers, industry and government.

The Rochester Chamber of Commerce is outstanding in the leadership it has exerted in this community and in its civic-mindedness. This was true when I grew up in this community and benefited immeasurably, both from the activities the Chamber carried on itself for the youth of the city and also from those it sponsored in the community. That this has continued to be true is demonstrated by the quality of the man who is formally taking over the leadership of the Chamber tonight, and by the subject that was chosen for this address. Whether we enjoy stability or not will depend in very great part on the sort of response that you and your counterparts throughout the land make to the current facts of the monetary picture. I deeply appreciate the opportunity to lay these facts and their interrelationships before you.

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Similarly, in the case of tight money and higher interest rates, the Federal Reserve System could in a technical sense look the other way. It could disregard the effects upon the real value of the dollar, of huge demands for borrowed funds in excess of current savings, impinging on a situation in which prices are already rising and demand is already pressing on industrial capacity. It is within the Reserve System's technical discretion to make sufficient reserves available to the commercial banking system to permit the banks to make loans in much larger volume. This would in effect, however, create money to offset the deficiency of savings. If the Federal Reserve System did this, it would betray its basic responsibility.

Price Trends

In the course of the last 18 months, the prosperity, stability and growth which this country had enjoyed began gradually to turn into a boom. An exuberant optimism developed, serious shortages appeared in key commodities, such as steel, and prices rose over an increasingly wide range of commodities. In the atmosphere of generally active demand, opportunities for employment were brisk and were reflected in increased wages. As costs of both labor and materials rose, they were increasingly passed on into higher prices for final products. Regulated agencies, such as railroads, squeezed by higher costs, requested and were granted rate increases, thus adding further to the cost of doing business. For a long time these expansive developments found only moderate reflection in the general cost of living, partly because our agriculture was going through a basic readjustment and food prices were low. More recently, as food prices first stabilized and then rose, the very general rise in costs and prices which had been gathering headway has been more fully reflected in the index of consumer prices. As this index is used by many of our leading industries to determine when wage adjustments shall be made, we are now experiencing an additional series of cost increases which industry will naturally wish to pass on in pricing intermediate and final products.

These developments are now sufficiently widespread to furnish unmistakable evidence that the mechanism of the spiral of inflation is at work. The spiral can be said to be still an infant in that the total rise in the cost of living is still less than 3 per cent. It is so unmistakably present, however, that it calls for consideration of the dangers involved in such a spiral and the existing means of coping with it.

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The operations of such a spiral undermine the very foundations of balanced industrial growth. Growth or expansion plans are necessarily concrete and are based on projections of market trends in the demand for specific products. These trends become quite misleading when they reflect not basic demands that may be expected to recur but rather anticipatory buying entered into as a sort of hedge against inflation. Expansion of capacity based on faulty forecasts may lead to serious imbalances in productive capacity and in the credit structure, imbalances that may set the stage for hard problems of readjustment later on.

Brakes on Inflation

Such is the prospect that would lie before us should the incipient spiral of inflation, now in being, gather headway and become first self-feeding and later self-accelerating. This simply cannot happen, however, without increasing supplies of money. As prices and wages and costs mount, more and more money is needed to finance transactions. Some of this financing can be effected by drawing down working capital and by making more intensive use of money already in existence, but there are limits to these expedients. A mounting spiral of inflation, accelerated by feed-back, can never go very far without additions to the money supply. We are safeguarded, therefore, as long as the Federal Reserve System maintains appropriate monetary policies. It is the one institution within our government which is explicitly charged, by the nature of its functions, with concern for the preservation of the purchasing power of the dollar. To be alert to the effect of its operations at all times and to stand adamant against inflation is a primary responsibility of the Federal Reserve System.

Basic Cause of Tight Money

When interest rates rise, as they have risen during the past year, in a context of (1) high-level employment, (2) output pressing on limits of capacity, (3) rising costs and prices, (4) increased velocity of money, and (5) deterioration of bank liquidity and corporate working capital ratios, and when all of these developments occur at a time of continued stability

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and some growth in the money supply, the only real explanation is that plans for investment in the aggregate are in excess of current savings. It follows, also, in this context that money cannot cease to be tight and equilibrium be restored unless either savings increase sufficiently to meet investment demands, or investment plans are scaled down to the availability of savings, or that a balance is achieved by a combination of both.

If the Federal Reserve System should disregard its mandate and release more reserves to the member banks, this would not relieve the situation. Rather, it would accentuate it, for the commercial banks would then lend more to potential borrowers seeking loans. These borrowers, with money in hand, would enter the markets to add their bids for scarce goods and scarce services to bids already there. The effect would be to spark an inflationary spiral and to accelerate the rise in prices, wages and costs. As a consequence, even more money would be needed to finance transactions. When the circle had worked itself out, money still would be tight because the basic economic requirements had not been met, i.e., saving had not come into equilibrium with demands for investment.

Now, the Federal Reserve System has, in fact, mitigated the rise of interest rates during the past year in the sense that it has increased somewhat the volume of reserves made available to its member banks, and, to the extent that increased loans and increased spending were made possible by these releases, the System shares in some part responsibility for the price advances that have occurred. It did not release reserves in sufficient volume, however, to neutralize the economic forces that were the fundamental cause of the rise in interest rates. Throughout the past year, as a result, commercial banks have operated within a general environment of restraint that has helped to temper the exuberance of the boom.

Price of Stability

What then is the price of stability so far as it is affected by conditions in the financial markets? It consists essentially of changes in the difficulty with which money can be borrowed, in the interest rate which must be paid for that borrowing, and in the rewards that accrue to those who save. Naturally many voices are raised in protest.

Loudest is that of the home builder and home buyer who counted on financing his transactions on mortgages subject to an interest ceiling of 4-1/2 per cent. Mortgage lenders, able to lend their money on mortgages of equal quality for 5 per cent or better, are obviously not interested in mortgages yielding less. More distressing yet is the plight of our municipal and school authorities who come to the market to borrow funds to enlarge sadly deficient school facilities. They are dismayed at the impact of higher interest outlays on school budgets that are already strained. Almost equally aggrieved are the small businessmen who complain that they are squeezed unfairly as compared with the giant corporations which not only may be better able to pay higher interest rates but also have wider access to markets in which to find the funds they seek. Most misleading are the voices that maintain that higher interest rates are needlessly swelling the costs of government

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because they apply to our huge national debt and that they are delaying the day when a well-ordered Federal budget will permit long-needed tax relief for our citizens.

Increasingly, voices representing all these points of view demand a reversal of current Federal Reserve policies or some exception to the impact of these policies so far as they affect a particular situation.

Now, the Federal Reserve has no power to favor some groups of borrowers as against others, for example, to favor public school authorities in their quest for borrowed money at the expense, say, of funds for plant expansion. All the Federal Reserve can do is to affect the total volume of funds available to the commercial banks to lend. Since the great bulk of loans does not pass through the banking system at all but is channeled from savers to borrowers directly, or through financial intermediaries such as insurance companies, the Federal Reserve System actually affects only the amount by which the banks augment savings that enter the market from other sources. Thus the Federal Reserve has no means to bring relief to any specific group of borrowers alone. It can only make reserves available to the commercial banking system as a whole, to be loaned in the market under competitive conditions. To increase such reserves under present conditions would, of course, increase the inflation. But would it also bring relief to the affected groups?

Partly in response to tighter money, building costs have been fairly steady over the past few months, but over the past two years they have increased three times as much as the cost of living. How long would home builders be able to develop mass markets if building costs were to inflate further? How many additional schools could, in fact, be built if costs of construction were to resume their recent rate of rise? Would not lower interest rates, if they stimulated a resumption of this rise, compound the problem? The small businessman is particularly vulnerable to unpredictable price movements. He is less able to cope with inflation than the large concern that can employ specialists to deal with the impact of rising costs on inventory, pricing and expansion policies. The budget-maker knows too well how rising costs ruin his carefully prepared itemization of prospective expenditures.

More sophisticated critics point out, correctly, that the huge demands for financing now present in the money markets are not entirely related to current industrial activity but partly to the financing of future activity when labor and material may well be in better supply. Is there not a real danger, they ask, that the current level of interest rates will stifle essential forward planning of our businessmen and set the stage for a recession later on?

There is no question but that this problem is real and that its relative weight must be taken into account in every decision concerning monetary policy. It is probably true that some of the over-exuberance that has characterized the American economy in the past two years had its origin in the very easy credit conditions that prevailed in 1954. We can see clearly now that this is true as to certain important segments of the home building industry.

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Because of the existence of this problem, the Federal Reserve System can never commit itself specifically with respect to its future course of action. It must always be in a position to adjust its policies to the requisites of stability. The balance between saving and spending is subject to many shifts, and the Federal Reserve System must always be in a position to respond flexibly to these shifts. It does this in a minor degree, in fact, almost continuously. Those who care to read the record meticulously will find that on more than one occasion during 1956 the Federal Reserve relaxed somewhat the emphasis with which it applied policies of restraint. On each occasion, a subsequent quickening of inflationary pressures indicated a continued need for restraint.

One generalization that emerges from these illustrations is that, despite the possibility of differential impacts, interest rates high enough to balance saving with investment are a cheap, not a dear, price to pay for stability when the alternative is inflation. Inflation, long continued, corrupts the foundations of society. It reaches into the bosom of the family, erodes savings, and undermines provision for sickness, education and old age.

What about "Mild Inflation"

Yet, there are other voices, urbane and persuasive, to suggest that a little inflation, a controlled inflation amounting to, say, 2 per cent a year, may not be too bad, particularly if the alternative be a deep depression. They suggest (1) that it may be a necessary price for growth and prosperity and insurance against the losses of deep depression, and (2) that workers' real wages are now protected by suitable collective bargaining contracts against the ravages of an annual 2 per cent increase in the cost of living. This view overlooks many pitfalls.

First, the cited alternative of deep depression is completely invalid. Interest costs that contribute to stability by balancing saving with investment do not set the stage for economic collapse. To the contrary, they help prevent imbalances from developing in the economy. If a depression occurs, it will be because these imbalances have actually developed, not because they were avoided.

Second, there is no such thing as a controlled inflation limited to 2 per cent per year. If it were once known that our government consciously embraced or tolerated such a goal, the incentive to save would be sadly diminished and the incentive to spend sharply increased. This in itself would lead to an acceleration of inflationary pressures. It would tend to make them self-feeding and would go far to eliminate any possibility that the pressures could be controlled within narrow limits.

Third, escalator clauses cannot protect the whole economy from inflation. At the best, they insulate a portion of the economy at the expense of the rest. This is the road to internal disruption and social chaos.

Finally, continued inflation, even if it could be controlled to a rate of 2 per cent per annum, would by no means be mild. It would be equal to an erosion of the purchasing power of the dollar by about one half in the

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course of each generation. For example, a worker retiring at age 65 on a pension of $100 per month would have the equivalent of only about $82 per month at age 75, and of only about $67 per month at age 85. If he lived to be one hundred, his pension then would be the equivalent of only $50 in current prices.

These calculations illustrate the tremendous stake that the American worker has recently acquired in stability in the purchasing power of money. Among the outstanding gains achieved by collective bargaining in recent years is the widespread adoption of industrial pension and retirement plans based on the worker's earnings during his active working life. If we should experience merely creeping inflation, those pensions will be seriously deficient in buying power as compared with what the worker had the right to expect. If the inflation should be anything more than creeping, the loss would be disastrous.

Two other important provisions of modern collective bargaining contracts relate to automatic cost of living adjustments and automatic adjustments for increases in general productivity. Where in effect the first clearly protects the worker from inflation so far as current earnings are concerned, it also automatically translates rising consumer prices into rising costs of production. The second diminishes the extent to which growth in productivity may act to cushion inflationary pressures.

Thus, should our government come to tolerate a goal of even mild inflation, these new features of collective bargaining agreements would tend actually to speed the interplay of generally inflating costs and prices upon each other at the same time that the real value of the worker's pension was being dissipated.

No such calamity is implicit in these agreements, however, if our government continues to stand firm for a stable dollar. In an environment where the purchasing power of money is stable, these key provisions that now characterize so many collective bargaining contracts are not mutually inconsistent. Rather, they mutually reinforce each other in promoting the prospects of a widely based and stable prosperity.

Community Response

The last thing I would want to imply is that the Federal Reserve can produce or guarantee sustainable growth or stability or a completely stable purchasing power of the dollar. That happy result depends on mutually harmonious and reinforcing interreactions between all parts of our society. The Federal Reserve does play an indispensable role, however, in the quest for stability. I am certain that stability would be impossible if the Federal Reserve failed in its duty to adopt appropriate policies directed toward sustainable economic growth, high levels of activity and stability in the purchasing power of the dollar.

The adoption of these policies by the Federal Reserve, however, by no means insures their effectiveness. That depends on a constructive reaction by every element in the community. To revert to the earlier analogy, a community in which the citizens were preponderantly law abiding would still be

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lawless should the Courts fail to administer the law. On the other hand, a community that was essentially lawless would remain so no matter how conscientiously the Courts acted on the cases that came before them. Equally, in the problem of achieving and maintaining stability, the Federal Reserve can refuse to fuel the fires from which the inflationary spiral springs. Also, on appropriate occasion such as the present, when saving is vitally necessary to provide the ingredients for growth, it can so operate as to permit market forces to increase the incentives for saving. But sustainable growth will not be forthcoming if the community does not respond to these incentives and does not, in fact, curtail its consumption and increase its savings. In the same vein, the Federal Reserve, when credit demands are expanding at a time of rising prices and excessive demands on our productive facilities, can permit this demand to be reflected in the availability of credit and a higher cost of borrowing. These are signals for all borrowers to see, to heed, and to cause a reexamination of their projected spending plans. The signals will not result in the most constructive outcome, however, if the borrowing elements in the community do not, in fact, review their programs and take steps to postpone or otherwise to economize on less essential outlays.

Stability can only be achieved by the whole community acting in harmonious response to the facts of each individual situation. The potential future before this economy is unbelievably bright, but that potential will not be realized if, as a community, we disregard the plain meaning of facts that are there for all to see. Today the situation calls not for expedients or palliatives to alleviate the impacts of higher interest rates but for constructive response to those rates, constructive in the sense of increased saving and sober review of projected expenditures. Although it is impossible to put a dollar figure on potential demand, the gap to be bridged between saving and projected investment expenditures is probably not very large. It must, however, be bridged, not by panic curtailment but by judicious rescheduling of outlays on the part of all of the major elements of our community--consumers, industry and government.

The Rochester Chamber of Commerce is outstanding in the leadership it has exerted in this community and in its civic-mindedness. This was true when I grew up in this community and benefited immeasurably, both from the activities the Chamber carried on itself for the youth of the city and also from those it sponsored in the community. That this has continued to be true is demonstrated by the quality of the man who is formally taking over the leadership of the Chamber tonight, and by the subject that was chosen for this address. Whether we enjoy stability or not will depend in very great part on the sort of response that you and your counterparts throughout the land make to the current facts of the monetary picture. I deeply appreciate the opportunity to lay these facts and their interrelationships before you.

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WWR's copy

Education in Accordance with Merit and Irrespective of Means

A Suggestion by
Winfield W. Riefler

Equality of opportunity for self-improvement and reward on the basis of merit rank high in the American scale of social values. As applied to opportunities for education, particularly post-graduate education, great emphasis has been placed on the screening of applicants for admission on the basis of merit rather than connections, and great effort has been made to see that scholarship or loan funds are sufficient to finance the education of qualified students who would otherwise be forced to forego educational opportunities for lack of means.

In the School of Advanced International Studies at the present time, funds available for loans or grants to deserving students are equal to about one-fifth of the total tuition charge. In addition, there are several competitive scholarships awarded purely on the basis of qualification without regard to means. In practice at the present time, a student at S.A.I.S. is expected to pay $1,000 a year as tuition, or $2,000 in all for two-year attendance. A considerable number of students, however, borrow all or part of their tuition from the scholarship and aid funds. This is in addition to those winning scholarship grants, which carry stipends that exceed tuition costs. It thus can be said that at least one out four of the students at S.A.I.S. are fully exemplifying the American ideal in that they are accepted on the basis of merit alone and are able to acquire the education they want without regard to whether

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or not they or their families possess the means to finance the tuition. In the case of three-fourths of the student body, however, this question cannot be answered so clearly. It is well within the range of possibility that some of the students now granted admission would have been turned down to make way for others with even more promise if scholarship funds were more adequate.

The present total annual amount budgeted for scholarship and aid funds amounts to $30,000, for the most part collected currently in the form of annual contributions from donors. If the S.A.I.S. were an endowed institution with special endowments to provide for scholarships, a scholarship endowment fund of around three-quarters of a million dollars would be required to provide an equivalent annual yield of $30,000. Of the $30,000 about half is awarded in the form of stipends which includes tuition, while the other half is made available to accepted students as loans or grants on the basis of need. The latter sum, roughly $15,000, corresponds to true scholarship funds and is equivalent to the yield on an endowment of some $350,000 to $400,000.

There is little that can be done to improve on our present scholarship practice so long as S.A.I.S. continues to exist almost wholly on the basis of annual contributions from donors. If, however, an opportunity for scholarship endowment funds in the amount of $400,000 should present itself, S.A.I.S. could eliminate completely the cost of tuition as a barrier to attendance.

If S.A.I.S. had $400,000 to finance the early years, it could announce in its catalogue that henceforth all payment of tuition for

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students admitted to the School would be on a deferred basis, to be paid by the students out of their earnings after graduation. This would mean that no tuition would be charged any student while he or she was in actual attendance at the School, but that instead the tuition charge would be payable at the rate of $100 annually for each year of attendance during the first twelve years immediately following graduation. For the typical student, with two years' residence, this would mean a tuition payment of $200 each year for the twelve years following his or her graduation. This sum would be well within the typical earning capacity of S.A.I.S. graduates during those first twelve years. It would be equal to borrowing the present $1,000 charged for tuition at an interest cost of about 2-3/4% for the actual time the money was borrowed. Of course, should any student wish to prepay his tuition, the twelve annual instalments due could be converted to a single cash payment of $1,000, i.e., an amount equal to the present tuition. He would not, however, be expected to do so, and there would be no flavor of suspicion of favoritism within the student body directed against those members who were paying on a deferred basis.

Were $400,000 to become available for such use, the current budget of the S.A.I.S. would be relieved of the $15,000 annual appropriation now made for aid loans and grants. However, if those contributions were continued in the budget until the deferred tuition payments plan was fully in operation, some 13 years, the additional endowment needed to put the proposed plan in operation would be reduced to around $250,000. These figures assume no defaults or delinquicies on deferred tuition payments.

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There undoubtedly would be some fall off of receipts due, but it probably would not be large.

There are several ways such a plan could be regarded. It could be thought of as adding to the self-respect of prospective students, in that they would be paying themselves for their professional education, an education which in some degree increases their earning capacity. It could also be thought of as an opportunity for donors with relatively modest means to remove in substantial degree the barrier that poverty imposes on opportunities for education at the S.A.I.S. A gift of as little as $250,000 would open the facilities of S.A.I.S. to substantially all who could qualify on merit and would go far to assure that our best human resources would, in fact, prepare themselves for international service.

Should such a gift be sought, it would probably be preferable that it be made to the Foreign Service Educational Foundation rather than the University. This would avoid any conflict between the proposed plan and the scholarship programs of other graduate schools of the University.

WRR:cls

3/28/57 - Original mailed to Mr. Paul Nitze, President — } Foreign Service Educational Foundation 1906 Florida Ave. N.W.
Copy mailed to Miss Priscilla Mason, Secretary }

Copy to Mr. Martin

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August 16, 1957.

Dear Tedj:

I am dismayed when I think of my deficiencies as a correspondent. Ever since I got back from Europe last winter I have had your Meyer manuscript draft and the explanation of why you couldn't use some of the material I suggested. I understand perfectly and should have written you long ago, but I really haven't yet caught up with the things that accumulated at that time. Just now we are in the midst of the Senate hearings and I have no peace whatever.

Meanwhile a copy of Banks and Politics in America comes to my desk. I have glanced through the format and it looks wonderful. I am going to read every word several times, of course, but I want you to know how grateful I am that you had a copy sent to me. Also, my deep congratulations on a big job undertaken and gloriously completed.

Dorothy doesn't know I am writing this but I know she joins me in sending both her love and mine to you and Melitta.

As ever,

Winfield W. Riefler,
Assistant to the Chairman.

Mr. Bray Hammond,
Thetford Center,
Vermont.

WWR:cls

WWR took book home

Book published by Princeton University Press, Princeton, N. J. – cost $12.50

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October 24, 1956.

Mr. Bray Hammond,
Thetford Center,
Vermont.

Dear Mr. Hammond:

In Mr. Riefler's absence from the office, I wish to acknowledge on his behalf your letter of October 22.

As you may have heard, Mr. Riefler is visiting, with Chairman Martin, central banks in England, Germany, and France, and is expected to return to the office around the middle of November. Your letter will receive his attention at that time.

Sincerely yours,

Catherine L. Schmidt,
Secretary to Mr. Riefler.

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Thetford Center,
Vermont.
22 October 1956.

Dear Win:

At last I have adapted myself sufficiently to the beauties of New England that I can turn my back on them and for a few minutes at a time pay attention to my work instead of gazing out my Vermont windows at the long and lovely horizon of New Hampshire mountains visible from them. So here is my reply to your invaluable letter of 30 August, and for your convenience I enclose the 14 pages of my text (Section 8, III) which is the subject of our discourse and which I beg you will please return to me.

The paragraph on page 2 that perplexed you condenses a record occupying several pages of the Board's minutes that perplexed me. I found Ogden Mills' request for open market purchases normal and understandable. Governor Meyer's objections surprised and puzzled me. But for two things I should have consulted you about them: one was a fear that my surprise merely reflected my ignorance; and the other was a guilty feeling that I had burdened you too much already. So I put the issue down baldly and succinctly just as I found it in the minutes (but much condensed), thinking that you would see it later and would signal it if it looked funny. Which is just what you did, so maybe I am not so dumb after all.

Your explanation of the dilemma is luminous, and the only doubt is whether Governor Meyer understood his position as well as you describe it. That, as you say, presents the problem of clarifying his position without putting him out of character. For his intelligence is that of a man of action, not a scholar, as I see more clearly after reading your diagnosis and noting how much more primitively he explains his motives than you do. (I intend no implication that you yourself are not also a man of action.)

But in this instance I suspect that he was motivated as much by the psychological effect of central bank action as by its mechanical effect, or more. He was habitually thinking of the significance that would be ascribed to his actions by his peers, especially his European friends. "What would people think?"—for as they thought so they would do. Thus he commends the British omission to raise their discount rate in August and September 1931, though that would be the prescribed method of checking withdrawals, because in their position, known to be weak, raising the rate would be interpreted as defensive and not a sign of strength; hence it would spread fear not confidence and stimulate withdrawals instead of

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retarding them. But the position of New York that autumn was strong and raising the discount rate there would confirm belief in her strength. It would have an effect the opposite of that in London, spreading confidence not fear and retarding withdrawals instead of stimulating them. "I made up my mind," he says, "that psychologically the greatest confidence would be produced by acting normally," that is, by putting up the rate; and he speaks sarcastically of George Harrison's slowness in raising New York rates after London's suspension 21 September. "I didn't think," he says he told Harrison, "I had to teach you the fundamental elements of international finance." He praised London for not raising the rate in the face of withdrawals, but for the same thing New York got blamed. He judged the action not as a mechanical measure but according to the interpretation that would be put on it.

So in January 1933 he quite consistently thought the Fed should not ease the market further, because to do so would be interpreted as a measure of desperation. Open market purchases, he said, would not only be inconsistent with rising money rates--which he deemed necessary to check foreign withdrawals, as you explain--but "they would be considered weak abroad." That is, they would be interpreted by the French, by Glass, by Willis, and by too many others, as a sign of yielding to inflation, which was still more generally feared by the conservatives than the current liquidation was. If the fears of the conservatives, already aroused quite enough, were further inflamed by what they would "interpret" as a surrender to inflation, the withdrawals would become worse than ever. Moreover, if it got out that the purchases desired by Ogden Mills were directly intended to facilitate Treasury financing the anti-inflationists would have been sure the world was coming to an end.

It is scarcely necessary to say that the Governor had no general fear of open market operations. In July 1932, for example, he told the Open Market Policy Conference that currency and gold withdrawals might have had disastrous effects in the preceding months except for the immense open market purchases the System had made. And it is significant of the deference to the current fear of inflation that in the statement released by the Open Market Policy Conference, 5 January 1933, the following appears:

> "The first and immediate objective of the open market policy was to contribute factors of safety and stability in meeting the forces of inflation. The larger objectives..., to assist and accelerate the forces of economic recovery, are now assuming importance. With this purpose in mind, the Conference has decided... to maintain... substantial excess member bank reserves... Adjustments in... holdings... will be in accordance with this policy."

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The timid imaginations that made it necessary to speak seriously of "the forces of inflation" in January 1933 and cautiously of economic recovery may have constrained Governor Meyer six weeks later when he opposed Ogden Mills' request for enlarged purchases, especially since such purchases might have been deemed to be more than the statement of the Conference implied.

What I say is not in conflict with your explanation that open market purchases would seem objectionable because they would finance speculation. It is something additional; and from my reading of Governor Meyer's records I suspect that it is what he thought of most. He spoke of speculators, to be sure, but they would "interpret" the open market purchases just as the orthodox in general would, besides deriving from them the funds with which to finance their speculations. And I think he was always apt to be more concerned with impressions, with the interpretations and psychological reactions arising from central bank action than with the latter's mechanical and objective effects. This seems to me evident in what he repeatedly says--not as deliberate statements of principle but as unconscious manifestations of his way of thinking. It also seems to me typical of a business man, especially a successful one, more accustomed to deal with people than with forces.

If I am right in the distinction I make, I have at least the advantage of access to more language of the Governor's own to rely on than if I try to make him explain himself in your more scientific fashion. You understand, Win, that in saying this I am not in the least depreciating your analysis, which certainly set me straight, but am trying to solve the problem you mention yourself of producing an explanation that is Governor Meyer's own and expressed in his language. In my book, I can go into the subject independently and more discursively, after your example.

I have two questions: First, have you read the Board's minutes to which I refer? Unless I have presented correctly the views there expressed, we may be wasting our time. So if you have not, will you please ask Miss Jones for the Board's minutes of 27 February 1933 and read pages 257-261?

Second, on the margin of my ms, beside the paragraph in question on page 2, you have written: "Is this true? I can't understand the action." Since your letter indicates that you do understand it, I presume the letter comes after the marginal comment and supersedes it. In between you have solved the puzzle. Is my surmise correct and may I disregard the question and comment on the ms?

With these matters out of the way, we can now get down to business. You have not informed us definitely that you and Dorothy are coming 9 November to spend the weekend with us, but we are counting on it. We have heard, however, that you are going to Europe for two weeks, or

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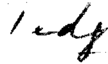
have gone. This is not credible, but leaves the question what two weeks. We hope to hear.

Dean Upgren and his wife have been most hospitable. At dinner with them we met Professor Herbert West, Chairman of Comparative Literature, who has flatteringly invited me to address his upperclassmen in a course on American Thought. I'll speak on Alexander Hamilton. This is your doing.

Yours,



Bray Hammond

Mr Winfield W. Riefler
Assistant to the Chairman,
Federal Reserve Board,
20th and C Streets, NW,
Washington 25, D. C.

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Section 8

III.

I take Saturday, 25 February 1933, as the beginning of the end. No adequate solution had been found for the trouble in Detroit, and the Michigan state moratorium had been continued. There were difficulties in Cleveland. On the 24th the governor of Maryland had proclaimed a state moratorium. The testimony of Charles E Mitchell before a congressional committee respecting operations of the National City Bank and its securities affiliate in preceding years had been shocking to the business world, or at least its more conservative part. Whereas banks had had to endure runs, and still did, an even worse punishment was the silent transfer of deposit accounts as large depositors shifted their funds from bank to bank and center to center in search of safety. The large city banks were suffering heavy withdrawals of currency by their country correspondents. Foreign exchange rates and money rates both at home and abroad were rising. Yet difficulties were still spotty, and hope persisted that the local and regional disturbances could be checked, and not become general. It was necessary, if possible, that some one keep cool; and in this conviction we wrote the President, Saturday the 25th, that it was important to avoid doing things that would make the situation worse. This was the letter in which, according to him, we were "minimizing the situation." (H H 210)

On Monday, 27 February 1933, we met with both Secretary Mills, who was <u>ex-officio</u> the Federal Reserve Board's chairman, and William H Woodin, designated to succeed him as secretary and as our chairman. Trouble was now

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developing among banks in the District of Columbia, which were under the supervision of the Comptroller of the Treasury. A fiscal problem also faced the Treasury. It had a refunding operation due the middle of March, and the pressure that banks were under might very well force them to sell government securities just at the time the Treasury would have a fresh offering to make. A good part of the trouble arose from the Treasury's having to supply an increased volume of funds to the Reconstruction Finance Corporation in order that the latter might have more to lend to weak banks; with the net result that strong banks that had to furnish the funds to be lent to the weak banks, would be unable to do so without selling securities. Secretary Mills therefore wanted the Federal Reserve Banks to ease the situation by open market purchases. (FRB M 257, 260)

But the Board ~~was seeking to make rates firmer, in line with the tendency at home as well as abroad, and open market purchases would conflict with this purpose.~~ I thought such a move would be not only ineffective but disturbing, ~~since~~ it would look like an attempt to help the Treasury and would therefore reflect on its credit as well as on the integrity of the Federal Reserve System. The other members agreed with me. We thought that the tendency toward higher rates should certainly be allowed to work itself out before the purchases desired by Secretary Mills were undertaken. (FRB M 258, 260, 261)

The next day, Thursday, 28 February 1933, I consulted the governors of all the Federal Reserve Banks except San Francisco and was informed that in general the situation if not better was at any rate not worse. I also

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told Governor Harrison, that in view of the evident speculation in foreign exchanges in New York, I thought it would be a good thing if the clearing house banks were to announce that they could supply all legitimate demand at reasonable rates but would not furnish exchange for speculation. (FRB M 263-64)

That same evening, Thursday, 28 February, there was a meeting in my office at which the issuance of clearing house certificates or scrip was discussed. It was important because Henry M Robinson, the Los Angeles banker who was President Hoover's personal adviser, thought the issuance of scrip was necessary and had persuaded the President it was. So the President had prepared a memorandum for Ogden Mills to take up with others concerned. The meeting was attended by men from the Treasury, the Board, the Comptroller's Office, the Reconstruction Finance Corporation, including Governor Black of the Federal Reserve Bank of Atlanta and Deputy Governor Rounds of the Federal Reserve Bank of New York, besides Secretary Mills, Mr Robinson, and myself. We discussed the matter a long time and came to no agreement. But even Robinson seemed to doubt the feasibility of scrip, and as I recall most if not all the rest did. A C Miller was perhaps an exception, though he may have been representing Hoover, for the argument he had seemed to be that we had to do something and so we should have scrip. It was the old idea that had been put in practice in 1907 and previous panics before the Federal Reserve Banks were established. Clearing houses would print certificates or scrip and individual banks could exchange some of their earning assets for the scrip and pay it out in place of currency. This

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was sensible if the currency could not be obtained, as had been the case before we had the Federal Reserve Banks, but it was no longer sensible now that we had not only the Reserve Banks but the Reconstruction Finance Corporation and any bank could get currency that had the assets to exchange for it. The idea was crazy. George Harrison and I had already opposed it at the White House. But it nevertheless had a lot of support and we had to waste a lot of time shutting it off. Ogden Mills was in the unhappy position of having to present Hoover's point of view, though no one saw the foolishness of the proposal better than he did. (FRB M 265, 279, 282-284; M & N 349; Tape 679, 687)

On Friday, 1 March, we had to take account of the large movement of funds from New York to other parts of the country and abroad and to get the Federal Reserve Bank of Chicago to relieve the pressure on New York by taking over some of their securities holdings. This need arose not from any weakness of the New York banks but from the fact that being the financial center and the depository of banks throughout the rest of the country and abroad they were liable to demands which though they could be met nevertheless tightened the money market and interfered with normal procedure. (FRB M 280-81) That night I was in New York and met with a group, including Mills and Woodin, to canvass means of meeting the acute situation. Woodin was not there to suggest anything, of course, for Roosevelt would not permit that, but to listen and learn, for his responsibilities would begin in three days. Banking holidays or legislative restrictions on the withdrawal of deposits were in effect in Michigan, New Jersey, Indiana, Maryland, Arkansas,

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Ohio, Alabama, Kentucky, Tennessee, and Nevada. (Banking, Chronology, 5)

The next day, Thursday, 2 March, holidays were proclaimed in Arizona, California, Louisiana, Mississippi, Oklahoma, and Oregon. There were local holidays in other states and everywhere the utmost uneasiness. (Banking, Chronology, 5)

That afternoon Dr Miller, who, as it happened, was a personal friend both of President Hoover and President-elect Roosevelt, called at the White House and urged upon Hoover, in accordance with the views of all the appointive members of the Board, that a national holiday be proclaimed. Hoover, according to his own account, was unwilling to do so without the support of his legal advisers and of Roosevelt; but since Miller apparently wanted the Board to try to do something to get the approval of Roosevelt or Congress, he says he gave Miller the letter of 2 March, which I have quoted, to be delivered to the Board. (Hoover 212; Myers and Newton 363) In that letter, however, Hoover said nothing about our trying to get anybody's approval but simply asked for our "recommendation accompanied by a form of proclamation," and for our advice about a scheme for guaranteeing bank deposits. He also consulted Secretary Mills, I think, for late that afternoon Mills arranged with Attorney General Mitchell for counsel of the Treasury and the Board to discuss with him the question of authority for the President to proclaim a holiday under the terms of the Trading-with-the-Enemy-Act of 1917. According to Secretary Mills and Walter Wyatt, the Board's Counsel, the Attorney General said there was sufficient color of authority in the act to warrant a proclamation if the President thought the emergency great enough but that the matter was not free of doubt and he preferred not

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to advise issuing one unless Roosevelt concurred. (FRB M 301; Myers and Newton, 364; Moley, 145; Hamlin, 2 March 1933) The Attorney General's opinion was an official one, of course, but not very definite, nor was it the only opinion of legal experts. It was our unanimous conclusion at the Board that a holiday should at once be declared, but we also thought that it should be agreed, if possible, that Congress would be called together to ratify the action promptly. Secretary Mills called the Mayflower Hotel, where Roosevelt and his party had arrived during the evening from New York, and reported our action. This was sometime after 11:00 p.m. About midnight, I believe, Dr Miller went to see Roosevelt at the hotel and tried to get an agreement between him and Hoover, but nothing came of it. Roosevelt, however, seemed to have made up his mind already to proclaim the holiday himself, if Hoover would not. But he refused to commit himself. I get that from both Glass and Moley. (Glass 341; Moley, 146, 148; FRB M 302; Hamlin, 2 March 1933)

The next day, Friday, 3 March 1933, the Board approved advances in the discount rate by New York and Chicago. Foreseeing advances over the week-end by other Reserve Banks and the want of a quorum to approve them since Secretary Mills would cease to be a member of the Board the next day at noon and Secretary-designate Woodin might not immediately become one, two of us were authorized to approve for the Board any additional increases by other Reserve Banks up to 4-1/2 per cent. (FRB M 304)

Many states had passed laws authorizing restrictions on the

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withdrawal of deposits and also the segregation of new deposits from old. It was encouraging to hear that currency deposits were being received by many banks in excess of needs and provision was made for such currency to be re-deposited with the Federal Reserve Banks in special accounts in order to foster the development, but on the whole news was bad. That day, Friday, 3 March, banking holidays were proclaimed in seven more states: Georgia, Idaho, New Mexico, Texas, Utah, Washington, and Wisconsin. (FRB M 304-5; Banking, Chronology, 5)

By afternoon the withdrawals from the Reserve Banks were threatening to reduce their reserves below the legal minimum. Universal closing appeared inevitable; and a little after four o'clock I went to the White House to report the situation to the President. The latter appeared agreeable to proclaiming a holiday, but only if Roosevelt would approve.

Note to Mr. Meyer: According to Moley and according to Myers and Newton, you and Ogden Mills were with Hoover at this hour in conference with Roosevelt and Moley.

Moley makes considerable of the meeting (pages 144-146). He says that Roosevelt went to the White House to pay the customary formal call of the President-elect upon the outgoing President, and that Hoover "surprised" him by calling in you and Mills and putting him under pressure to acquiesce in proclamation of a holiday. Roosevelt then "surprised" Hoover by calling in Moley, the latter says.

According to Myers and Newton (page 365), Hoover had "arranged" the conference and there was no trick or surprise about it.

According to "Ike" Hoover, the White House usher, the Roosevelts were having tea with the Hoovers; and the meeting Moley describes was some other time but apparently without you.

In your report to the Board, according to the Board's minutes and according to Hamlin's diary,

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there was no mention of such a conference at all. The minutes simply indicate that a little after 4 o'clock you left the Board meeting to go to the White House and report the strain on the Reserve Banks. On your return, according to the minutes, you rejoined the meeting and reported telling Hoover what the situation was--but with no mention of having been in a conference with him and Roosevelt. (FRB M 319-20)

Do you recall the situation?

A third meeting of the Board was held that night at 9:15 o'clock, Friday, 3 March 1933. Mr James was ill at home but in touch with us by telephone, as we were also with Secretary Mills down the hall in his office. Mr Hamlin was summoned from a concert. Reports from the country at large on the banking situation were discussed and consideration of the recommendation and form of proclamation requested by the President was resumed. It was our unanimous opinion that a nation-wide banking holiday would have to be proclaimed. The Senate had adjourned, and could not be expected to get together and act before the inauguration the following noon. Secretary Mills agreed with us. I telephoned the White House, stressing the gravity of the situation, and told Hoover we thought it was imperative that action be taken at once. He seemed less inclined to do anything than he had been a few hours before. Dr Miller tried again to see Roosevelt at the Mayflower Hotel about 10:00 p.m., but without success. Later he discussed the situation with Roosevelt by telephone. (Hamlin, 3 March 1933)

Meanwhile we got word from New York that the Federal Reserve Bank directors had adopted a resolution that in view of the national emergency created by the continued and increasing withdrawal of currency and gold from

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the banks, the Board should urge the President to declare a holiday. I tried to get Secretary Mills by telephone in his office, but he had gone to the White House, where President Hoover answered. So he and I had a second conversation. I again tried to convince him that a holiday was necessary, with or without Roosevelt, but with no success. Mills came back to join us, however, and we sent for James too. He was sick, but so were the rest of us by now.

We also had word that in Chicago the Reserve Bank directors had adopted a resolution like New York's urging that a holiday be proclaimed at once. The Chicago Bank expected demands the first thing Saturday morning for practically all the gold it had.

Mills did not seem to disagree with the rest of us at all about the action to be taken but only about the language to be used in answering the President's letter. Our reply as prepared began with the words, "Referring to your letter of March 2, 1933, and subsequent conversations, the Federal Reserve Board has been in session again this evening," and so on as already quoted. Mills felt the responsibilities of his position and wanted to protect Hoover all he could. He believed Hoover was inhibited by the Attorney General's opinion. I felt that the question of legality was mixed up too much with the question whether to act with or without the concurrence of Roosevelt. We finally settled the question by simply omitting the opening phrase of our letter, referring to Hoover's request of the 2d and subsequent conversations. Of course that made the letter read as if we were acting on our own initiative; and it enabled Hoover to slap us down

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the next morning in his letter of the 4th, which also I have quoted, for bothering him at the last minute with an unwelcome recommendation which he would not follow. (FRB M 330)

Whether we thought of that I doubt, but at any rate, the letter being unanimously approved, I signed it and sent it by Mr. Fahy, my secretary, to the White House. Some time after one o'clock Mr. Fahy returned. He said that when he got to the White House, the President had gone to bed and no one was willing to disturb him without Mr Richey's permission. So Richey was called. He authorized Hoover's being disturbed, and Hoover was given the letter which we had spent so much time preparing in compliance with his request and which he was at a loss to understand why we had sent. After all, I am not surprised that he was either forgetful or sore. The pressure was terrible, no one likes to be awakened at 1:30 a.m., and the substance of the letter was disagreeable. He did not want to proclaim a holiday and he disliked being advised to do so. What he wanted was to force Roosevelt into a commitment implicating himself in Hoover's action. The idea was crazy. I am not overcome with admiration for Roosevelt when I say this.

After getting off the letter to Hoover, the Board continued in session till about 4:00 a.m. There were several states in which banking holidays were not in effect and it was important to get them in line if there was to be no proclamation by the President. The most critical were Illinois and New York. Shortly after 3 o'clock, we got word first from

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New York and then from Chicago that in both states holidays would be proclaimed. The state holidays would be observed by the twelve Federal Reserve Banks and their branches as by local banking institutions. That would take care of things through Saturday morning.

Of these crowded and almost continuous efforts by the Federal Reserve Board to get action on the crisis, Hoover says nothing in his Memoirs after quoting his letter of 2 March asking for a recommendation accompanied by a form of proclamation. "The majority of the Board," he says, "again declined to have any part in the proposed recommendations to Roosevelt or the Congress." And he concluded that the Board "was indeed a weak reed for a nation to lean on in time of trouble." The fact is that the Board was not divided but unanimous, including the President's own Secretary of the Treasury, and in response to his request it gave him a recommendation that was well-considered, vigorous, and repeated. Hoover might have explained the grounds on which he rejected our recommendation--grounds which were seasonable, though I happen to think they were not very convincing--but instead he chose to make it appear that we did nothing whatever. His letter to us, Saturday morning, 4 March, was among the very last of his official acts.

Respecting these events, I should like to quote from Charles S Hamlin's diary, now in the Library of Congress. Hamlin says plenty of harsh things about me in his diary one time or another; but on this occasion, speaking of our efforts with the President he says: "During the earlier part of the evening Hoover called up Governor Meyer, who told him of the

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unanimous agreement of the Board and begged him both as adviser and personal friend to issue the proclamation. Hoover was evidently very angry with Governor Meyer, but Governor Meyer was most courteous and firm." (Hamlin, Index-Digest vol. 22, page 28; FRB Files 470.-in slightly different language)

Hamlin also mentions Hoover's final letter to the Board, Saturday morning, 4 March, in which Hoover charged that when the Board sent him its final letter urging him to proclaim a holiday, it knew of Roosevelt's statement that he did not wish a proclamation issued and knew also of the readiness of the governors of Illinois and New York to proclaim a holiday. Hamlin says that Adolph Berle told him Monday, 6 March, that Hoover's statement of Roosevelt's wish was "absolutely false." Hamlin says further that the Board did not know of the readiness of the Illinois and New York governors to declare a holiday till sometime between three and four o'clock in the morning--well after delivery of the letter--and that the statement that it did know of their readiness was "absolutely false."

Note to Mr. Meyer: I doubt if you will wish to use this quotation but include it for your information.

The Board held no formal meeting Saturday, Sunday, or Monday, but the members were in their offices and we had frequent conferences, including one on Sunday with Secretary Woodin and other Treasury officials, regarding developments in the banking situation and methods of coping with them. Sunday evening, President Roosevelt officially decided to proclaim a nation-wide holiday. Apparently, he had made up his mind the day before, if not

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earlier, to do so. In substance the proclamation he issued was identical with that prepared for Mr Hoover by the Board's General Counsel, Walter Wyatt, and the occasional verbal changes in it were merely matters of style. It went into effect the first thing Monday morning, unifying the problem as a national one instead of having responsibility for it scattered among the forty-eight states.

Note to Mr Meyer: The material in the two preceding subsections, II and III, presents questions I am unable to answer. The difficulty is that too much of it involves literary rights, restrictions, copyright, courtesy, and so forth.

All of the letters in the interchange between the Board and the President at the end of Hoover's administration, except the last two, are published by Myers and Newton in their "documented narrative," or in Hoover's memoirs, or in both. These last two I found in the Board's files and minutes. The status of this material involves both legality and courtesy. The Myers and Newton book was copyrighted in 1936 by Scribners, the memoirs by Hoover himself in 1952.

These questions occur to me:

Does Scribner's copyright extend to the letters?

Does the probable fact that the Board's permission to quote its letters was not obtained by Hoover or by Myers and Newton affect the copyright?

In order to publish the Board's letter of 4 March to Hoover, signed by you, must you ask the Board's permission?

If you do ask it, will the Board grant permission?

In order to publish Hoover's letter of 4 March to the Board, must you ask Hoover's permission?

If you do ask it, will Hoover grant the permission?

Assuming that all the material quoted is or has been rightfully in your possession, I wonder what

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liability you might incur by publishing it without permission.

With respect to the Hamlin diary, I have obtained permission to consult it, but you would be under a moral obligation to obtain Mrs. Hamlin's permission to quote it. Assuming you wish to quote it, are you reluctant to request that permission?

Aside from the quoted letters and diary excerpts, the story itself is a compound of information drawn from the following sources and not readily identifiable, I believe, with any one source:

Your records and files
The Federal Reserve Board's files and minutes
Federal Reserve Bulletins and Annual Reports
The Press
Myers and Newton, The Hoover Administration
Hoover, Memoirs

I have also drawn on the following:

Moley, After Seven Years
Jesse Jones, Fifty Billion Dollars
Lawrence Sullivan, Prelude to Panic
Arthur Ballantine, When All the Banks Closed
Smith and Beasley, Carter Glass
Upham and Lamke, Closed and Distressed Banks
Harris, Twenty Years of Federal Reserve Policy
James, Growth of Chicago Banks

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August 30, 1956.

Dear Bray:

Enclosed are my comments on the manuscript. I found it fascinating and, with one exception, have made only a few marginal notes for your consideration. The exception refers to the second paragraph on page 2, Section 8 III, and in fact to the whole section. When I first read the paragraph, I felt that the policy move sounded queer and needed amplification. I started to amplify it before reading the remainder of the chapter. Now that I have read the whole chapter, I am convinced that what you need here is not so much modifications of the paragraph along the lines I have indicated in the margin but rather the insertion of a wholly new section or paragraph which would deal with the general policy problem facing the Federal Reserve System at that time.

It was the sort of problem that typically arises just before a financial panic. In view of widespread fears arising out of losses on deposits and the bank holidays, the public was rapidly losing its confidence in all financial institutions, and seeking to minimize its losses. This took three forms, (1) withdrawals of deposits in the form of currency, (2) withdrawals of deposits for gold, and (3) the use of deposits to purchase foreign exchange. If one tries to ascribe rational bases to these reactions on the part of the public, one would say that the individual depositor, who did not fear for the dollar and did not expect devaluation but only feared for the safety or liquidity of the banking system, withdrew his deposits in the form of currency. On the other hand, the individual who feared for the dollar also and had no faith in foreign currencies withdrew his deposits in the form of gold. Finally, the individual who feared for the gold standard or expected devaluation either withdrew his deposits in gold or, if he wished to put himself in a position to profit from the situation, bought foreign currencies. Such purchases of foreign currencies would, of course, increase the drain of gold also, since foreign central banks might well take the dollars coming into their possession in the form of gold withdrawals from the Federal Reserve.

These concurrent developments, which were cumulating rapidly during the weeks preceding the banking crisis, posed a serious dilemma for central bank policy. Both the withdrawals of currency and gold, unless offset by open market operations, tended to tighten the money market, a development which the monetary authorities would ordinarily

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deplore during a depression and therefore seek to offset. On the other hand, in the immediate context of the crisis, the monetary authorities could not ignore the fact that easy money and the ready availability of credit to a certain class of wealthy individuals might accentuate the drain, should these individuals pledge their credit to obtain a larger volume of currency, gold, or foreign currencies. The fact that very remunerative profits might accrue to speculators holding foreign exchange if the country should subsequently go off gold or devalue could not be ignored. Such speculation had turned out very successfully when the pound was devalued in 1931, and there were plenty of individuals of good credit standing aware of the fact. In fact, the instability of exchange rates that arose as an aftermath of World War I had produced a group of skilled operators in foreign exchanges who specialised in situations such as this.

The real danger in the situation arose from the fact that such speculators were not at all limited to the deposits they had in hand. If their credit standing was good, which it was in all too many cases, they were free to borrow from the banks to the full extent of their credit line, and to take large positions, say, in Swiss francs or sterling. Their ability to multiply their speculative resourses in this fashion would depend, of course, on the willingness of banks to lend. As reserve positions were tightened by the withdrawals of currency and gold, the willingness of banks to lend for these purposes, as well as others, would tend to diminish. On the other hand, if the withdrawals of currency and gold were offset by open market purchases on the part of Reserve Banks, the monetary authorities would, in effect, be financing indirectly a speculative move which threatened the gold Reserve base of its own existence.

The traditional central bank procedure in a financial crisis of this nature, i.e., a crisis that is dominated by lack of confidence and speculation in foreign currencies, was not only to let withdrawals of this nature tighten the market but, in addition, to add further tightness by raising discount rates. At the same time, central banks traditionally were supposed to see to it that money was available to necessitous borrowers though at a high penalty rate. The theory was that tight money would cause banks to call in credits, that such calls would be particularly hard on speculative borrowers as compared to traditional business customers, and that the professional speculators would be forced to liquidate their positions and thus set the stage for a return of gold and confidence. At the same time, to minimize business repercussions from the credit stringency which was supposed not only to be sharp but also of short duration, the central bank was supposed to see to it that money would always be available on some terms to necessitous borrowers.

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The above summarizes, I think, the rationale of this traditional position. It was no longer accepted blindly in the world that developed after World War I, due to greater awareness of the importance of monetary policy to economic activity in general. In the general climate of opinion after World War I, the preponderance was that the central bank should keep money rates low throughout a depression, offsetting whatever market factors there were that might tend to tighten the money position. This opinion, however, assumed that the possibility of financial panics had disappeared. It did not take into account in its premises the possibility of the actual financial situation which faced the U. S. in the opening months of 1933.

The conflict in indicated paths of action as represented by these two positions arose in most acute form in the weeks immediately preceding the bank closing. What was urgently needed was some decisive event or move capable of clearing up the situation and restoring confidence in the currency and in the dollar so that normal economic processes could be resumed and provide an environment in which abundant, cheap and easy credit would provide a constructive force. What was conspicuously lacking was that environment. The efforts of the Reconstruction Finance Corporation to accomplish this result had failed because they were restricted to loans and to making those loans only on the security of sound collateral. The idea of preventing the crisis by having the R. F. C. buy preferred stock in banks had been turned down. As a result, the natural forces of the market were acting to produce a panic and thus create a situation in which the impasse would have to be resolved (as it later was).

During the development of the crisis, the extreme positions between which the Board had to decide were whether it would offset the currency going into hoarding and the gold going abroad and thus facilitate in some degree the financing of even more speculation against the dollar, or whether it would risk advancing the crisis in time by raising discount rates to higher levels. It pursued a middle course between these extremes. It refrained, on the one hand, from easing the market by offsetting the panic withdrawals. This permitted the market to tighten somewhat. Discount rates were raised ultimately but not until the last moment when the gold reserves of the Federal Reserve Banks were seriously threatened. This latter action was hardly a policy action. It was rather sort of a ritual action taken in conformity with central bank tradition that the central bank must raise discount rates when its gold reserves are drained toward the legal limits. Under prevailing conditions, it had no effect, positive or negative, except possibly to maintain some degree of confidence in the integrity of the System on the part of some of the more conservative elements

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of the financial community. The truth was that by late February 1933 the crisis had gone far beyond the point where it was affected by open market actions or discount rate moves. The stage had broadened to the point where only a reorganization of the financial system would restore sufficient order to permit money to function constructively in the economy.

I don't know what kind of a section you can concoct to bring in something of the above and keep it in line with what Governor Meyer would say and that would be true to his own thoughts on the situation. I give it to you as background in order to permit a richer interpretation of his remarks on page 2, where he says the Board wanted somewhat higher rates, his remarks on page 3, where he talks about limiting foreign exchange to speculators, and his remarks later on in the chapter where he notes the rise in the discount rate. Without some sort of general preparation, the reader, who is versed only in the modern school that whatever happens, willy-nilly, money must remain easy during a depression, would utterly fail to understand why Governor Meyer took some of these positions or allowed some of these things to happen.

Sincerely,

Winfield W. Riefler,
Assistant to the Chairman.

Mr. Bray Hammond,
Thetford Center,
Vermont.

WWR:cls

Manuscript enclosed

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CENTER FOR ADVANCED STUDY IN THE BEHAVIORAL SCIENCES

202 Junipero Serra Boulevard • Stanford, California DAvenport 5-0026

October 1, 1957

Mr. Winfield W. Riefler
Assistant to the Chairman
Board of Governors of the
Federal Reserve System
Washington, D.C.

Dear Win:

As the Governor of North Carolina said to the Governor of South Carolina, "~~there's~~ Its a long time between letters." Your letter of August 16 has only just reached me here after being forwarded from Chicago. It was nice to hear from you.

I write now mostly to let you know that we are out here in Stanford at the Center for the coming year. If, by any chance, you get out this way to the San Francisco Bank or for any other reason, I certainly hope you will let us know so that we will have a chance to get together.

I hope in the meantime you have had a chance to talk to Dave Fand and that it was mutually profitable.

Best personal regards from Rose and me.

Sincerely yours,

MF:bb

Milton Friedman

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August 16, 1957.

Mr. Milton Friedman,
Department of Economics,
The University of Chicago,
Chicago 37, Illinois.

Dear Milton:

This is a poor time to be answering your good letter of last May which arrived while I was abroad.

I have heard about David Fand in very favorable terms and would like to see him. I have been meaning to call him up and get him over but have been so completely bogged down getting ready for and participating in the current hearings, in addition to all the other things that seem to happen around here, that I just haven't had the time. I do mean to go ahead with it.

Meanwhile my best personal regards to Rose and you.

Sincerely,

Winfield W. Riefler,
Assistant to the Chairman.

WWR:ole

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May 29, 1957.

Mr. Milton Friedman,
Department of Economics,
The University of Chicago,
Chicago 37, Illinois.

Dear Mr. Friedman:

In Mr. Riefler's absence from the office, I wish to acknowledge on his behalf your letter of May 27, referring to David Fand.

Mr. Riefler is en route to Basle, Switzerland, to attend the Annual General Meeting of the Bank for International Settlements. Your letter will receive his attention upon his return to the office on June 17.

Sincerely yours,

Catherine L. Schmidt,
Secretary to Mr. Riefler.

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THE UNIVERSITY OF CHICAGO
CHICAGO 37 • ILLINOIS
DEPARTMENT OF ECONOMICS

Economics Research Center

27 May 1957

Mr. Winfield Riefler
Board of Governors, Federal Reserve System
Washington, D. C.

Dear Win:

I have been meaning to write you for a long time to record explicitly how right you were last year, and how wrong I was. In retrospect it is certainly clear that tight money was called for over this period.

But though confession is good for the soul, the immediate occasion for this letter is different. A couple of weeks ago, one of our former students, David Fand, who is now working for the Committee for Economic Development, was in town. In the course of conversation, it turned out that he would be interested in experience which would enable him to observe the making of monetary policy from close up. It occurred to me that you might some time have need for an assistant somewhat more sophisticated than the usual run, and that if so, Fand would be an ideal person for you.

Fand is a rather unusual person and has very great possibilities. Though his innate interest is largely on the problems of the formation of policy and the role of economic analysis in policy formation, he did a thesis here which involved detailed grubbing into facts and figures. His subject was the size of non-national bank deposits and vault cash for the period before the Board's estimates begin. He produced estimates for the period from 1875-1896 that are a decided improvement on anything previously available, and in the course of which he acquired an extraordinary detailed knowledge of the banking structure and system of the time.

I hope you will pardon this random shot in the dark.

Best personal regards and wishes.

Sincerely yours,

Milton Friedman

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