C O P Y

AMERICAN LIFE CONVENTION
230 N. Michigan Avenue, Chicago 1, Ill.

LIFE INSURANCE ASSOCIATION OF AMERICA
488 Madison Avenue, New York 22, N. Y.

March 1, 1954

Mr. William McC. Martin, Jr., Chairman
Board of Governors of the Federal Reserve System
Washington, D. C.

Dear Bill:

The Joint Committee on Economic Policy of the American Life Convention and the Life Insurance Association of America held a meeting last Friday at which we discussed a number of questions regarding credit and debt management policies of the Government. The Committee believes you would like to know our conclusions. They are along the following lines.

We are greatly concerned about the strong emphasis which is being placed upon an easy credit policy as a Government instrument to reverse the moderate downturn in business activity which we have been experiencing. As nearly everyone agrees, and as was demonstrated so clearly last Spring, a restrictive credit and debt management policy can be effective in curbing a boom. On the other hand, there is little evidence that an easy money policy has much effect as a stimulus to business activity in a downturn. It is our experience that the level of interest rates seems to have very little effect upon the volume of corporate bond financing, and that actually such financing has expanded in periods of high or rising rates. Obviously, other factors than the interest rate govern the volume of bond financing. Similarly, our study of residential construction and financing indicates that the level of mortgage interest rates is not an important factor and that actually increasing residential construction has usually coincided with rising rates.

As we review monetary policy beginning in the Summer of last year, we cannot but think that it has gone much too fast. In early June of last year, at the bottom of the Government securities market price-wise, the 3-1/4's were selling on a 3.33 yield basis, and today they have fallen in yield to a 2.72% basis, or a decline in less than a year of 60 basis points. There has, of course, been a corresponding decline in the yields on other Government securities and on corporate bonds, particularly those which were publicly offered and are traded in the market. It is our view that this pronounced decline in interest rates has been the direct result of Federal Reserve credit policy.

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From the time the Federal Reserve entered the market last Spring until the end of the year, between open market operations and the reduction in reserve requirements the Federal Reserve has supplied the banking system with over $3.0 billion in reserves. Moreover, the steps which the Federal Reserve has taken have exerted a highly magnified effect in the capital markets because of psychological forces and the thinness of supply in the long-term portion of the Federal debt. Basically there has been little change in the over-all demand for and supply of capital funds arising out of the savings of the people.

Life insurance companies and other savings institutions are becoming more and more concerned about the abrupt change which has occurred in the interest rate picture based upon Government policy. This abrupt change has been a shock to company officers because, if continued at the present pace, it could quickly raise again the question of whether life insurance companies will be able to earn the rate of return assumed in policy contracts. The reason for this is that as rates go lower life insurance companies and other institutional investors will inevitably be hit with a heavy wave of refunding of debt which was issued at higher rates. Not only do sharply falling rates mean that our current investments will yield a lower return, but we face the danger that much of our portfolio will be refunded on the new lower rate basis, and thus the effect of probably rather temporary low interest rates would be imposed upon policyholders and other savers for as long as decades to come. This refunding will affect institutional investors differently because some have been able to protect themselves better than others against the call of their bonds. That is to say, some investors have been able to fortify themselves better against an early call of their bonds or have been able to obtain higher call prices. In view of comments in the President's Economic Report about the importance of thrift in the long-run growth of our economy, is it in the long-run public interest to create serious problems of interest return for life insurance companies and other savings institutions? Is such a policy fair to the millions of savers throughout the country who save through life insurance, savings bonds, pension funds, and similar channels? The answer might be in the affirmative if an easy credit policy held out the prospect of aiding in bringing about an upturn in business activity at the present time, but there is serious doubt that this is the case.

Our views about credit policy might be summarized as follows. First, it is axiomatic that credit policy must be flexible and that as a result we must have interest rate flexibility on both the up side and the down side of the business cycle. However, we think it is a mistake for credit policy to encourage <u>abrupt</u> changes in interest rates and also <u>wide swings</u>.

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Secondly, we should recognize that a <u>restrictive</u> credit policy can do a great deal toward curbing a boom, but once a downturn has occurred an <u>easy</u> credit policy does little to reverse the trend of business activity. In this connection it should be kept carefully in mind that at a time such as the present, psychological forces in the investment field are rampant and that markets can be pushed to extremes simply by talk about policies.

But if it is wise at the present time to go slowly toward further easing of credit, nevertheless we do not advocate that the Federal Government stand by without doing anything if business conditions continue to decline. We think that the President's Economic Report and the President's recent remarks in his press conference several days ago indicate the type of measures which the Government should take at this time if business conditions continue to trend downward. In such circumstances the Government should resort to such direct measures as a bold reduction in income taxes to stimulate private personal spending, along with the tax revisions which have already been proposed to encourage business spending. In addition, we think the President should have the powers which are proposed to alter various insured and guaranteed mortgage terms because mortgages should always carry rates and terms which will attract investment funds.

With respect to debt management policy, as you undoubtedly have recognised, the attempt to use debt management in a countercyclical fashion poses an apparent dilemma. In times of inflationary pressures at which it would seem desirable for the Treasury to borrow at long term with savings institutions, it is bound to be true that these institutions will have more attractive alternative investment outlets in the corporate bond and mortgage field, and we are highly doubtful that the Treasury will ever be able to do much in the way of lengthening the maturity of the debt in such periods. On the other hand, in a period of economic downturn, in which savings institutions, because of the lack of alternative investment outlets, might desire a long-term Government bond offering, many would argue that the Treasury should be doing its financing on a short or intermediate-term basis with the commercial banking system. This would seem to mean that the time is never good for long-term Treasury financing. However, we cannot accept this conclusion. The supply of savings tends to exceed suitable outlets in a downturn, and it is of the utmost importance to get these savings invested.

Our thinking is that it is highly important for many reasons for the Treasury to get a larger proportion of its debt in long maturities. We believe, therefore, that to accomplish this purpose the Treasury should do its long-term financing when it has the opportunity to do so, namely, when savings institutions have funds which cannot find an outlet in private investments.

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This letter has been frank, but I know you appreciate frankness. If you would like to have us do so, I am sure that a delegation from our Committee would be glad to visit with you in Washington.

Sincerely,

/s/ Carrol M. Shanks

Carrol M. Shanks, Chairman
Joint Committee on Economic Policy
American Life Convention
and
Life Insurance Association of America

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