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FEDERAL RESERVE BANK OF NEW YORK

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see p4

August 31, 1953

Hon. Paul H. Douglas,
Senate Office Building,
Washington, D. C.

Dear Senator Douglas:

There has been sent to me copies of your July correspondence with Marriner Eccles and of your remarks in the Senate, when you asked and received consent to have this correspondence printed in the Congressional Record. I am writing to you because I have valued your informed support of the Federal Reserve System so highly, and because I think some of the conclusions Marriner has drawn, and you seem to have drawn, from the developments of the first half of this year may be wrong.

For my purpose, we can pass by Marriner's outline history of past events in the field of credit policy and debt management. As usual there is much in it with which I would agree and quite a bit with which I would disagree. I am writing about developments in the period since January 1953 which, oddly enough, coincides with the period during which the "new" administration has been at Washington.

Now off the Board

Marriner's statement and your remarks raise perhaps three immediate ~~and important~~ questions.

(1) Was there a change to a "hard and tight" monetary policy after the new administration took office; and was the reduction in the money supply in the first five months of 1953 an unusual and untimely development resulting from such a change of policy?

Fed tight did not cause slowdown

(2) Has there been a change since December 1952 from the situation of high production and employment and stable prices which is attributed to the period from March 1951 to December 1952, as a result of the monetary and debt management policies that have been followed?

(3) Should the money supply vary directly and proportionately with short term changes in the volume of production and trade, or should the growth in the money supply parallel the long term growth in the economy, increasing less than the physical volume of productive activity in inflationary periods, and decreasing less (or even continuing to increase gradually) in periods when deflationary tendencies predominate?

Recent Monetary Policy and Changes in the Money Supply

Actually the monetary policy in effect during the first four months of 1953 was a continuation of the policy that had been in effect for some time, although it did have more publicity in the later period. For a variety of reasons, however, including the failure of seasonal loan repayments to develop on the scale that had been anticipated, the failure of tax receipts to come up to expectations and the consequent prospect of heavier Treasury borrowing, the continued large volume of corporate and "municipal" security flotations, and lack of clarity in or misinterpretations of public discussions of Federal Reserve policy, the money and security markets began to show signs of strain late in April. The Federal Reserve System was not blind to this situation, and took action early in May to give assurance that sufficient reserves would be made available to the banking system to meet real needs for funds by the Government and private borrowers.

As for the reduction in the money supply during the first five months of 1953, it is quite understandable. The fact is that the money supply (defined as comprising privately owned demand deposits and currency) has declined in the first five months of every year since 1946, even in years in which many consider the increase in the money supply to have been excessive. The reasons for this seasonal decline in the first few months of each year apparently include heavy tax receipts and retirement of Government securities by the Treasury, a seasonal tendency toward loan contraction after the fall expansion, and some reduction in currency circulation after the Christmas holiday period. The figures for the first five months of each of the last seven years are as follows:

Change in Money Supply during First Five Months of Each Year

	Dollar Amount in billions	Percentage Change
1947	-2.4	-2.2
1948	-5.4	-4.8
1949	-4.1	-3.7
1950	-1.5	-1.3
1951	-3.3	-2.8
1952	-3.2	-2.6
1953	-4.5	-3.5

You will observe that the percentage reduction during the first five months of 1953 was less than in the corresponding periods of 1948 and 1949, and was only slightly greater than the average for the four years 1947-1950 (3.5 per cent compared with 3.0 per cent).

Since there are seasonal variations in the money supply, a better measure of the trend is the year-to-year change. In that respect, the increase from June 1952 to June 1953, although unquestionably less than the increase in the physical volume of production, was considerably greater in dollar amount, and somewhat greater percentagewise, than the average for the five years from June 30, 1946 to June 30, 1951 (all but three months of which were in the period during which monetary and debt management policies were criticized as having been strongly inflationary). Furthermore, the increase during the past year followed a considerably greater increase in the previous year -- one which clearly outstripped the rise in physical production. The figures for the past seven years are as follows:

Change in Money Supply during Year Ended June 30

	Dollar amount in billions	Percentage Change
1947	+2.4	+2.4
1948	-0.2	-0.1
1949	-1.2	-1.1
1950	+3.1	+2.9
1951	+4.5	+4.1
1952	+6.5	+5.7
1953	+3.0	+2.5

Another factor to be taken into account in this connection, as Marriner and you point out, is changes in the velocity or rate of use of money. These changes are not always downward, however, as Marriner's discussion might imply. The velocity data have been under revision in recent months and have not been published, but there is reason to believe that the rate of turnover of money has increased appreciably, thus supplementing the increase in the quantity of money over the past year.

Recent Changes in Economic Conditions

Both Marriner and you appear to regard the economic situation from March 1951 to December 1952 as eminently sound and healthy (except for the growth in consumer and mortgage credit in that period and in preceding years). You both profess to see a change in the direction of deflationary tendencies since the advent of the new administration, which, in your opinion, made the monetary and debt management policies of the early months of 1953 quite inappropriate.

So far as the actual data go, there is little to support that conclusion, although we may all have our ideas as to the future. It is true that some of the basic commodities (notably farm products because of large production and reduced export demand) have been weak in recent months, but a number of them were weak also in the period from March 1951 to December 1952. The general wholesale price index changed by only one-tenth of a percentage point from December 1952 to June 1953, while during the period from March 1951 to December 1952 it fell by six percentage points, as you stated. The consumer price index also has been almost unchanged (slightly higher, in fact). The production index leveled off in the second quarter of this year (perhaps partly because of the difficulty of making proper seasonal adjustments), but the June index was still six points above December and 15 points higher than a year ago. The gross national product, income payments to individuals, and employment continued to rise. In short, the general economic situation in the first half of 1953 was about as near the ideal one of high production, income, and employment, without inflation, as we ever attain. Furthermore, there is at least a possibility that, but for the tight money policy, new inflationary pressures might have developed so that this highly desirable condition would not have been maintained, and the danger and depth of a recession might have been increased.

Growth in the Money Supply
<u>Required for Economic Stability</u>

Marriner's statement of what he thinks should be the objective of debt management and monetary policy seems to me to have been the objective during 1953. Opinions may differ, of course, as to the action which is called for at any given time to achieve this objective. I would hesitate, however, to adopt the simple formula that changes in the money supply should parallel changes in production and employment on a short term basis. Disregarding the element of seasonal fluctuation in the money supply, there remains the question of whether a policy of promoting changes in the money supply directly proportionate to changes in production and employment, even on a year-to-year basis, is likely to be most conducive to the maintenance of stability in the economy at high levels. If that were true, there might have been no basis for the System's fight for greater freedom of action beginning in August 1950 and continuing up to the "accord" in March 1951, a fight in which you aided so greatly. The money supply then had been increasing rapidly, but not so fast as production and employment.

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I would say that a better theory for the guidance of central bankers, in seeking to make their contribution to economic stability, is that growth in the money supply should parallel the long term growth in productive activity. That calls for a policy of resisting too rapid expansion of bank credit and the money supply in boom periods (which may merely validate higher costs and prices) and resisting credit contraction in periods of recession.

I hope that you will forgive this long letter. The importance of the subject, to me, made it seem worth writing. The problem we faced at the beginning of the year, as I saw it, was how to help prevent, by monetary means, the development of a bubble on top of a boom without adopting a deflationary policy. The danger was there, and it has been avoided. As soon as our policy seemed to be becoming too restrictive it was modified, and assurance was given that reserves would be available to meet the seasonal and growth needs of credit during the remainder of the year. Up to this moment the economy has continued its broad vigorous development, at high levels of production, income and employment, and inflationary and deflationary forces have stayed in balance. Balance at high levels is always precarious, however. If we should be heading into a readjustment or recession as Marriner, and maybe you, seem to believe, I should hope it would not be blamed on the Federal Reserve System - at least not because of a faulty analysis of our past actions. We try to follow the economic facts of life, not the election returns.

Yours faithfully,

ALLAN SPROUL
Allan Sproul,
President.