February 3

By Hand

Bob--

Herewith the answer to the broad question you raised. We will go over the testimony and supply you with any additional capsule answers coming out of the testimony.

WMM

Enclosure

Why not finance any unavoidable Federal deficit by: (a) selling to nonbank investors whatever amount of Government securities they will purchase; (b) selling the balance needed to cover a deficit to the Federal Reserve or to the commercial banks; and (c) preventing any pyramiding expansion of the money supply in consequence thereof by an appropriate bank reserve or asset holding requirement?

This solution to the Government deficit problem is a "printing press" solution. It would relate money creation and expansion to Federal deficits and not to the needs of the economy. It would make yields on Federal securities the product of Government fiat rather than the product of supply and demand forces in the market. It would remove an essential restraint on Government spending because any resulting deficit could seemingly be financed at minimum cost and effort. It would commit the Government to a patently inflationary financial policy, with forewarning to investors that they could not count on the purchasing power of dollars invested in Government or any other fixed income securities.

The time it would take for this forewarning to be fully understood by investors, domestic and international, would not be long. The nonbank market for Government securities would quickly atrophy. Sooner or later, obligatory monetization of public debt would become the only method available for financing deficits. An accelerating inflationary spiral would, in brief time, engulf the economy.

The foregoing is a short and direct diagnosis of the probable consequences of the suggested method of financing Government deficits.

Technically, the Federal Reserve could be given authority to raise the required reserves of commercial banks sufficiently to cover the creation of reserve funds which would result from its purchases of deficit finance securities. Alternatively, if the monetization device were to allocate Treasury securities not sold to nonbank investors among commercial banks, the Federal Reserve technically could be provided with an authority to require the banks to retain the securities they were obliged to purchase.

But these authorities would be quite beside the point. They would not prevent the fundamental tie-up of deficit spending of Government and money creation. They would not provide the public with assurances that the value of money would be preserved. And they would raise grave questions, shattering to public confidence, about the maintenance of a private enterprise economy.

Advocates of this solution to the financing of Federal deficits may say this is all exaggeration because only small deficits would in fact need to be financed through the banking system. But once the procedure were established, how could any investor in Government securities be sure that it would not be expanded at any time. In such a case, his reaction would certainly be to withdraw from investment in Government securities and concentrate his investment in other securities. In order to keep interest rates on Government securities from rising--in fact, in order to maintain a functioning market for these securities at all--Federal Reserve intervention in the market would become unavoidable

We have now outstanding a marketable Federal debt of around $175 billion. Each year we have refundings in the neighborhood of $30 billion, aside from Treasury bills which total $30 billion and turn over nearly four times a year. If these refundings are not taken up by holders of maturing issues, the Treasury has to borrow the cash to retire them. Usually, the Treasury must borrow each year large amounts of cash, quite aside from any deficit, to pay off holders of maturing debt who decline to subscribe to exchange offerings. Accordingly, the amount of securities that could potentially become available for direct sale to the banking system in any year under the proposal could be simply huge. The larger the amount of Government securities that investors were inclined to sell from their holdings of nonmatured marketable issues, or to redeem from their holdings of nonmarketable securities, the more intractable and unmanageable the financing problem of Treasury would become.

February 3, 1959