Form No. 131

Office Correspondence

FEDERAL RESERVE BOARD

Date December 20, 1934

To Governor Eccles

Subject: Administration of Unemployment Insurance Reserve Funds

From Mr. Goldenweiser and Mr. Currie

Eccles

LBC.

GPO 16—852

The accompanying list of proposals was worked out by Messrs. Viner, Riefler, Hansen, Powell and Sweezy. It is not in any way official and has not been passed upon by any committee. Mr. Viner proposes to see the Secretary this morning in order to ascertain whether he is agreeable to the administration of the reserve funds being undertaken by the Federal Reserve Board.

In our judgment it would be better for the Federal Reserve banks not to have the responsibility for handling the insurance reserve. Our proposal would be that the handling of that reserve be left to the Secretary of the Treasury who would be expected to keep it invested in United States Government obligations or otherwise.

So long as the Secretary of the Treasury keeps the funds invested in the market, changes in the fund arising from growth during periods of prosperity and from the necessity of making payments in times of unemployment would in no way conflict with our open-market policy. While it is true that during a period of business decline more Government securities would be coming on the market under this plan, it is at just such times that the Reserve banks would most likely be buying securities, so that the Government bond market would not be unfavorably affected.

Our chief reason for suggesting that the Secretary of the Treasury handle the insurance reserve is that the payment of interest at not less than 3 per cent by the Federal Reserve banks would create unnecessary difficulties. As the proposal reads at the present time it does not make it clear whether the Government guaranty includes the member banks' dividends. If it does not, it would arouse a good deal of opposition on the part of the banks or else necessitate the use of the Federal Reserve banks' surplus in years when net earnings, after payment of interest on the insurance reserve, will not be sufficient to pay the dividends. On the other hand, if the Government guarantees dividends as well as expenses of the Reserve banks, then it would seem that a 6 per cent return to member banks would be excessive.

The necessity for the Federal Reserve System to depend on Government appropriations to meet deficits arising from the need of paying interest on these funds would be highly undesirable because it would bring the Federal Reserve System to Congress periodically and create a lot of opportunity for meddling with the System.

As an alternative, we propose that the Federal Reserve banks take charge of the insurance reserves, with the understanding that they will keep them invested and that they will credit the fund with such earnings as they actually make on these investments. If, however, it is felt desirable to guarantee a minimum return for the funds, then let the Government undertake to make up to the Reserve banks the difference between what the investments actually earn and the guaranteed minimum, which may be 3 per cent or any other figure. This alternative would avoid the complications about member bank dividends and about the necessity of the Federal Reserve asking for appropriations from Congress. Such appropriations as will be necessary will be entirely in pursuance of the Government's guaranty of a minimum return to the insurance reserve on its investments.

It is, of course, impossible to estimate now the probable magnitude of the reserve funds. Mr. Sweezy tells us, however, that if the insurance plan had started in 1922 with the proposed rates the reserve fund would have amounted to around $2,000,000,000 in 1929.

ADMINISTRATION OF UNEMPLOYMENT INSURANCE RESERVE FUNDS

(1) The funds of each state shall be deposited with the Federal Reserve bank of the district in which the state capital is located.

(2) The insurance reserve deposits shall be managed by the authorities of the Federal Reserve System as an integral part of the means at their disposal for carrying out their general function of credit control and business stabilization, with authority to invest or sterilize these funds. (See appendix A)

(3) In investing the insurance reserve deposits, the Federal Reserve authorities shall be restricted to such categories of earning assets as the Federal Reserve banks are otherwise permitted to hold. (See appendix B)

(4) The Federal Reserve banks shall pay interest on the unemployment insurance reserve deposits at the average rate paid by the United States Treasury on its outstanding interest-bearing obligations, provided, however, that the rate paid on these deposits shall not be less than three per cent. Interest shall be paid monthly on daily average balances, and the rate, if above three per cent, shall be that computed by the Treasury on a daily average basis for Treasury obligations outstanding during the preceding month.

(5) Whenever the expense and realized losses of any Federal Reserve bank, including interest on unemployment insurance reserve deposits, exceed its income during any year so that a charge against surplus must be made, the United States Treasury shall reimburse the Federal Reserve bank for such charges against its surplus account. (See appendix C)

(6) The Federal Reserve banks shall not be required to carry any minimum cash reserve against unemployment insurance reserve deposits. (See appendix D)

November 13, 1934.