Cunnz? 6-1934

FINANCING THE DEFICIT.

Assumption: Total expenditures in the next calendar year and probably fiscal year will exceed by a large sum the revenue derived from taxation.

Problem: How should the necessary new money be raised?

Possibilities: A. Sale of long dated bonds to individuals, banks, and reserve banks.

B. Sale of short dated issues to commercial banks and to the reserve banks.

C. Combination of A and B.

Discussion of A.

1. Treasury viewpoint.

(a) Advantage. Once the bonds are sold the Government's financing problem is solved and its annual charges on account of its bonded indebtedness are fixed and known.

(b) Disadvantage. At present the interest rates are considerably higher than the rates on short dated issues.

2. Viewpoint of lenders. It is a fact that at the present the yield of long dated Governments is as low as it has ever been, that there is a distinct possibility of a long continued rise in commodity prices, and that similar rises in the past have coincided with falling bond prices. Thus the purchaser of long dated Governments runs the risk of capital depreciation in the future. The lower the present bond yields, the greater the risk. Bankers whose liabilities are fixed in dollars and who operate on

a thin margin, are particularly adversely affected by falling bond prices. From 1900 to 1913 English banks were forced to write off 20 million pounds depreciation on their holdings of irredeemable Consols. The disinclination of the reserve banks to hold long dated bonds is understandable. It is probably that the reserve banks will find it desirable on general monetary grounds to liquidate their investment holdings within a relatively short period of time. Long dated bonds may have already depreciated and since their market is not as active nor as broad as that of short dated securities, it may be difficult to dispose of a large additional amount without incurring further depreciation.

Discussion of B.

1. Advantages. Borrowing at the present and probably for the durance of the depression can be done more cheaply by using short dated issues. Regardless of how fearful bankers may be of the outcome of the Administration's policies they would subscribe to short dated issues since by so doing they earn some interest and take no risk. They may, on the other hand, be on occasions extremely reluctant to take long dated issues and run the risk of depreciation and they may seek to make the price of their cooperation definite commitments on the part of the Administration which the latter may be reluctant to give.

2. Disadvantages. When business recovery has proceeded for some time the rate of interest on short-term loans may rise above the rate now prevailing on long dated Governments. In the course of say 10 years the Treasury may pay a higher average rate on short dated than on long dated bonds.

There appears to be little force to the objection to an increase of the floating debt on the grounds that it makes for uncontrollable inflation. Should the banks refuse to renew short-term paper they will presumably be refusing to make any loans — a violent deflationary development which it would be proper to offset by forcing the reserve banks to take the securities. The only other possible way in which the existence of a floating debt may force the issuance of new money at a time when it is undesirable would be for the banks to renew the issues but at a much higher rate. This would increase Government expenditures on interest account and might conceivably lead to new borrowings. Thus an additional 4% on 5 billion would amount to 200 million. This obviously is a matter of minor importance.

Discussion of C.

3% might be regarded as about as low a rate on long dated bonds as we are likely to see maintained over a long period. It is true that British Consols sold at a lower yield basis in the 1890s but that was a period, broadly speaking, of depression and falling prices. It is not at the moment feasible to float a long issue with a 3% coupon. If however, the Treasury used up a portion of its deposits in commercial banks and induced the reserve banks to purchase more short dated issues, the prospects of funding on a 3% basis would improve. A supply of long dated securities coming on the market would, for the time being, be decreased and excess reserves of commercial banks would be increased. Both forces would make for higher bond prices.