Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 13, 1939

To Chairman Eccles

Subject:

From Emile Despres

Attached is a memorandum on the Lee Bill for forced loans in wartime, prepared in response to Mr. Currie's request for my comments on this proposed measure. Mr. Currie reports that Senator Lee has talked to him about it and will probably come in to discuss his plan with you. Copies of the Bill itself, the report of the Senate Committee on Military Affairs, and a transcript of a Radio Forum program dealing with the measure were passed along to me by Mr. Currie and are being held in my files.

ED

M E M O R A N D U M October 12, 1939

TO: Mr. Currie RE: Comments on Lee Bill for

FROM: Emile Despres Forced Loans in Wartime

Under the provisions of the Lee Bill, the Federal Government's borrowing requirements would be met, in the event of war or national conscription, by requiring individuals to purchase non-tax-exempt Government obligations bearing not more than 1 per cent interest and having a maturity of at least fifty years. Such securities would be allotted to individuals in accordance with quotas based upon their net wealth.

As a first step, a census of the net wealth of individuals is to be undertaken upon declaration of war or enactment of conscription. The proportion of the individual's net wealth "subject to the borrowing power of the United States" is then established on a graduated scale, the proportion, after a $1,000 exemption, being 5 per cent for the next $9,000 of individual net wealth, 10 per cent for the next $90,000, and 15 per cent for the next $150,000. The rate continues to advance by stages to 30 per cent of net wealth over $1,000,000, 50 per cent of net wealth over $5,000,000, and 75 per cent of net wealth over $1

$100,000,000. New issues of Government securities are to be allocated among individuals in proportions corresponding to the individual quotas established by the above formula. If these quotas become exhausted, a new series of quotas is to be established by deducting from each individual's net wealth as shown in the original census the amount of Government securities already purchased, and then applying to this residual the same graduated scale of percentages.

Discretionary authority is granted to the President to accept, instead of cash, "property or services which are valuable for the prosecution of the war or the improvement of the national defense," or secured promissory notes bearing interest at 6 per cent. The President is also authorized to issue currency against the security of such assets other than cash as may be received in payment for Government obligations.

The chief defect of this proposed method of war borrowing is due to its use of net wealth as a yardstick for measuring capacity to purchase Government securities. First, the task of making even a crude appraisal of securities, mortgages, insurance policies, and physical property is much too formidable to permit a satisfactory census within any brief time. Second, such an appraisal, if made, would not provide, even in principle, an appropriate criterion of ability to purchase Government securities. In the last analysis, funds with which to purchase Government securities must come from previously existing holdings of cash and from current savings out of income. Thus, the appropriate basis for allocating Government securities, under a system of forced loans, is not provided by a formula based upon net wealth, but rather by one based upon (1) cash plus net short term assets and (2) income. An important connection does exist between ownership of long term assets and ability to lend, but this connection is indirect, and depends upon the income provided by such assets. Particular individuals, by selling their securities and property and surrendering their insurance policies, may put themselves into a position to purchase Government securities in excess of the amounts permitted by net short term assets including cash, and by their current savings out of income; this cannot be generalized, however, for the economy as a whole, except to the extent that the banking system creates additional deposits by taking over the securities and property offered for sale by individuals.

This defect of the formula proposed in the Lee Bill originates in a confusion between wealth and money. The Government's specific financial requirement is a requirement for money, because it is by spending money that it obtains the materials and labor needed in wartime. An individual's ability to furnish money to the Government is not directly measured by his net wealth, because wealth includes physical property, stocks and other titles to property, and claims on property which range all the way from bonds, mortgages, and life insurance at one extreme to currency and demand deposits at the other. The gap between money and other claims on and titles to wealth could be bridged in some degree by a shift of assets among individuals and corporations, by which means some individuals whose wealth consisted largely of property and securities would be able to obtain money from other individuals, corporations, and institutional investors in exchange for these assets. To some extent also, this gap could be bridged by the banking system, which might create additional deposits by purchasing some of the securities and mortgages offered for sale by individuals. These bridges would scarcely be adequate, however, in relation to the heavy requirements of war finance. Extensive shifting of assets among individuals and corporations would have a disruptive effect upon security markets and financial markets generally, while the types of assets which it is considered appropriate for commercial banks to acquire from other holders are somewhat restricted. It seems clear, therefore, that the Lee Bill should be revised by substituting an allotment formula based upon (1) holdings of cash plus net short term assets, and (2) income, for the present formula based upon wealth.

The question remains to be examined whether a system of forced allotment of Government securities, revised along the lines indicated above, would provide a desirable instrument of war finance. Considerations both of equity and of economic effects furnish a strong case for a measure of this sort. The argument that conscription of financial power should accompany conscription of manpower is strongly persuasive. Under the present arrangements governing the distribution of Government as well as of other securities, banks, other institutional investors, and individuals, are free to determine the terms at which they will be induced to exchange their idle cash for such securities. Prevailing yields of Government securities have been relatively low, owing to the large volume of excess reserves and idle bank deposits, but even with present conditions of monetary ease, the Government's borrowing requirements could be met at far lower interest rates under a system of forced allocation than under the existing free market system.

The establishment of the lowest practicable interest rates for new Government securities is of particular importance when the country is at war, because of the magnitude of the Government's borrowing requirements and of the desirability of minimizing the increase in public debt service. War borrowing, though it does not, of course, provide a means of shifting the costs of war to future generations, does necessitate future transfers of income from the general body of taxpayers to the holders of Government obligations. These securities are likely to find their principal market among individuals and corporations who have substantial accumulated holdings of idle cash, or who are enjoying a large current income. If one regards the longer term economic problem as one of achieving a redirection of income toward increased consumption expenditure, an increase of substantial magnitude in the interest charge on the public debt may seriously intensify the difficulty of adjusting the flow of income to the available volume of investment outlets.

Although a substantial reduction in interest rates would relieve this source of future economic maladjustment, it might be argued that the difficulty could be obviated, instead of being merely relieved, by resorting exclusively to taxation as a method of war finance. This, however, is a counsel of perfection. It would be impossible to devise a tax system which captured all savings, and undesirable to adopt a system which left little room for saving of the "rainy day" variety. Taxation of the type which bears chiefly upon consumption would, if pressed too far, weaken the working man's incentive to effort and to efficiency.

A system of forced allocation of new issues of Government securities, besides relieving the difficulties of postwar readjustment, might provide a useful instrument of monetary control during the period of hostilities. Under a formula based upon (1) idle cash and (2) income, corporations and institutional investors as well as individuals would be required to subscribe in specified amounts to new public issues. The decision whether commercial banks were to be brought into the scheme would depend upon whether an expansion of bank assets and deposits was thought desirable. If banks were included, their allotment might be adjusted in relation to the movements in their other assets and to desired changes in the volume of deposits. If banks were omitted, this would be equivalent to financing the Government's borrowing requirements wholly from accumulated idle cash and from current savings out of incomes. Drafts upon idle cash should exert the same type of inflationary effect as the creation of new deposits, but there may be some advantage in using up existing idle funds before additional depostt money is created. After the growth in active circulation requirements which accompanies expansion in national income had depleted the supply of idle cash, the question could be faced whether some expansion in bank deposits would be permitted. In any event, the monetary authorities, by assigning to individuals and corporations the amounts which they must save and invest in Government securities, could keep the expansion of bank deposits under close control.