TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE: September 6, 1934.

TO The Secretary of the Treasury

FROM Mr. Eccles

Re: Suggestions designed to improve the long-term Government bond market.

I have been giving some thought to the problems involved in financing by long-term Government bonds. Certain suggestions come to my mind as worthy of consideration if the present orthodox methods of financing are to be pursued with success.

In view of the large holdings of Government bonds by banks and the apparent nervousness whenever the Government bond market takes a slump it is probably wise that certain changes be made in order that the banks might feel more secure against possible future losses in their holdings.

As long as the Government continues to finance its requirements in the orthodox way it is important that careful account be taken of timing the operations of supporting the Government market. Once momentum has developed it is much more difficult to head off a continued slump in the Government securities. If prompt and aggressive action is taken by the Federal Reserve and the Treasury to support the Government bond market fluctuations will tend to be much narrower. It seems to me to be absolutely essential that vigorous action be taken in order to provide adequate Government credit at low rates in a depression, thus taking the power of control out of the hands of private financial interests and in addition increasing the effectiveness of control over the monetary system of the United States.

In this connection it may be well to reflect that banks of the United States are being forced more and more to invest their funds in securities in view of the absence of demand for commercial loans and that in the future we may expect a continuation of this trend. Thus if we are going to look at banks as institutions which should engage in lending solely upon the so-called self-liquidating commercial loan we are simply losing sight of a major change in our methods of business financing and from which it appears there can be no significant change as long as we have an increasing concentration of industry and trade in the hands of large corporations which have an abundance of working capital and a ready access under normal conditions to the organized securities markets.

Under these conditions the Federal agency for control must think in terms of controlling the money supply, namely, cash and demand deposits rather than continuing to stress the liquidity of bank assets as the all important factor in sound banking practice. When such so-called liquid assets do not exist in sufficient quantities to supply the volume of money necessary to carry our economic structure, Government securities or other sound investment securities must replace this deficiency in commercial loans in the portfolios of commercial banks if we are to obtain a sufficient supply of money to provide an adequate price level to enable us to maintain the present debt structure and to support an increasing volume of business activity. Thus it is necessary that Government securities should be regarded as the equivalent of currency by banks and that the banks should stand no chance of loss through purchasing them. In order to provide this assurance the Federal Reserve should be required to purchase Government securities in as large quantities as necessary so as to provide a market for Government securities at low rates thereby making funds available to meet the requirements of a recovery program.

Perhaps for the time being the Government should rely more upon short-term issues of say a three year maximum to provide its necessary funds, because banks would have much less aversion to purchasing this type of issue. There would still be a large volume of long-term Government bonds outstanding with Government guaranteed new bonds being currently issued by the H. O. L. C. and the F. F. M. C. which puts continual pressure on the market. It is highly advisable that the long-term Government market be maintained on a low yield basis as rates on Governments exert a considerable influence upon rates throughout the long-term investment market and certainly a revival of construction and general business recovery depends in large degree upon the existence of a low level of interest rates for capital financing.

In addition, to improve the immediate market for Government bonds as bank investments and hence tend to allay the apprehension which is now felt toward them in some quarters, I suggest that you should use your influence to require the Federal Reserve banks to adopt a long-term policy of loaning to their members on Government securities or those fully guaranteed at the par value of such securities. The Federal Reserve banks should advise all member banks to this effect as well as give appropriate publicity through the press. Such statements would tend to relieve the banks of any fear of loss by being forced to convert their present holdings of Government securities into cash in the future.

There is every reason for the Federal Reserve to adopt a policy such as this inasmuch as the Emergency Banking Act already permits the Federal Reserve system to issue currency on a 100% backing by Government bonds, thereby in effect recognizing them as the equivalent of currency. While there would likely be little, if any, borrowing from the Federal Reserve banks at the present time in view of the great amount of excess reserves held by banks, nevertheless the recognition of a value equivalent to that of currency for Government securities would have a wholesome and favorable psychological effect.

It is further suggested that if the Federal Reserve banks adopt the above policy, the Comptroller's office be then required in making bank examinations to list Government bonds, direct and/or fully guaranteed, in bank examination reports at cost or market whichever is the greater except that where cost is more than par then Governments would be listed by the reporting banks at market or par whichever is greater. The effect of this would be that if individual banks had an appreciation in Governments it could be used to offset the depreciation on other assets. Whereas, if there was a depreciation between the cost price and market price it would only be taken into account down to the par value of the bonds, becuase of the recognition of their equivalence to currency which is at par value.

There is a further political danger which may become more apparent if action is not taken to improve the Government bond market and insure ample funds to enable the Government to carry out its recovery program. Certain Congressmen and Senators are almost sure to start agitation for a policy of currency inflation under powers which already exist and for legislation to create some form of monetary authority or central bank as a substitution for the present Federal Reserve system. These developments would entail serious consequences and it would be unfortunate to have them forced upon the Administration with mandatory provisions that have not been carefully worked out from the standpoint of their monetary and economic effects.