Govt finance

MEMORANDUM TO MR. ECCLES:

Re: Comments on the proposal to obtain a wider distribution of Government securities.

I am not very much impressed by the alleged necessity of obtaining a wider distribution of Government securities in the hands of individuals. Of course, it may be that these reports to this effect as coming from officials who are suggesting a wide selling drive may be only propaganda with purpose of getting greater banker support to Government financing. If this is true then the whole question becomes of no importance. However, on the other hand if the statements are taken seriously and there is to be a Treasury drive it seems to me that some action should be taken to point out that the advantages of a wider holding of Government securities are more apparent than real and that efforts to effect such a situation would be undesirable at the present time.

In the first place, the question of possible stability of the Government market in the future should be discussed. I cannot conceive that banks would get out of Governments as fast as individuals in a period of expanding business activity and profits. The banks now have excess reserve of approximately $2,000,000,000. This would mean that there could be an expansion of bank credit and bank deposits of $20,000,000,000 provided there were no off-setting of reserves through money flowing out into circulation, gold exports or Federal Reserve action in reducing member bank reserve balances before there would be any pressure against reserves and hence before the banks would have to liquidate Governments in order to place funds into loans and securities which would give them a higher yield. Whereas, in the case of individuals with expanding profits there would be extreme pressure for them to liquidate their Governments and to place the funds into stocks and bonds which would yield greater return. This conclusion I think can be borne out by the experience of the past. During the period from 1922 to 1929 when the public debt was actually decreasing at a fairly rapid rate and when business was relatively prosperous the banks' holdings of Government securities ~~was~~ were increasing. Moreover, the individual has no necessity of holding Governments as a secondary reserve as is the practice of the banks.

Another important consideration particularly at this time is that if Governments are sold to individuals there is no increase at all in the total volume of bank deposits and hence money available for spending, whereas, if banks with excess reserves are buying Governments there tends to be an immediate increase in the total volume of deposits subject to check. Of course it is true that the individuals may be holding idle deposit balances in the hands of banks and these would be turned over to the Government and would hence become active deposit accounts, and this of course would be a desirable effect for it would increase the velocity of circulation of bank deposits and hence would increase the income of the country as a whole. Still it would be better to increase the volume of demand deposits as well as the velocity of their circulation.

The idea that banks will refuse to purchase Governments in the future is in my opinion given more weight than is justified. After all, the Government's bargaining position in this connection is very strong. The banks would have a great deal of difficulty in placing funds in business enterprises in the form of loans and investments which would meet their standards of safety. Thus in effect what is happening is that the Government is providing banks with practically their only available form of earning assets. The Government has given them the excess reserves which enables them to increase their loans and investments and hence deposits and are paying them 3% on the credit so extended. Moreover, there is always athreat which the Government can hold over the banks that if the banks are not willing to provide these funds the Government itself can do that either by issuing non-interest bearing obligations, namely currency, or by Federal Reserve bond purchases, and would thereby deprive the banks of any income at all from the increasing of demand deposits.

Quite naturally, the banks would like to see as high a rate as possible on the new Governments which come out considering the low earnings which they now have. For the Government to permit them to obtain such earnings considering the general money market situation would be not taking advantage of the strong bargaining position that the Government now has.

Another factor in the situation is with regard to the possibilities of control of the volume of bank deposits in the future. I have already commented upon the necessity of obtaining larger demand deposits during the depression period and pointed out that the selling of Governments to banks is the most direct way to obtain this end. In a period of expanding credit it would be undesirable that the process of retiring Governments should be hastening inflation. If Governments are in the hands of the banks I think that this inflation can be controlled to a greater extent. In the future when the Government is purchasing its own securities for retirement if the bonds come from banks, bank investments for the system as a whole are cut down at the same time that deposits are cut down. While this would mean a release of reserves the banks would have to go through a process of expansion in order to build up deposits to the amount that were lost. The Federal Reserve also might cooperate in this process by open market operations which would mop up the increase in reserves and the banks in order to expand would then have to borrow from the Federal Reserve provided they had no unused balances. This procedure would tend to have the effect of curtailing credit expansion, although it must be admitted that it would take very careful management to assure its success.

If there should be a drive to place more Governments in the hands of individuals by the selling of securities of low denominations or by creating an instalment selling plan for Government securities I would heartily condemn it. It seems to me that the volume of available funds for this type of purchases is probably very small at the present time. To organize and to promote a high pressure selling campaign comparable to that of war times when "thrift stamps" and "baby bonds" were being sold to the public seems to me would be a costly method of financing and a needless waste of effort considering the probable results that would be realized. Also I think that such a campaign would be highly undesirable in that if it was aggressively carried on there might be a savings program in general on the part of many individuals who would otherwise spend their funds and this would probably have a bad effect upon the recovery program. Moreover a campaign for public purchases of Governments might have an unfortunate psychological effect at the present time. It might be taken in many quarters as an admission of weakness on the part of the United States Government and that the Government is finding it necessary to go to all of its citizens with patriotic appeals for funds to carry on its program. In view of the strong position of Government bonds and from the general money market situation it seems to me that the Treasury can well assume a position of independence in its financing operations and that this is the type of attitude which would be most healthy at the present time.

H.H.