December 3, 1940.

MEMORANDUM:

TO - Mr. Bell

FROM - Chairman Eccles

These are the preliminary memoranda re Treasury financing which I discussed with you over the telephone.

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STRICTLY CONFIDENTIAL December 3, 1940

Preliminary memorandum on Treasury financing based on a discussion by members of the Board of Governors and Mr. Sinclair, President of the Federal Reserve Bank of Philadelphia

The Treasury's cash balance is now under a billion dollars, and net expenditures over the next three months will be substantial. These facts clearly indicate the need for some nearby financing. The character of the financing should be considered from the standpoint of its bearing upon the national economy and, immediately, in relation to its effect upon the defense program. Financing the defense program as it relates to the national economy raises many problems which cannot be discussed within the limits of this memorandum but which we shall be glad to discuss at an appropriate time. In general the monetary and fiscal aspects of the program are concerned with the question of avoiding, on the one hand, undue or premature restriction of our total economic effort before a satisfactory level of national income and employment is reached, while avoiding, on the other hand, the danger of inflation. The further problem, while the defense program is under way, of avoiding serious bottlenecks in production and distribution, which might have effects very similar to those of a general inflation, must probably be approached mainly by measures other than monetary or fiscal.

Aside from these bottlenecks there is still much unemployed labor and industrial capacity and many raw products in abundant supply, and as long as this situation continues the resources for national defense should not be obtained at the expense of peacetime activities and consumption. We have reached a level of output, however, well beyond anything previously attained even in the late twenties, and next year the level will almost surely be substantially higher. There are estimates that the national income, this year about $74 billion, will rise next year to about $80 billion and that by 1942 or 1943 it will reach $90 billion in terms of the present price level. Obviously in the face of such a prospect, especially when the expansion is occurring in response to the stimulus of large defense expenditures and British war purchases, the possibility of an inflation, whereby the expansion would go into prices rather than into output, must be an ever-present concern of the monetary and fiscal authorities.

On the monetary and fiscal side, we have to reckon with the fact that the volume of demand deposits and currency is larger than ever before, that excess reserves are huge and are increasing, that the Government debt is already large, that Government securities have become the chief asset of the banks, and that purchases of securities by the banks create additional deposits. As to taxation, the new tax measures of 1940 have substantially increased the revenue in prospect for the coming year, and what is even more important, in considering the problem of financing the entire defense program over the next several years, have given us a tax structure which will yield substantial further increases in revenue as the national income rises.

The financing program best suited to these circumstances would appear to be one combining borrowing and taxation in such a manner that borrowing will lessen and tax revenue increase as the national income rises and the danger of inflation draws nearer. As regards borrowing, which is the immediate problem, it appears that under present circumstances--and this will become increasingly important as the defense program proceeds--the Treasury should confine its borrowing as much as possible to non-bank investors and thus prevent the further piling up of deposits by the banks. Pending other steps that may be taken to this end, a long bond should be issued at this time in an effort to interest as many non-bank investors as possible and to discourage the further purchase of Government securities by banks. Another advantage of a long-term issue would be that it would help to supply the present demand for such securities and tend to prevent further increases in market prices.

Other means of increasing sales to the savings groups might be considered as part of a longer-term program. First, sales of the present type of savings bond might be increased by a more intensified campaign and by again allowing trust accounts to purchase these issues. Second, the Treasury might issue a new type of savings bond which would pay a semi-annual coupon and be redeemable at the Treasury prior to maturity at a discount. Third, the Treasury might issue a registered non-negotiable bond which would be salable only to the savings groups of the country and could be made either irredeemable prior to maturity, redeemable at a discount on perhaps three months' notice, or convertible into some selected outstanding issue. The fundamental problem to be met, however, is to find means of reducing the volume of unused reserves in the hands of banks available and pressing for investment.

More specifically, it is recommended that the Treasury should refund both the maturing notes and bonds in December and should raise about \$500,000,000 to \$750,000,000 of cash. It seems likely that holders of the notes and bonds should be given the option of refunding into either an intermediate or a long-term bond and that cash should be raised through a long-term bond. Other alternatives would be to refund in December and raise cash by a long-term bond in January or to refund in December and raise cash through national defense bills.

It would probably be advisable to do the refunding in December, because this procedure would clear the decks for future financing and is expected in the market. It is also recommended that the Treasury should raise \$500,000,000 to \$750,000,000 of cash in December. The Treasury's cash balance, which is now \$900,000,000, would be down to about \$600,000,000 by the end of December and would be entirely eliminated by the end of February if no cash is raised in the interim. The raising of cash might be deferred until January, but it is probably desirable to complete the entire financing at one time. It appears that the raising of cash up to about \$750,000,000 would still leave a margin of safety within the statutory debt limitation.

Present market conditions are such that the Treasury could without difficulty issue long-term bonds. During the past month long-term bonds have advanced in price by more than two points. Reporting member banks have added $100,000,000 to their Government bond holdings since October 9, and insurance companies have also been substantial purchasers. There has been a relatively small supply of securities in the market except from the System Account. The present situation tends to induce banks to purchase bonds of longer maturities in order to obtain income necessary to meet expenses and dividends. Under present conditions, therefore, it appears quite certain that intermediate and long-term bonds would be readily absorbed in the market. Their issuance would also serve to restrain a further sharp rise in prices over the next few months.

Such an operation can be carried out successfully, provided the offering restricts the allotment of long bonds to an amount that the market can comfortably digest. The demand for ~~long~~ bonds during recent weeks has been largely centered in the intermediate issues, and the rise in price of the four longest bonds may be weighed more by the absence of offerings than size of the demand. This does not imply that there is not a substantial backlog of demand for long bonds, because there is, but there is reason to doubt that the market would readily absorb a long bond in an amount much in excess of $1,000,000,000. It might be advisable, therefore, to limit the long-term bond to a cash offering, in order to avoid the possibility that due to the large premium on the long-term bond the bulk of the exchanges would be for this issue, creating an outstanding amount between $1,500,000,000 and $2,000,000,000. Limiting the long-term bond to a cash offering would also avoid arbitrage transactions and wide fluctuations in the rights between the time of closing the books on cash subscriptions and the time of closing on exchanges. It is recognized that a long-term bond would not be distributed exclusively to non-bank investors, since a number of banks would purchase the issue for the underwriting profit, and others would hold the issue as a permanent investment. A long-term bond, however, would fit into the category of an investment suitable for non-bank investors and would represent a mile-post in the market by which further long-term financing could be more readily gauged.

In view of the size of the financing it would probably be desirable to give holders of the maturing bonds and notes an option. The option should be between a long bond and an intermediate bond rather than a note, since most investors have a decided preference for intermediate bonds rather than for notes at current low yields. The maturing bonds have been outstanding for about 10 years, and a large proportion are in the hands of insurance companies and savings banks. Under these conditions there might be some advantage in permitting the exchange of the bonds for the new long-term bond issued for cash, at the same time protecting the market by requiring that the new bonds would be issued for exchange only on the basis of a registered bond which would be delivered after three to six months. Consideration might be given also to raising the limit on preferred allotments on cash subscriptions to $10,000 or $25,000. Such a step would tend to encourage individual subscriptions and to reduce allotments to banks.

STRICTLY CONFIDENTIAL

December 3, 1940

The discussion in the memorandum indicates quite clearly that the defense program should be financed from the savings of the country rather than from a further expansion of bank credit and that an influence in this direction would be the issuance of long-term bonds. While the general program should probably be of this nature, there are certain considerations that might make it desirable to follow for the immediate future an interim program of short-term securities. In view of the large volume of excess reserves and bank deposits and the possibility of inflationary tendencies developing at some time in the future, it seems likely that steps will be considered for reducing excess reserves to a more reasonable level. In addition to the uncertainties that will be produced in the market by such discussions, there will be other uncertainties regarding comprehensive banking legislation, tax legislation, and the proposal for making future issues of public securities fully taxable. Until these questions are settled the market cannot be expected to measure long-term interest rates with fairness.

With the removal of the influence of large surplus banking funds on the market, long-term rates, which are now at record low levels, might increase somewhat to a point that would more nearly reflect the level necessary for attracting the savings of the country. If a long-term bond should be issued at the present time it would be vulnerable to an increase in rates. If this condition is anticipated it may be more in the public interest to protect investors from impairment in market value by deferring the issuance of long-term bonds until after such an adjustment has occurred.

Under this program short-term securities would be floated at the present time and would later be refunded into long-term bonds. If this program should be adopted the Treasury might find it desirable to issue a statement outlining its reasons for this procedure.