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TREASURY FINANCING POLICIES

The present situation. - Following the end of the war in Europe, the principal emphasis in Treasury financing policies will shift from raising new funds to refunding maturing and callable issues. In each of the fiscal years ended on June 30, 1943 and 1944, the public debt increased by about 60 billion dollars. In the current fiscal year, the increase will be about 40 billion dollars. In the next fiscal year, it may decline to 10 or 20 billion dollars, depending upon when the war in the Pacific ends.

At the present time, the debt is 210 billion dollars. It is composed to the extent of 30 per cent of bills, certificates, and notes, about 40 per cent of Treasury bonds, and 30 per cent of savings bonds, savings notes, and special issues. The short-term securities are held principally by the banking system, while the nonmarketable securities are held almost entirely by nonbank investors. Nearly half of commercial bank holdings are in bills, certificates, and notes, and about three-fourths of their bond holdings mature within ten years.

DISTRIBUTION OF U. S. GOVERNMENT DEBT, AUGUST 31, 1944
(In billions of dollars)

Kind of securities	Total outstanding	Classes of holders					
		Federal Reserve Banks	Commercial banks	U.S. Government agencies and trust funds	Mutual savings banks	Insurance companies	Other investors
Total ^{1/}	209.8	15.8	71.5	20.0	7.5	17.5	77.5
Treasury bills	15.7	10.1	4.8	--	--	--	.8
Certificates	30.0	3.4	17.1	.1	.1	.4	8.9
Treasury notes	18.1	1.1	12.7	.1	.3	.3	3.6
Treasury bonds	81.2	1.3	34.6	4.3	6.9	16.6	17.5
Savings bonds	36.9	--	.7	--	.2	.2	35.8
Savings notes	10.0	--	.1	--	--	--	9.9
Special issues	15.5	--	--	15.5	--	--	--
Guaranteeds	1.5	--	1.0	--	--	--	.5

^{1/} Including small amounts of depositary bonds, adjusted service bonds, and prewar bonds not shown separately.

The increase in commercial bank holdings of Government securities has resulted in a rapid growth of bank earnings, notwithstanding the large concentration of holdings in short-term securities. The ratio of net earnings after taxes to total capital accounts at member banks increased from 6.2 per cent in 1940 to 8.8 per cent in 1943. In 1944, the ratio will probably be nearly 10 per cent. At the same time, the capital accounts of banks have increased through the retention of earnings.

During the past year, commercial banks have added substantially to their holdings of higher-yield securities, comprising certificates, notes, and bonds, and have reduced their holdings of $3/8$ per cent bills. The pattern of rates has been maintained, but the demand for higher-yield securities has resulted in downward pressure on yields for certificates, notes, and bonds. There is every reason to believe that this pressure will continue as long as investors think that the present pattern of rates will be maintained. In order to maintain the pattern of rates, the Federal Reserve during the past two months has sold about 300 million dollars of notes and bonds and at the same time has acquired 2 billion of bills.

Federal Reserve policy since the beginning of the war has been directed toward stabilizing the market for Government securities by providing banks with sufficient reserves to enable them to purchase securities not taken by other investors. The end of the war in Europe may diminish the importance of this phase of Federal Reserve policy, because with the decrease in the rate of growth of the debt nonbank investors will have sufficient funds in 1945 to absorb nearly all of the increase in the debt. Banks, therefore, will not need to increase their holdings of Government securities by anything like the increases during recent years. Many banks will be able to buy additional securities, however, particularly during drives, when their excess reserves increase. The desire of banks to purchase additional securities at a time when the demands of other investors are nearly sufficient to absorb existing supplies will exert pressure toward a further rise in prices of Government securities, that is, toward a further decline in interest rates. Medium-term securities will be particularly strong. If the pattern of rates is to be maintained, the System will either have to sell from their limited holdings of medium-term securities in order to keep prices from rising and yields from declining, or else some other method of limiting bank purchases of securities will have to be devised.

To summarize, the present situation is one of (1) a large public debt that will continue to increase but at a rapidly diminishing rate, (2) a considerable short-term debt, which is held principally by the banking system, (3) large and increasing commercial bank earnings, (4) considerable pressure for yields on certificates, notes, and bonds to decline, and (5) greatly diminished need for Federal Reserve policy to be directed toward supplying additional reserves to banks to support war financing. The development of financing policies that will be appropriate to the changing situation and that will permit the Federal Reserve to adjust its credit policy to new conditions is a task that must be undertaken promptly by the Federal Reserve and the Treasury. It should be kept in mind that in order to discharge its responsibilities the Federal Reserve should be in a position at all times to exert a restraining as well as an expansive influence on bank credit.

In managing Treasury financing during the next few years, the refunding and perhaps the retiring of maturing and called securities will probably be the major task in contrast to the recent situation when the principal problem has been to raise additional funds. This task can be handled in a number of different ways that will have widely different repercussions on the banking system. Some of the ways are:

(1) Refunding of short-term into long-term securities. - Traditionally, it has been considered good policy whenever conditions permit to refund short-term into long-term debt and to reserve short-term instruments for emergency use. The main purpose of such a policy has been to distribute maturities and to avoid the possibility of having to meet large and unwieldy maturities at a time when conditions were unfavorable. This may be the proper policy to follow in refinancing private debt, since private debtors have no control over and no responsibility for market conditions. In the management of the Government debt, however, the monetary and fiscal authorities can largely control the terms and conditions of refinancing, and they have responsibility for the adoption of policies that will be in the general public interest.

To follow the traditional policy of refunding the short-term Government debt into long-term debt as rapidly as possible would lead to a number of undesirable consequences, particularly in view of the size and distribution of the present debt. Such a policy, by lengthening the average maturity of the Government debt, would result in an increased interest cost and in less flexibility to the Treasury in managing the debt. The consequent increase in commercial bank holdings of longer-term securities would further increase commercial bank earnings, which are already large. This would make the Treasury and the banking system more vulnerable to political attack on the grounds that banks were making unreasonable profits from the public debt. In addition, an increase in the outstanding amount of long-term securities is inherently not in the best public interest if interest rates subsequently change; if interest rates rise the investor will be receiving less than the current rate of interest and will suffer a loss on any securities that he may sell, while if interest rates decline the Treasury will be paying more interest than is necessary at the current rate. Since the average maturity of bank holdings of Government securities would be lengthened, the depreciation of the value of bank holdings would be larger if interest rates should rise. Because of this, the Federal Reserve might be hesitant to pursue a policy of credit restraint, even if such a course should appear to be desirable on general economic grounds.

(2) Maintenance of present maturity distribution. - Instead of refunding maturing and called issues into longer-term securities, the Treasury might attempt to maintain the present maturity distribution of the debt. Certificates would then be refunded into certificates, notes into notes, and bonds into bonds. The maturity distribution of commercial bank holdings would remain about as it is at present. The rate of interest that banks would earn on their holdings of Government securities would show little change, and any further increase in earnings would depend upon additions to holdings.

It would be difficult, however, to follow this policy and at the same time to maintain the existing pattern of rates. Banks would probably continue to prefer medium-term, higher-yield issues over the short-term, low-yield issues, particularly as long as the Federal Reserve continued its policy of supporting the pattern. Yields on longer-term issues would decline relative to yields on short-term issues. This might be desirable if the period were one of deflation and particularly if conditions seemed to call for stimulation of building, of foreign loans, or of other activities that may be affected by medium-term yields. If, on the other hand, the period were one of inflation

and if the situation seemed to call for a diminution of such activities, this policy would be inadvisable. There is also considerable question as to whether it would be desirable to have medium-term interest rates decline further from present low levels, in view of the many institutional adjustments that this would require in our financial system.

(3) Special measures. - In view of the serious objections to the adoption of a policy of refunding short-term debt into longer-term securities and in view of the difficulty of maintaining the pattern of rates if the existing maturity distribution is continued, some special measures may be needed to meet the situation.

(a) One such measure would be to issue a special type of security for purchase by banks, such as the so-called Treasury deposit receipts used by the British Government, and to require that commercial bank holdings of marketable Government securities be limited to a certain percentage of their savings deposits and of time deposits belonging to groups permitted to hold savings deposits. Under this provision, commercial banks would be required to exchange their excess holdings of marketable securities, as thus determined, for the Treasury deposit receipts. The deposit receipts would not be marketable, but could be sold to the Reserve Banks or redeemed at the Treasury by banks needing reserves. They would bear a rate of interest no higher than is necessary to provide banks with reasonable profits. Existing holdings of securities to be exchanged for them would include issues that have not yet matured or are not yet callable.

Such a measure would result in a removal of nearly all of the existing pressure on the pattern of rates, because the demand by banks for marketable issues would be considerably limited. It would also help to maintain bank earnings at a reasonable level. The proposal, however, raises a question of equity to banks that have purchased their existing holdings in good faith and with a Treasury contract that the securities are not callable or will not mature before a specified date. (Mr. Dreibelbis is examining the legal questions involved.) In order to provide a satisfactory market for nonbank investors, who would hold the remaining marketable securities and who could not sell them to banks, the Federal Reserve would need to engage in much larger open-market operations. It is possible that at times these operations might conflict with credit policy.

Instead of requiring an immediate exchange of all existing holdings, banks could be given the opportunity to exchange issues that mature or are called for Treasury deposit receipts but not for any marketable issues that might be offered in exchange to other holders. In order to make this variation effective, it would be necessary to prohibit banks from making any increases or shifts in their present holdings of marketable securities. This variation would make it possible to control bank earnings, and it would remove most of the existing pressure on the pattern of rates. It would be more equitable to banks than would the original proposal, since banks would not be forced to exchange their holdings before maturity. Although not forced to exchange them even at maturity, most banks would probably do so, because the choice would be between holding Treasury deposit receipts or holding idle funds. (Mr. Dreibelbis is examining the legal questions involved.)

On the other hand, this variation would increase the difficulties of operating individual banks that were gaining or losing deposits. Banks that were losing deposits would be forced either to sell marketable securities, which could not be purchased by banks that were gaining deposits, or to redeem deposit receipts. In the latter case, it might be necessary to develop some complicated method of allocating deposit receipts to banks that were gaining deposits. Such allocation would be much more difficult than it is in the United Kingdom, because in this country there are about 14,000 commercial banks, compared with 11 in the United Kingdom. This variation might also conflict with credit policy, for reasons stated under the original proposal as well as because the Federal Reserve would be under the necessity continuously of standing ready to purchase marketable securities when they were offered for sale by banks losing deposits.

(b) Perhaps a better solution along these general lines would be the enactment of legislation requiring all commercial banks in the country to hold, in addition to present reserve requirements, a specified amount of Treasury deposit receipts in relation to their demand deposits. In order to provide banks with the required amount of deposit receipts, the Treasury would have to stand ready to issue deposit receipts to banks in exchange for such portion of the banks' holdings as the banks would have to dispose of, giving the option to the banks to choose which of their securities would be exchanged. Banks would still be permitted to hold marketable securities, but the funds available for such issues would be limited by the new requirements.

Bank earnings would be under better control, and the possibility of the pattern of rates being influenced by bank transactions would be greatly reduced. Federal Reserve influence over credit conditions would be strengthened to the extent that the influence that banks now have on the pattern of rates would be reduced. An objection to this proposal arises from the fact that there are wide variations among individual banks in the ratio between their holdings of Government securities and their demand deposits. In order to prevent the liquidation of loans at some banks, the requirement should be placed rather low, with the result that many banks would continue to hold large amounts of marketable securities.

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