STRICTLY CONFIDENTIAL February 23, 1945

To: Chairman Eccles Subject: Treasury financing program

From: L. M. Piser

Attached is a draft of the memorandum that you asked me to prepare on the subject of your Treasury financing program. I am in full agreement with the program, except that (1) I would like to go further by substituting for the corporate drive an offering of securities subject to allotment and (2) I think that the proposed limitation on war loan collateral would have many serious disadvantages. The first disadvantage of the proposed limitation is that, by increasing the profit that is derived from playing the pattern of rates, it would encourage corporations to sell from their existing holdings of certificates. Second, by making war loan deposits unattractive, it would reduce the incentive for bankers, who constitute a large proportion of the sales organization, to push the sale of securities to nonbank investors in the drive. Third, since all of the present war loan deposits are secured by recent issues of Government securities, most of which mature in more than six months, it would be necessary for commercial banks to shift a considerable amount of their collateral in order to meet the new requirement; although this shift might be relatively easy for the larger banks, which hold large amounts of these short-term securities, it would produce difficulties in the case of banks that hold no bills and relatively small amounts of other short-term securities. Fourth, since all of the new issues of securities included in the drive will mature in more than six months, it would limit seriously the increase in war loan deposits during the drive. War loan deposits should increase to some extent during the drive, because otherwise the proceeds of the issues would be added to Treasury deposits at the Reserve Banks, which would make it necessary for the Federal Reserve to purchase an equal amount of Government securities in order to supply reserves.

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Attachment

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Draft

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# TREASURY FINANCING PROGRAM

Objectives. The principal objective of open market policy and financing policy during the war continues to be the sale of the maximum amount of Government securities to nonbank investors. It is important that nonbank investors purchase these securities out of their existing holdings of cash rather than by borrowing and that they hold the securities. The recent large oversubscriptions in the drives have been accomplished principally by nonbank sales of securities to the banking system. This development not only obscures the principal objective of war financing but is undesirable in itself because it involves speculation, free-riding, and unnecessary activity in the market.

A second objective is to reduce the growth in the interest cost of the debt to the Treasury. This, however, should not be a primary objective. If it were, the Treasury could avoid any cost by financing its entire requirements by the issuance of currency. Such a policy, however, would merely add to the inflationary potentialities of war financing. This objective is rather, therefore, to reduce the interest cost to the lowest level that is compatible with maintaining strong pressure to sell securities to nonbank investors.

A third objective is to reduce the growth in earnings by commercial banks. Banks earnings are now at record high levels. If they increase further, banks will be subject to criticism on the grounds of profiteering from the war financing.

In order to further these objectives, the following program is recommended:

1. That the Treasury increase the outstanding amount of Treasury bills by 1.3 billion dollars by the end of May.

2. That the offerings in the Seventh War Loan, in addition to savings bonds and savings notes, comprise 7/8 per cent certificates, and 1 1/2 per cent securities, and 2 1/4 and 2 1/2 per cent restricted bonds.

3. That the maturities of the 2 1/4 and 2 1/2 per cent bonds not be extended by more than a year beyond the maturities indicated by the structure of yields as it existed at the time of the last drive and that commercial banks be prohibited from purchasing these bonds until five years preceding the call date.

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4. That the drive be divided into two distinct parts, one for individuals and the other for corporations.

5. That, after the end of the corporate drive, the Treasury make a direct offering of 3 billion dollars of certificates and 1 1/2 per cent securities to commercial banks.

6. That the Treasury discontinue the offering of otherwise restricted issues to commercial banks on the basis of their time deposits.

Treasury bills. While some increase in outstanding bills is desirable, because it would provide the Federal Reserve with securities to supply reserves at a small interest cost to the Treasury, the increase should be considerably less than the amount of reserve funds needed. Additional bills would be purchased almost immediately by the Federal Reserve. Some of the reserves created by these purchases would go to banks not needing them, and these banks would be encouraged to use the funds to purchase longer-term securities. This would further increase bank earnings, further reduce interest rates, and expand bank credit unnecessarily. On the other hand, when banks provide their own reserves by selling securities, the reserves go where they are needed when they are needed.

Between February 14 and the end of May, the Federal Reserve will need to supply 3.1 billion dollars of reserves. This total includes 1.6 billion to meet an increase in money in circulation and 1.5 billion to meet an increase in required reserves. About 700 million dollars of this total will be supplied by member bank borrowing, leaving 2.4 billion of securities to be purchased by the Federal Reserve.

If reporting member banks reduce their holdings of bills from the February 14 level of 2.4 billion dollars to 1.8 billion, the level at the end of November, they will sell about 600 million to the Federal Reserve. In addition, the Federal Reserve will purchase other securities from banks that are in need of reserves and that do not hold bills, from corporations that need funds with which to pay their income taxes on March 15, and from various nonbank investors preparing for the drive. It seems likely, therefore, that the increase should be limited to 1.3 billion dollars.

Offerings in the drive. It is recommended that the Treasury at announce at the present time the principal terms of the Seventh War Loan. The offerings, in addition to savings bonds and savings notes, would comprise 7/8 per cent certificates, 1 1/2 per cent securities, and 2 1/4 and 2 1/2 per cent restricted bonds. The maturity of the 1 1/2 per cent securities would be determined in relation to the level of the market after the announcement and at the time of the offering.

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A maximum rate of 1 1/2 rather than 1 3/4 per cent on unrestricted securities would have a number of advantages. The lower rate would reduce the interest cost of the debt and the growth in bank earnings. It also would reduce the temptation for commercial banks to arrange for indirect purchases and would reduce the amount of free-riding and speculation. At the same time, it would not be likely to reduce materially the demand from nonbank investors.

Although in the Sixth War Loan policing eliminated some of the most flagrant abuses of previous drives, it was unsatisfactory from other points of view. Many commercial banks were reluctant to cooperate, in view of the undesirable effects on their customer relations. Individuals complained of unfairness, because individual subscriptions for securities that were for resale shortly after the close of the drive were supposed to be rejected whereas such subscriptions from corporations were not questioned. In addition, policing could not reach all cases of abuse, because most of the individuals involved in direct arrangements with commercial banks are relatively wealthy and could subscribe for the issues without borrowing from banks. The policing activities greatly increased the volume of work by the Reserve Banks in the midst of the regular drive volume and impaired their relations with member banks.

Any attempt to police subscriptions is likely to produce unsatisfactory results when the temptation on the part of banks and their customers is strong. The issuance of 1 3/4s instead of 2s would reduce indirect subscriptions and free-riding to some extent, but still would leave a major problem. It seems preferable, therefore, to reduce the temptation further rather than to rely upon policing methods alone.

The maturities of the 2 1/4 and 2 1/2 per cent bonds should not be extended by more than a year beyond the maturities indicated by the structure of yields as it existed at the time of the last drive. An extension of maturities would not reduce the interest cost to the Treasury, and it might create a bad market situation in the event of large sales by nonbank investors. It is likely that the prices of the existing issues of 2 1/4 and 2 1/2 per cent bonds would decline to close to par on an announcement that there would be no material change in the terms of the new issues, but if the prices remained at a high level this would be an advantage, since it would provide an incentive to nonbank investors to increase their purchases in the drive.

It is recommended also that commercial banks be prohibited from purchasing these bonds until five years preceding the call date. This would be in accordance with the original practice with regard to restricted bonds. Otherwise, commercial banks could purchase these bonds when their yields were still at relatively high levels.

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It is especially important to include 2 1/2 per cent bonds in the drive. Otherwise, the prices of the existing 2 1/2 per cent bonds would increase further, with the result that the long-term rate would decline. The 2 1/2 per cent rate has been the most important rate in the entire war financing program. Even at the 2 1/2 per cent rate, however, it has been difficult to encourage purchases of Government securities. A reduction in that rate would increase the difficulty by reducing the incentive to save. These securities are in an entirely different category from unrestricted securities, because they can be held only by individual savers and by institutions that hold savings of the public and therefore cannot involve speculation or an unnecessary expansion in bank credit. Finally, if the long-term rate were reduced, it might be impossible later to restore the 2 1/2 per cent rate if that course seemed to be desirable, because it would involve permitting newly-issued 2 1/4 per cent bonds to decline below par.

Separation of the drive. It is recommended that the drive be divided into two distinct parts, one for individuals, partnerships, and trust accounts, and the other for corporations. The individual drive would start on April 1 or as soon afterward as is practicable from the point of view of the selling organization. The separation of the individual drive would overcome an important objection to the recent drives that the large totals discourage individual purchases. The quota for the individual drive would be increased to a point that would place individuals and the selling organization under substantial, but not impossible, pressure. It is recommended, therefore, that the total quota for individuals be placed at 7 billion dollars and the quota for Series E savings bonds at 4 billion.

After the close of the counting period for the individual drive, there would be a drive for other nonbank investors. The quota would be decreased to 5 billion dollars. With such a small quota, there would be no need for these investors to sell any of their existing holdings. The selling organization would be instructed to discourage the making of quotas by selling from existing holdings.

After the end of the corporate drive, the Treasury would make a direct offering of 3 billion dollars of certificates and 1 1/2 per cent securities to commercial banks. Subscriptions from each bank would be limited to a proportion of its capital and surplus, designed to result in subscriptions not far in excess of 3 billion dollars. In the past, there have been two reasons for eliminating direct offerings to commercial banks. First, the channeling of all offerings in the first instance through nonbank investors probably has resulted in increasing the amount of securities that are held by nonbank investors. Second, the premiums that have been quoted in the market after the drive have been some deterrent to purchases by commercial banks.

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This device, however, probably has served its purpose. Commercial banks have found that many nonbank investors are willing to subscribe for securities for the purpose of reselling the securities to commercial banks at little or no premium. Banks that have followed the Treasury's request, however, have been able to purchase securities only by paying substantial premiums to speculators. In effect, therefore, the Treasury, by not making direct offerings to commercial banks, makes it advantageous for banks not to follow the Treasury's own request. In addition to putting bank purchases on a more straightforward basis, a direct offering to banks would permit banks to purchase new securities at par rather than to pay premiums to speculators or to make special arrangements with nonbank investors. It also would reduce the upward pressure on bond prices, would reduce speculative subscriptions, and would reduce the shifting of securities in connection with the drives. Direct bank financing should have no adverse public reaction, because those who realize that indirect bank participation has been an important part of recent drives would recognize the advantages of the change, whereas those who do not know this fact would be unlikely to realize that any change had been made.

The Treasury would discontinue the offering of otherwise restricted issues to commercial banks on the basis of their time deposits. The previous allotment of securities on the basis of time deposits seems to have been used by the banks principally as a means of obtaining 2 per cent bonds at par. There is no evidence that they have used these securities in order to increase the rates paid on savings deposits but rather that they have used them to increase further their earnings. If these offerings are continued, however, it is suggested that they be limited to banks that pay not less than 1 1/2 per cent on savings deposits.

Another suggestion is that the Treasury require that at least 75 per cent of war loan deposits be secured by Government securities maturing in not more than six months. This provision would eliminate all of the incentive for banks to bid for war loan deposit accounts. It also would encourage banks to keep a relatively large amount of short-term securities and thereby would tend to reduce the interest cost of the debt to the Treasury and the growth in bank earnings. Finally, it would provide sufficient demand from commercial banks to lower the yields on short-term certificates without the necessity for the Federal Reserve to lower these yields by purchasing these securities, which would add to reserves.

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