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CREDIT POLICY AND THE PUBLIC DEBT

Now that the public debt is no longer increasing but the threat of inflation is even more pressing than during the war, the principal problem that faces the Treasury and the Federal Reserve System is to prevent further expansion of bank credit. This should be accomplished without an increase in the interest cost of the debt to the Treasury. There is here advanced the outline of a proposal that should go a long way toward meeting this problem.

Need for Action to Check Credit Expansion. — Since the middle of 1940, commercial bank deposits and currency have increased by 103 billion dollars. Practically all of this increase has resulted from 96 billion dollars of purchases of Government securities by commercial banks and the Federal Reserve Banks and 6 billion of loans on Government securities. Of this total expansion in deposits and currency, 13 billion dollars occurred during the Victory Loan.

Much of this expansion, especially during the early years of the war, was desirable to provide the money supply needed in an expanding and abnormal war economy. A large part of it, however, especially during the past year or two has reflected unnecessarily large purchases of securities by banks. As banks have become convinced that long-term interest rates will be maintained they have to an increasing extent sold their lower rate issues to the Federal Reserve Banks and purchased the higher-rate issues available to them. This is a profitable operation and banks cannot be blamed for taking advantage of the opportunity offered. Other investors, who sell the medium-term securities to banks, purchase long-term high-rate issues not eligible for bank purchase. This accounts for the recent bull market in Treasury bonds.

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If present policies continue to be followed, banks will continue, with official encouragement, to bid securities away from nonbank investors. The door to Reserve Bank credit is now wide open. Commercial banks, by selling certificates to the Federal Reserve, obtain additional reserves that enable the banking system as a whole to expand by five times the amount sold to the Federal Reserve. The Federal Reserve, therefore, is an accessory to the continued expansion of bank credit and to the resulting decline in long-term interest rates.

Continuance of these tendencies will to a considerable extent undo the work that has been done in the drives to place Government securities with nonbank investors. It will result in a continued increase in prices of long-term bonds and a further decline in their yields. Continued declines in long-term yields will raise problems, first as to subsidizing and later possibly having to socialize insurance companies, savings banks, and endowed institutions. It will also result in an ever-increasing supply of funds spilling over into lower-grade bonds, common stocks, commodities, and real estate. In this manner present policies are helping to promote an inflationary boom which would be a poor prologue for the maintenance of full production and high employment in the post-transition period. A positive change in policies is necessary to check these tendencies.

The Congress had charged the Federal Reserve System with the responsibility for governing its open market purchases and sales "with regard to their bearing upon the general credit situation of the country." The Federal Reserve cannot dodge this responsibility. In fact it must soon make its annual report to Congress on the means by which it has met and will continue to meet this responsibility. While it is well understood that Federal Reserve

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policies and actions taken alone could not stop inflationary tendencies, they can influence important elements in the situation and they should be among the weapons employed. Nor is it believed that any drastic action resulting in a rise in interest rates is necessary or desirable. But, now that the war is over, continuance of policies that were designed to facilitate the borrowing by the Treasury of more than 200 billion dollars cannot be justified in a period when the public debt is declining and inflationary developments threaten.

Further expansion of bank holdings of Government securities, representing in effect monetization of the public debt, can be stopped by use of the customary instruments of Federal Reserve policy, that is, by ceasing to buy all securities offered at fixed rates. This policy, however, probably would result in some rise in short-term interest rates. This in turn would increase the interest cost of the debt as maturing issues were refunded. It could also increase commercial bank earnings.

For member banks alone net profits since 1940 have more than doubled. An expansion of about 720 million in annual earnings on Government securities has substantially exceeded an increase in expenses. Even though the major part of profits has been added to the banks' capital accounts, the proportion of yearly profits to capital accounts has increased from 6.2 to 10.6 per cent. Continued expansion in bank holdings of Government securities will mean even larger profits in 1946.

Program for Action. -- In order to enable the Treasury and the Federal Reserve to prevent the further growth of bank credit without increasing the short-term rate, while maintaining a 2-1/2 per cent yield on the longest-term securities, and at the same time to prevent commercial bank earnings from increasing further the following four-point program is presented for consideration by the Federal Reserve and the Treasury:

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1. <u>Elimination of preferential discount rate</u>. -- The Federal Reserve would discontinue the preferential discount rate. As long as the preferential rate is in effect, commercial banks are encouraged to borrow at 1/2 per cent either to purchase higher-yielding Government securities or, when banks are short of reserves, to avoid selling higher-yielding Government securities. It also encourages banks to lend on securities at low rates, thus giving substantial profits to borrowers. In either case the level of bank credit and the level of bank earnings are at higher levels than otherwise would be the case. The importance of this is shown by the fact that borrowings last November reached a peak of about 800 million dollars, which supported 4 billion of bank credit. Even after the increase in excess reserves in December and January, borrowings are still about 200 million dollars. They will probably increase again as reserve requirements increase with the shift of deposits from war loan accounts to accounts that require reserves. This preferential rate was established to encourage banks to purchase short-term securities at a time when some increase in bank holdings was considered desirable; it is no longer needed for that purpose and serves only to permit banks to buy more longer-term securities.

Discontinuance of the preferential rate would not increase interest rates, as long as the Federal Reserve continues to support certificates at 7/8 per cent by purchasing whatever amount of certificates might be necessary for this purpose.

2. <u>Change in bill offerings and discontinuance of posted rate</u>. -- The Treasury would reduce the weekly offering of Treasury bills from 1.3 billion dollars to 500 million, and would refund each week the remaining 800 million dollars of bills, which are held by the Federal Reserve, into special certificates with a rate of 1/8 per cent. This would reduce the outstanding

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amount of bills to 6.5 billion dollars, an amount sufficient to cover the needs of the banking system to meet day-to-day fluctuations in reserve funds.

The Federal Reserve would discontinue the bill buying rate and the repurchase option but would support the market for bills by purchasing any bills not otherwise absorbed at a satisfactory rate. The currently prevailing rate of 3/8 per cent in Treasury bills would be permitted to rise gradually until it reached a point where it would be in line with the rate on certificates. It might start at 1/2 per cent and in the end would probably not go over 3/4 per cent, as long as the certificate rate remained at 7/8 per cent. The Federal Reserve would purchase and sell bills freely at around the market rate for the purpose of assisting banks in making day-to-day adjustments in their reserve positions. This would again make Treasury bills an instrument that is traded freely in the market. Many banks would probably prefer bills to certificates, and the Treasury, by increasing the outstanding amount of bills and reducing certificates, could save a little interest.

Under this proposal, the increase in the bill rate would not be at the expense of a higher interest cost to the Treasury. Upon completion of the entire bill cycle, the Treasury would have outstanding, instead of 17.0 billion dollars of bills at 3/8 per cent, which cost 64 million a year in interest, 6.5 billion of bills at 3/4 per cent or less and 10.5 billion of special certificates at 1/8 per cent, which together would cost not over 62 million a year.

3. Use of Treasury balance to retire debt.-- The Treasury would reduce its large cash balance by redeeming in cash about 10 billion dollars of maturing certificates, notes, and bonds. This would reduce the interest cost of the debt by 110 million dollars a year and would relieve the Treasury from possible

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criticism that it is maintaining an unnecessarily large cash balance. The Treasury could point out that the amount retired was equal approximately to the excess of sales over the goal in the Victory Loan. With the cash balance reduced to a normal level, the Treasury could retire additional debt or issue new securities, depending upon its needs.

Of this 10 billion dollars of retirements, about a fourth is held by the Federal Reserve and most of the remainder by commercial banks. As a result of these redemptions, war loan deposits and bank holdings of securities would decline. The decline in bank holdings would reduce the volume of bank credit and also commercial bank earnings.

4. Legislation to require banks to hold specified amounts of short-term Government securities.-- The Treasury and the Federal Reserve jointly would ask the Congress for legislation to permit the establishment of a requirement that all commercial banks in the country maintain their holdings of Treasury bills and certificates at or above a specified percentage of their net demand deposits. This provision would make possible a limitation on bank credit expansion without raising short-term rates. The exact requirement, which should be left to the discretion of the Federal Reserve within limits, could be placed sufficiently high so that commercial banks as a whole would need to purchase bills and certificates on balance.

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By this means commercial banks, rather than the Federal Reserve, would support the market for certificates, and this might even reduce the rate to 3/4 per cent. The certificate market, therefore, might no longer require unlimited Federal Reserve purchases to keep the rate down. Commercial banks as a whole might need to sell some notes and bonds, which would reverse the present tendency for commercial bank purchases to pull down the medium-term and long-term rates and would tend to make the long-term rate return toward 2-1/2 per cent. The Federal Reserve, by making any purchases that might be necessary, could maintain the 7/8 per cent rate on certificates and the 2-1/2 per cent rate on long-term bonds.

Limitation on bank credit expansion would be determined by the bill-certificate requirement and by limiting the outstanding amount of bills and certificates, together with a requirement that any banks not holding the required amount of bills and certificates would hold additional reserve balances to make up the shortage. The expansion and contraction of bank credit would be influenced by changes in the bill-certificate requirement and in the outstanding amount of bills and certificates. Although this requirement could be used to prevent further expansion of bank credit at the present time, it is also sufficiently flexible to encourage an expansion of bank credit at any time the deflationary developments might make such an expansion desirable.

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