August 22, 1946.

Dear John:

The enclosed letter is the one I spoke to you about at lunch today. I am sure you will find it in complete accord with your address, of which I heartily approve. It will provide supporting reasons for some of the views which you expressed.

I hope it may give some information which will be of assistance to you in your conference with the bankers tomorrow.

Sincerely,

The Honorable John W. Snyder,
Secretary of the Treasury,
Washington, D. C.

Enclosure

MSE:b

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August 22, 1946.

The Honorable John W. Snyder,
Secretary of the Treasury,
Washington, D. C.

Dear John:

I appreciated the opportunity to discuss fully with you recently the problems connected with the management of the public debt. These discussions, I believe, were very useful, and with the thought that it might be of some help to you in connection with your further consideration and discussions of the problems, I have put down in writing the main points that we discussed and I am passing them along to you.

The vast amounts of money and public debt which were created in the process of war finance have greatly added to the present inflation potential. But, they are a matter of past policy. We cannot retrace our steps and, within a short period, materially reduce either the debt or the money supply. The ultimate solution to inflation lies in a high level of production. Only with greater production, reduced consumption, and increased savings will it be possible to obtain sufficient yield from existing tax rates to have a budget surplus and to retire some of the debt. Thus to retrace our steps is at best a very slow process.

While there is relatively little on the inflation front that can be done in the monetary field, some minor steps can be taken. A continuation of the debt retirement program will help. Even after the cash balance has been reduced to a minimum working level, and despite the forecasted small budget deficit, it is possible to continue to reduce the bank-held debt through receipts from Government trust accounts and the sale of savings bonds. The present bill-buying program should be abandoned later in the year. The amount of bills that the market would absorb should be offered on a bid basis. With the certificate rate being held at 7/8 per cent, the bill rate probably would be between 5/8 per cent and 3/4 per cent. The market would not likely take more than 3 to 4 billion dollars of bills. The balance of the bills, in excess of what the market would take, would be taken by the Federal Reserve under a special arrangement at a low rate and avoid

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the weekly turnover of bills. Reserve requirements could be increased in New York City and Chicago if the strength of the bond market from bank acquisitions of Government securities indicated the need. This action would require banks in New York and Chicago to sell about 1.5 billion dollars of Government securities. For some time the above three actions would discourage further monetization of the debt by the commercial banks, keep intermediate and long-term interest rates from declining, and make it unnecessary to increase the short-term rate.

Bankers, dealers, insurance companies and others are recommending an increase in short-term interest rates as a means of combating inflation. They overemphasize the effectiveness of monetary controls in the present situation. An increase in short-term interest rates for some time, as I have indicated above, would be unnecessary. To do so now would also be undesirable because it would add to the interest cost of the Government debt and raise bank earnings which are already at an abnormally high level, due entirely to the interest paid them on the Government debt. If bank earnings increase further as a result of an increase in the short-term rate, banks will tend to rely more on their Governments and less on the making of private loans. A moderate increase in interest rates would not in any way be effective in combating inflation. A sharp rise in rates is out of the question because it would cause a serious drop in the bond market and in addition would add greatly to the cost of carrying the public debt, which is already very high. This would also stop the sale of savings bonds at existing rates and cause large redemptions.

Some argue that short-term rates should not be raised but that some flexibility should be introduced. They suggest that this would bring uncertainties into the market which would discourage banks from shifting into longer term issues. This is quite unrealistic. There could be very little uncertainty as to rates in view of the large volume of securities that mature monthly. If a policy were adopted permitting short-term rates to rise without setting an upper limit, the Treasury would have difficulty in refunding its maturities, since banks and other investors would be inclined to withhold funds because of the uncertainty in rates. The question then is not whether the short-term rate should be pegged at 7/8 per cent or permitted to fluctuate up and down, but whether it should be pegged at 1, 1-1/4, or 1-1/2 per cent, or some other level. There is no natural level.

The same group that want the short-term rate increased are also advocating that the Treasury offer additional long-term 2-1/2 per cent marketable securities for investment of funds by insurance companies and savings banks. This would be a serious mistake. It now appears that the Federal Reserve will have to support the long-

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term 2-1/2 per cent rate indefinitely. This in effect makes these securities, regardless of their term, a demand liability and gives the holder who sells prior to maturity the benefit not only of the higher rate but a premium dependent upon the spread between the short and long-term rate. It would be difficult if not impossible to price a 2-1/2 per cent market issue at the present time. Also, there would be great speculation in such an issue. If the issue were limited to insurance companies and savings banks there would be complaint by those who were not permitted to subscribe on the ground that they had been discriminated against in favor of insurance companies and savings banks. The issuance of additional 2-1/2 per cent marketable bonds would not serve to increase savings of individuals who are largely responsible for inflationary pressures. Series E, F, and G savings bonds already offer attractive investment outlets for individuals.

There is a serious question of whether the Government has any obligation to private insurance companies and savings banks, over which it has no power of regulation or control, to provide 2-1/2 per cent investments at a time when the Government is not needing funds. There could be no justification for doing so except as the surplus funds were used to reduce by a like amount demand deposits and Government securities held by commercial banks. Such a refunding of short-term securities held by banks into long-term securities held by insurance companies and savings banks would cost the Government the difference between the 7/8 per cent short-term and 2-1/2 per cent long-term rates. The Treasury, therefore, must be sure if such refunding is done that it will accomplish this purpose of reducing demand deposits and Government securities held by commercial banks. If 2-1/2 per cent securities are made readily available to insurance companies and savings banks there will be less pressure for them to purchase private bond issues, such as world bank securities and many eligible corporate issues, and to make mortgage loans.

If additional long-term securities are offered, however, they should be nonmarketable securities and the amount of subscriptions should be limited under some formula which would prevent switching out of lower yielding bank-eligible securities to raise funds with which to subscribe to the new securities. The yield on nonmarketable issues depends on the period held, which is only fair as long as there is a difference between the short-term bank rates and the long-term investment rates. Nonmarketable securities protect the Treasury against investors who buy long-term securities for short-term holding. They are no more of a demand liability than are marketable securities as long as the market is supported.

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To summarize, there is relatively little on the inflation front that can be done in the monetary field. The debt retirement program should be continued, the bill-buying program should be abandoned later in the year, and reserve requirements could be increased in New York and Chicago. These actions would for some time discourage further monetization of the debt by commercial banks and make it unnecessary to increase the short-term rate. An increase in the short-term rate is undesirable; it would not be effective in combating inflation. It would serve only to increase the cost of the Government debt and add to bank earnings. The question is not whether this rate should be pegged at 7/8 per cent or permitted to fluctuate up and down, but whether it should be pegged at 1, 1-1/4, 1-1/2 per cent or some other level. There cannot be uncertainty in the short-term rate when the Treasury has large amounts of securities that have to be refunded monthly. Additional long-term 2-1/2 per cent marketable bonds should not be offered. Such an offering would make only for speculation and instability in the market. If any additional long-term securities are offered they should be nonmarketable securities, the subscriptions should be limited, and the funds should be used to reduce demand deposits and Government securities held by commercial banks. The argument that the Treasury is now faced with a large volume of demand obligations is not effective. Under present conditions, the entire debt is in effect a demand obligation, since the Federal Reserve assures the Treasury at all times of a ready market for its offerings and provides holders of securities with a market under the pattern of rates. There is no possibility of a free market with the debt as large as it is today -- the total public debt is now more than twice as large as the total private debt. The public interest demands a stable market for Government securities and low rates.

Sincerely yours,

M. S. Eccles,
Chairman.

DMK:b

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THE SECRETARY OF THE TREASURY

WASHINGTON

August
Twenty-third
1946

Dear Marriner:

Thanks very much for sending the information enclosed in your letter of the 22nd. It was very helpful.

With kind regards,

Sincerely,

Hon. Marriner S. Eccles
Chairman, Board of Governors
Federal Reserve System
Washington, D. C.

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