FEDERAL HOUSING ADMINISTRATION
WASHINGTON, D. C.

OFFICE OF THE
FINANCIAL ADVISER

April 7, 1938

Honorable Marriner S. Eccles
Board of Governors of the
Federal Reserve System
Washington, D. C.

Dear Mr. Eccles:

Mr. Daiger is out of town for a few days and, at his request, I am enclosing a revised copy of the memorandum dated March 26, suggesting a solution for the difficulties in the railroad bond market.

I understand that you have already received a copy of the previous memorandum.

Yours very truly,

Richard R. Quay

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Enclosure

Revised Apr. 7, 1938 March 26, 1938

Suggested Action to Meet Present Financial Crisis

The demoralizing situation that has developed with respect to railroad bonds has now become the crucial factor in the economic condition of the country. Whether there is to be a further recession of business during the next several months (or at best a slight rise from the present level) or whether there is to be a marked and sustained rise, beginning in the late spring or early summer, will depend mainly upon what government does or omits to do to grapple with the present crisis in the capital markets.

During recent weeks the railroad bond market has reached a stage that plainly reflects bewilderment and panic on the part of financial institutions. The problem that this presents, therefore, is no longer a railroad problem. It has gone far beyond that, and is now an economic and political problem of the first magnitude. The large aspect of the problem is to avert a long deflationary movement, the direct effects of which would be experienced in our capital markets and our financial institutions, and the repercussions of which would be felt throughout the economic structure.

Railroad bonds have for the past six months or more been subjected to a strain closely analogous to that to which bank deposits were subjected in 1931-33. Strong boxes have been emptied of rails, and the resultant deflation of values has menaced a number of institutions and has made some of them the subject of dangerous rumor.

The Standard Statistics index of railroad bond prices yesterday was 53.1. As the average for January of last year was 100.6, the asset value of bond portfolios has virtually been cut in half over a period of 15 months. Yesterday's average of prices was the low for the year. The severity of the decline is reflected in the high-grade rails as well as in the second-grade rails. The former, as compiled in the Dow-Jones index, show a decline from 113.1, which was the average for January of last year, to 91.3 yesterday--21.8 points. For the same period, the second-grade bonds show a decline from 94.8 to 44.0--50.8 points.

The main factors in our capital structure that required rehabilitation after 1929-33 have been rehabilitated, with the single exception of the railroad debt. The acute need for this rehabilitation has been recognized by government, but the natural and inevitable uncertainty over the form which the rehabilitation will take--and the possibility that it will take a form entailing huge loss to institutional holders of railroad bonds--has produced a crucial situation in the capital markets at the very time when, except for this, the trend of business generally might easily and quickly be upward.

The factors favorable to a marked rise in business activity and employment during the next several months are (1) the greatly improved inventory situation as compared with six months ago, and (2) the greatly improved outlook for residential construction as compared with even 60 days ago. But the effect of these and other favorable factors on the general business and financial psychology is confused and distorted by the panicky liquidation of railroad bonds that has produced the present crisis. Unless this is dealt with promptly and vigorously, and with full realization of its institutional aspects as distinguished from its railroad aspects, then any hope of a steady improvement in general business this year must be abandoned.

A fundamental reorganization of the railroads cannot be accomplished in less than a year or two at best. The most practical and most promptly effective course of governmental action in the immediate crisis, therefore, would be frank recognition of the vital national interest, not in the railroads only, but in the institutional holders of railroad bonds as well, and frank sharing of the risks of railroad reorganization. The form that this risk-sharing might properly take in the national interest is the shoring-up of the railroad debt structure in a manner similar to that employed in shoring up the farm-mortgage debt structure, the home-mortgage debt structure, and the bank deposit structure.

> Specifically, the RFC might be directed to take at any time prior to July 1, 1938, any railroad bonds offered to it by the owner thereof in exchange for RFC debentures guaranteed as to principal and interest by the United States, bearing interest at 3 per cent, maturing July 1 nearest the maturity date of the railroad bonds exchanged for the debentures, and callable on any interest date upon 60 days notice. The amount of RFC debentures given in any such exchange would be limited to the par value of the bonds, the market value current at the time the bonds were acquired by the owner, or the average market value as determined by the RFC for the five-year period ending December 31, 1937, whichever was lowest.

The essential point is that government shall make known now the answer to that part of the railroad riddle which is disrupting the capital markets and threatening the general business prospect for months ahead. The specific plan suggested would do that in a decisive way.

Not least important among the economic advantages to be gained is that the process of railroad reorganization would itself be greatly improved by governmental action removing the market pressure on railroad bonds. Where the public interest could best be served by drastic reorganization, then drastic reorganization could itself be accomplished in an orderly way without blowing the capital markets wide open in the process.

As to whatever stake in the railroads the RFC might acquire under the plan suggested, the investment ought to average out fairly well. The RFC would be acquiring bonds at, say, around 80, and cutting the fixed charges on them around 30 to 40 per cent. Under those conditions, its position in a reorganization scheme ought not to involve any extraordinary loss as compared with other losses already realized or in prospect. The loss involved would in any event be a small price to pay for putting an end to financial liquidation and deflation at what otherwise appears to be the turning point of industrial production and employment for 1938.