

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date June 14, 1940

To Chairman Eccles

Subject: Financing the defense

From L. M. Piser

program

STRICTLY CONFIDENTIAL

The inauguration of a major defense program makes it desirable to consider not only the production problems involved but also the financing and credit policies that should be followed. Before a general program is discussed there are two minor points that may be considered. First, the financing of the defense program should not be limited by statute. It has been suggested, for example, that the Treasury should issue only 1 to 5 year obligations which would be retired out of new taxes. Such a limitation would unnecessarily tie the hands of the Treasury and might have undesirable effects on the economy. Second, this would seem an opportune time for the Treasury to shift from tax exempt to taxable issues. Since tax rates are being increased further the elimination of tax-exempt securities becomes even more desirable than in the past.

The financing and credit policy that is followed should depend upon changes in business and credit conditions, although it may need to be tempered by the action of the Government security market. For several years the financing policy that has been advocated has been the issuance of short-term securities. The purpose was at first to restore the level of bank deposits to a figure commensurate with full business recovery and more recently to reduce the risk of price fluctuations on bank holdings. Credit policy has encouraged the continuance of low money rates as a stimulation to the expansion of bank credit, capital financing, and private enterprise. As a result at least in part of these policies the amount of bank deposits has increased to a new record high level. Excess reserves are also at a record high level, and no steps have been taken for the past three years to reduce them. Unemployment continues large, however, and industry is still operating far from capacity.

There are no signs as yet of the development of a general inflation in the near future. It seems unlikely, moreover, that a general inflation will develop until this country comes much closer to full employment and capacity operations. While it is true that certain bottlenecks will be reached in the case of industries directly affected by the defense program, these will probably remain special situations to be corrected by methods other than a broad financing and credit policy. That such bottlenecks will develop into a general inflation when there is still a large amount of unemployment and when most industries are operating far below capacity is not likely.

Under such conditions it does not seem desirable at present to change radically the financing policy that has been advocated in the past or the credit policy that has been followed. With regard to credit policy, there appears to be no immediate occasion to reduce excess reserves, but it might be desirable to take steps to prevent further increases. In view of the high level of deposits and the increased possibility that inflationary tendencies may develop in the future, it might be desirable so to shape the financing program as to discourage a further increase in deposits. A step in this direction might result from the issuance of intermediate rather than short-term securities. This would tend to discourage banks from adding to their holdings of Government securities and to encourage the purchase of these securities out of savings, through increasing holdings by insurance companies, savings banks, trust accounts, and individuals.

A financing policy concentrated on intermediate bonds and a credit policy designed to prevent further increases in excess reserves might be continued until inflationary forces begin to develop with the approach of full employment and capacity operations. At such a time an entirely different program would be appropriate. Steps should then be taken to reduce excess reserves and to raise interest rates for the purpose of discouraging private expenditures and the growth of deposits and increasing individual holdings of securities. Other points in the program might include an increase in taxes designed to reduce private expenditures.

The financing program at that time should be directed at borrowing from the savings groups rather than from banks. To some extent this would result inevitably from the conditions assumed, since with the development of inflation banks would presumably have a rapid increase in loans and bond prices would be declining. Since they would need a smaller amount of earnings from investments and since the bond market would look less attractive to them, they would probably be reducing their holdings of investments. This process could be aided by a financing policy which included the issuance of long-term bonds, since such issues would be purchased largely out of savings.

The suggestion has also been made that in order to place the securities with savers rather than with banks, it might be desirable to use a new type of bond that could be sold only to savers. These might be registered bonds sold only to life insurance companies, savings banks, trust accounts, and individuals. At the present time the inauguration of such a program would appear undesirable because an innovation of this nature might be interpreted as a sign that the

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Treasury anticipated especial difficulty in financing the defense program, whereas actually there is no reason to anticipate any difficulty in view of the large amount of uninvested funds.

Even in the event of an inflationary development, question may be raised as to whether this method would be any more effective in placing the securities with the saving classes than would be the issuance of the present type of long-term bonds. If such issues were made non-negotiable they would be less attractive and a higher rate would need to be paid than on negotiable issues. If they were made negotiable but could be held only by insurance companies, savings banks, trust accounts, and individuals, there would also be some limitation on their attractiveness and a higher rate would be necessary. If they were made non-negotiable but could be redeemed at the Treasury for cash on the demand of the holder, such a demand might be embarrassing to the Treasury if it were engaged in war-time financing, which would involve a heavy drain on the savings and credit facilities of the country. Perhaps the best procedure for special issues of this type would be to make such issues non-negotiable but to allow holders to refund them into similar securities bearing a higher rate whenever an index of the cost of Government borrowing increased by a moderate amount, say $1/4$ of 1 per cent.

Even if such a procedure should be decided upon, saving groups might circumvent its object by buying the special bonds for their own portfolios and selling part of their present holdings of ordinary bonds to banks. To the extent that this was done bank credit and bank deposits would expand, which would be contrary to the purpose of the special issues. There may be some question also whether the creation of another special class of Government obligations in addition to savings bonds might not result in unnecessary confusion in the market.

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