BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date January 23, 1943

To Chairman Eccles

Subject:

From Mr. Carpenter

CONFIDENTIAL

Attached is a revised draft of the memorandum prepared by Mr. Piser with respect to Treasury financing and open market policies, which was discussed at the meeting on Thursday afternoon and which will be taken up at the meeting of the Federal Open Market Committee on Monday.

Attachment

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January 22, 1943

TREASURY FINANCING AND OPEN MARKET POLICIES

The financing problem

The President's Budget Message estimated that war expenditures would increase from 74 billion dollars in the current fiscal year to 97 billion in the fiscal year ending on June 30, 1944. Total budget expenditures would increase from 80 to 104 billion dollars and net receipts from 23 to 33 billion dollars; the budget deficit would rise from 57 to 71 billion dollars. Including expenditures by Government corporations and agencies the gross deficit was placed at 62 billion dollars in the current fiscal year and at 76 billion in the next fiscal year.

The President recommended the collection of not less than 16 billion dollars of additional funds by taxation, savings, or both in the fiscal year 1944. If this objective is attained, the deficit would be reduced to 60 billion dollars. Receipts would still, however, be less than half of expenditures. The raising of an additional 16 billion dollars from individuals in taxes and savings would be an important step in combating inflation. A pay-as-you-go plan (on the Ruml or some other model) should also be adopted in order to tap income as it is earned and to prevent it from bidding for civilian goods. Such a plan would also facilitate collections, particularly from individuals who have never before paid income taxes.

For the calendar year 1943 the increase in the debt is estimated at 66 billion dollars. Any increases in taxes collected in the calendar year would reduce this amount correspondingly. The objective of financing policy should be to obtain from nonbanking sources as large a part as possible of the increase in the public debt. With a total expenditure on goods

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and services including war material of 175 billions, of which 36 billions will be taken by taxes already on the books, and with goods and services available to civilians aggregating only 72 billions, there will be 67 billion dollars in the hands of the public that could be used for additional taxes and savings. It should be possible, therefore, to finance the war with only very limited use of bank credit. The problem is to induce the holders of funds to place them in Government securities. Purchases of as much as 30 billion dollars by the banks would represent a degree of failure of our efforts to place securities with nonbanking investors. (More detailed figures and a chart on this subject are attached as a supplement).

The selling organization

The organization for selling Government securities should be modified considerably. The Victory Fund Committees and the War Savings Staff should be combined into one organization under the Secretary and the Reserve Bank Presidents. A considerable amount of confusion and irritation resulted in the December Victory Fund Drive from duplication in the selling efforts of the two groups. Consolidation is necessary in order to avoid such confusion in the future.

The War Savings Staff has been highly successful in promoting pay roll deduction plans and other forms of regular saving in Series E bonds. These efforts should be continued currently, but a proper balance should be obtained between Series E bonds and other securities. Despite the concentration of the popular selling effort on Series E bonds they accounted for not much more than a tenth of the increase in the interest-bearing debt in 1942. With a much larger problem of financing now, these bonds become still

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unexpectedly arise. A change in the terms of redemption might reduce purchases of Series E bonds by bona fide investors, and might cause some confusion between existing bonds and the new kinds.

Consideration might also be given to elimination of the $25 denomination. Most of the redemptions are in $25 bonds. Some decline in redemptions would result from requiring the accumulation of enough funds by each individual to purchase a $50 bond, and the confusion among investors would probably be less than it would be from a change in the terms of redemption. It is suggested that the entire subject of E bonds be reconsidered in the light of the present situation.

Victory Fund Drives

the redemption period of new issues of savings bonds to a year and to require 60 days' notice before redemption.

On the other hand, it is likely that most purchasers of Series E bonds have no intention at the time of purchase of redeeming the bonds, but value the redemption provision in case the need for funds should unexpectedly arise. A change in the terms of redemption might reduce purchases of Series E bonds by bona fide investors, and might cause some confusion between existing bonds and the new kinds.

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Victory Fund Drives

The question of the most desirable length of time between Victory Fund Drives presents a problem. The interval must be long enough to permit

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the accumulation of a substantial amount of funds and to make the most efficient use of the volunteer workers. It must be short enough to keep the Treasury supplied with funds and to prevent potential investors from becoming discouraged in the absence of offerings and seeking other uses for their funds. Perhaps three or four months would be the most satisfactory period for the present, but a lengthening to six months might be desirable as soon as it can be accomplished.

One method of increasing subscriptions and of permitting a lengthening of the period between drives would be the adoption of a partial-payment plan for Treasury bonds. Without such a plan investors leave their accumulating funds idle or place them in short-term securities, which they later sell in order to subscribe for new issues. A plan whereby they could pay for their purchases in instalments over a period of time would enable them to subscribe for not only the amount of their idle funds at the time of the drive but also the amount of funds that they expect to receive in the period before the next drive. Such a plan would help insurance companies as well as many corporations and individuals.

It would also seem desirable to offer securities to banks at a different time from that of the periodic sales campaigns directed at nonbank investors. In the December drive considerable difficulty was experienced in maintaining excess reserves sufficiently large to assure adequate commercial bank subscriptions at a time when the Treasury was receiving a substantial amount of funds from nonbanking subscriptions. Purchases were larger than was necessary for the maintenance of the pattern of rates.

Securities offered during drives include nonbanking 2 1/2 per cent bonds, as well as 2 per cent and 1 3/4 per cent market bonds, 1 1/2 per cent

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and 1 1/4 per cent notes, and 7/8 per cent certificates. Not all of these securities would be offered at any one time, and the choice in each financing would depend on the anticipated demand for each type. The continued large demand for bills indicates that the supply should be increased further.

Modifications in securities

Although the distribution of bills has widened considerably, a further increase could be obtained if Treasury offerings of bills were at a flat rate of 3/8 of 1 per cent. Tenders for $100,000 or less might be allotted in full with larger tenders allotted on a percentage basis. The limit on full allotments should be placed at a fairly low figure, since otherwise there would be danger that an insufficient amount of regular bids would be received.

Consideration might be given to the elimination of Series F and G bonds. To a large extent these bonds are purchased by investors who would buy other issues if Series F and G bonds were not available. On the other hand, the bonds are also purchased by investors who would not buy long-term bonds having a risk of market depreciation, and the elimination of Series G bonds particularly might reduce total sales of Government securities to nonbanking investors.

Excess reserves

Under the financing program outlined above the level of excess reserves would constitute less of a problem. The separation of commercial bank financing from the Victory Fund Drives would make it unnecessary to purchase securities in order to maintain the level of excess reserves during the Drives. Securities would be purchased only for the purpose of maintaining the pattern of rates. If each commercial bank financing is in relatively small amounts, adequate subscriptions could be obtained with a

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smaller amount of excess reserves than has been necessary in the past. At other times the level of excess reserves would be of considerably less importance.

Delivery of the recent large issues of Government securities has resulted in sharp overnight increases in reserve requirements. This disturbing factor would be lessened by the passage of the proposed legislation removing reserve requirements from war loan deposits. Further encouragement of the opening of new war loan deposit accounts and of an increase in the authorized amount of existing accounts would reduce the disturbing effect of large cash payments to the Treasury. A widespread use of war loan deposits, together with the buying and repurchase provisions on Treasury bills and occasional resort to borrowing at the preferential rate, should enable banks to operate with a smaller amount of excess reserves and to adjust their excess reserves automatically without the need for active Federal Reserve intervention. Federal Reserve purchases other than those of bills at the buying rate would then be confined to the maintenance of the pattern of rates.

Whenever excess reserves should be increased or should be prevented from declining, this would be accomplished best by purchases of securities, preferably bills, by the Federal Reserve directly from the Treasury. For example, if it should be decided to increase reserves by 200 million dollars and the weekly maturity of bills was 500 million dollars, the Federal Reserve might purchase 200 million of the offering directly. The amount offered to the market would be reduced to 300 million dollars, and the market would receive 200 million in reserve funds. This would assure immediate translation of the direct purchases into additions

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to bank reserves, without waiting for the Treasury to disburse the proceeds to meet expenditures.

Unless direct purchases by the above method are made, the situation that developed in December may be repeated. At that time the Federal Reserve was attempting to maintain excess reserves at 2.5 billion dollars, and the amount of bills and many other types of securities available for purchase by the System was insufficient for the purpose. It was necessary, therefore, to buy high-premium bonds. To state it in another way, the Federal Reserve was committed to make large purchases, and this becoming known to the market, the holders made use of the opportunity of disposing of the highest priced obligations in their possession. The Federal Reserve had no choice but to buy them. Direct purchases of bills as suggested above would provide a more satisfactory means of adding to bank reserves when necessary.

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PROSPECTS FOR PRODUCTION, INCOME, AND SAVINGS, 1943

The attached table shows recent estimates of probable value of national production in the calendar year 1943 and uses that may be made of funds available, compared with the situation in 1941 and 1942. It is estimated that the total value of goods produced and services rendered in 1943 will be 175 billion dollars at present prices, compared with 152 billion in 1942. Over half of this year's product will be for war purposes and, after allowing for other governmental activities, production of goods and services for civilian use (including both capital goods and consumers' goods) will be 72 billion dollars, compared with 90 billion or more in each of the two previous years.

Of the total amount of funds (175 billion dollars) to be received by businesses and individuals for producing these goods and services, about 36 billion dollars will be absorbed by business and personal taxes. Of the remainder, and after purchasing 72 billion dollars' worth of civilian goods and services, which is all that will be available, individuals and businesses will still have 67 billion dollars of income at their disposal. This amount will be available for paying additional taxes, for purchasing Government securities, for repayment of debt, and for building up bank deposits or currency hoards. To the extent that the money is not used for the purchase of Government securities additional amounts of these securities will have to be absorbed by the banking system. If the money will be used to bid up prices, then the figures of production, taxes, and expenditures would all be raised, and the balance remaining might be a little, but not not much, smaller.

National Product and Uses of Funds
1941-1943

	Calendar Years		
	1941	1942	1943 hypothetical
Production of goods and services -- gross national product	120	152	175
War activities	11	49	90
Other government - Federal, State, and local 1/	14	13	13
Private capital goods	19	8	1
Consumers goods and services	76	82	71
National income 2/	95	117	137
Uses of funds - total	120	152	175
Taxes 1/ - Federal and other; business and personal	16	23	36
Private capital goods	19	8	1
Consumers goods and services	76	82	71
Available for savings and other accumulations	9	39	67
Business accumulations	-1	11	19
Social security accumulations	1	2	3
Personal savings	9	26	45

1/ From government expenditures and taxes are deducted payments for pensions,

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In his Budget message the President gave a figure of 16 billion dollars as the amount needed to be obtained from individuals in the form of additional taxes and savings to avoid inflation. This amount is arrived at by deducting from the 67 billion dollars of extra purchasing power the aggregate amount of business accumulations, social security accumulations, and customary savings of individuals. This aggregate may be expected not to be spent for goods but to be kept idle or invested in Government securities. The remaining 16 billion is likely to enter the markets for goods, unless special measures are taken to absorb it. The spending of this extra 16 billion dollars for consumers' goods would result in inflation.

The figure of 67 billion dollars may be compared with 39 billion dollars, which was the total available in 1942 to business and individuals after taxes and spending. Last year out of this amount nonbank investors increased their holdings of Government securities by 22 billion dollars, added 15 billion to their bank deposits and currency holdings, and retired some bank debt. The growth in bank deposits and currency corresponded closely, percentagewise, to the increase in gross national product during 1942, which was about 30 per cent. During 1943 national product (at constant prices) is not expected to increase by more than 10 or 15 per cent and would require for its absorption by the economy, at the present rate of turnover, an increase of less than 15 billion dollars in total bank deposits and currency. Thus nonbanking investors would have left, in excess of cash requirements, at least 50 billion dollars that could be used to buy Government securities.

The accompanying chart shows two possible trends in national income and in total bank deposits and currency during the next two years, depending upon what people do with their available funds. The curves marked A show the increase in bank deposits that would result if banks took 50 per cent of the increase in the public debt (the percentage taken in 1942) and the level of national income that would result if this money were used as actively as money is now being used. The curves marked B show for national income the maximum amounts apparently attainable at constant prices, and for deposits and currency the amounts that such a volume of income would call for at present rates of turnover. These curves show what would happen if people bought only the amount of goods available without bidding up prices, retained only such deposits as they needed, and invested the remainder of their incomes in Government securities. In this event, banks would have to buy only the relatively small amounts of securities that would be needed to create the necessary amount of deposits plus currency.

In the first case, under Assumption A, commercial and Federal Reserve Banks would buy about 33 billion dollars of the probable increase of 66 billion

(Footnotes continued)
relief, etc., which are not considered a part of gross national product or a drain on funds available. Without this deduction the figures for total taxes would be 17, 25, and 38 billion dollars respectively. Of the 1943 total 22 billion represents business taxes, and the remainder is mostly personal taxes.

2/ Gross national product less business taxes, depreciation and depletion charges, other business reserves, and various corporate adjustments.

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in the public debt in 1943, whereas under Assumption B they would need to buy less than 15 billion dollars of securities. Reserve Bank purchases to supply currency demands and additional required reserves would be 9 billion under Assumption A and 3 billion under Assumption B. The former situation represents a continuation of last year's trend, but this trend need not continue next year when incomes will be larger and supplies of goods smaller than last year. The figures under Assumption B, no doubt, represent the minimum of bank buying that can be expected. Actual results will probably be somewhere between these levels, although if there should be a runaway price rise, even the larger figures shown would be exceeded.

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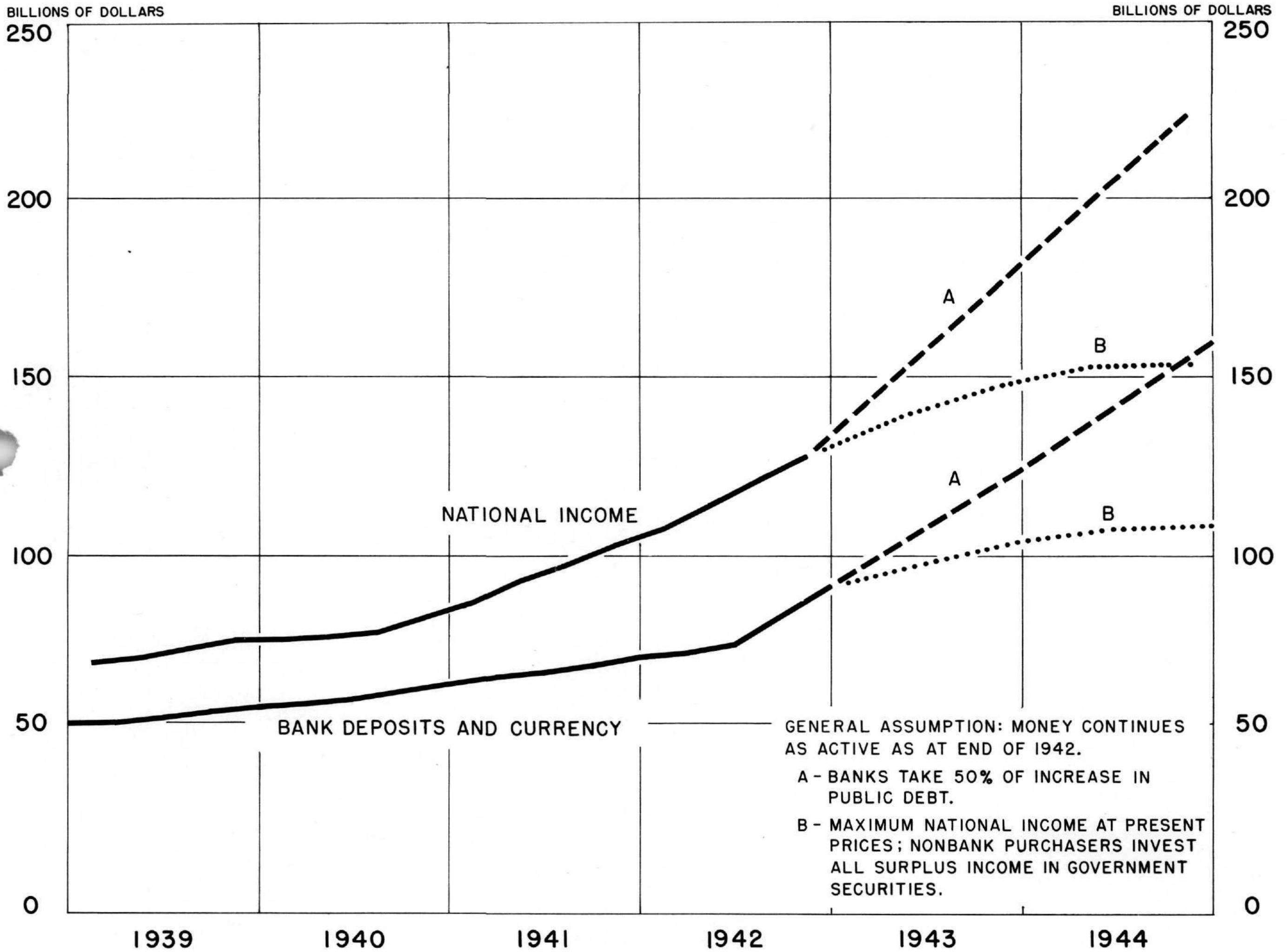

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