FEDERAL RESERVE BANK

OF NEW YORK

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March 25, 1944.

Hon. M. S. Eccles, Chairman,
Federal Open Market Committee,
Board of Governors of the
  Federal Reserve System,
Washington 25, D. C.

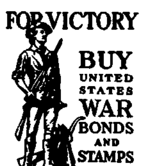
Dear Marriner:

Enclosed is a tentative draft of a memorandum on Treasury Financing and Credit Policy which I thought it would be helpful to have before us at our discussion meeting on Tuesday. It may be that, by the time I get to the meeting, I shall have changed some of my ideas, but I am convinced the general approach is the right one.

Yours sincerely,

Allan Sproul, Vice Chairman,
Federal Open Market Committee.

Enc.



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TREASURY FINANCING AND CREDIT POLICY

1. The main objectives of Treasury financing policy and credit administration still are borrowing as much as possible from non-bank investors while maintaining an interest rate structure with a maximum market borrowing rate of 2 1/2%.

2. There is no question of our ability to maintain the maximum borrowing rate of 2 1/2%, but we are still measurably short of the goal of maximum borrowing from non-bank investors. While the Treasury must be certain that it will obtain the funds needed to finance the war, it should not permit early estimates of receipts and expenditures, and too gloomy forecasts of non-bank borrowing, to cause it to embrace bank borrowing too much and too soon.

3. Actual developments may depart considerably from the estimates. The estimate for government expenditures rightly assumes that it will be necessary to continue the war program without curtailment to the end of the year, but once our invading forces have become established in Europe, this may not be so. Cash Receipts may well be larger than are assumed by the Treasury estimates (for example, if corporations retain tax notes and use cash to pay taxes) and the amount of securities to be redeemed may be smaller (particularly if a vigorous campaign to encourage holding of Series E bonds, and stressing the advantages of such holding, were launched). In other words, the estimates have properly assumed the worst, but that should not mean that the worst method of financing must be adopted before these estimates have further proved themselves.

4. The estimates seem actually faulty in their conservative appraisal of possible sales to non-bank investors. The net absorption of government securities by non-bank investors (exclusive of Federal agencies and trust funds) is placed at $33,300,000,000 for 1944, compared with $28,000,000,000 for 1943. Without assuming any improvement in the sales program, or any increase in selling pressure, a figure $2 or $3 billion higher seems reasonable. The cards are stacked in favor of 1944, with a drive at the beginning of the year (drawing off funds accumulated in November and December 1943), and drives scheduled for the middle and for the close of the year, so that all funds available throughout the year should be mopped up.

This may be illustrated by comparisons with two previous periods of 12 months which included 3 war loan drives, and each of which ended with a drive, although neither began with a drive as did 1944. During the year ending October 31, 1943, which embraced the First, Second, and Third drives, non-banking investors absorbed $34,700,000,000 of government securities. During the year ending February 29, 1944, embracing the Second, Third, and Fourth drives, non-bank investors took approximately $36,400,000,000. If we do no better than we have in the immediate past, non-bank investors should buy at least $36,000,000,000 of government securities in 1944.

5. But we should do better than we have done. According to Treasury estimates, the net absorption of Federal securities by non-bank investors was only 50% of the net savings available in the October 1943 - February 1944 period, compared with 60% in May - October 1943, and 65% in January - April 1943. Another Treasury estimate is that only about 50% of the people of the country were actually solicited in the Fourth War Loan drive. These figures are not good enough. If we are to prevent an accelerated rise in idle cash, in the form of currency and bank deposits, we must sell not far from $40,000,000,000 of government securities to non-bank investors in 1944.

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6. Steps should immediately be taken to improve our performance in selling securities to non-bank investors, including:

a. Further strengthening the sales organization to include a larger, more active permanent staff, in the States, to promote an increase in payroll savings, and a larger, more active volunteer staff to increase actual solicitations during drives.

b. An increase in short-term rates of interest, particularly to attract idle corporate funds. Treasury estimates for 1944 indicate that purchases by corporations will increase very little compared with 1943, yet corporations are known to have large cash balances, in relation to their liabilities and their holdings of government securities. When the Treasury is too niggardly in the rates of interest it pays on its indebtedness the results may be somewhat the same as when borrowing is done without payment of interest (printing the money) - the money supply (currency and bank deposits) rises rapidly because the investment of accumulating funds does not appear worthwhile. Net yields, after taxes, on Treasury bills and certificates, to corporations, particularly in the higher tax brackets, are extremely low.

c. Offering market bonds, and 2 1/2% bonds (and 2 1/4% bonds when issued) of restricted marketability, in denominations of $100, to tap the small investor market which does not want a registered bond.

d. Offering a general partial payment plan for market bonds, further to broaden sales to small investors, and a special partial payment plan for market bonds and bonds of restricted marketability for the use of insurance companies, savings banks, pension funds, trusts, etc.

7. It may be that in the absence of a sterner tax program, no larger proportion of current savings can be diverted to government use, but the attempt must be made, and made even more vigorously than in the past. If the attempt fails, recourse can be had to the banks, between the Fifth and Sixth drives, when present estimates will have been further tested, and when otherwise Treasury balances would be reduced below what the Treasury deems safe.

8. In the light of these general observations, it is recommended that there be no direct recourse to the banks before the Fifth War Loan drive.

9. <u>Fifth War Loan</u>:

<u>Timing</u>: A three to four week drive in June or June - July, at the time considered best by the sales organization.

<u>Securities</u>: It is recommended that there be offered to all non-bank investors, throughout the drive, the following securities:

(a) Series E, F and G War Bonds and Series C Savings Note
(b) A certificate of indebtedness or a short note
(c) A 2% bond of 8 - 10 year maturity
(d) A 2 1/2% bond of restricted marketability (reopen the 2 1/2% bond of 1965 - 70.)

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10. In lieu of another 7/8% certificate of indebtedness, a short note bearing, say, 1% interest, might be preferable. This could be fitted into a program of readjustment of interest rates at the short end of the pattern, and should further broaden the market for short securities among non-bank investors, particularly corporations whose net return, after taxes, is very small in any case.

11. In addition, and as part of this general program, a change in Treasury bill offerings to a 4 month 5/8% bill should be made. This would have the advantage of helping to create a more tenable interest rate structure for the war and immediate post-war period; it might increase somewhat the market for Treasury bills among banks continuing to hold excess reserves, and among corporations; it would increase the volume of bills available for purchase by the Federal Reserve banks; and it would bring in $4 billion of new money to the Treasury.

If it is argued that these bills would flow largely into the hands of the Federal Reserve banks, and that there is no need for justification for the Treasury's paying a higher price for such funds than at present, it could be agreed (by the Board of Governors, the Federal Open Market Committee, and each of the Federal Reserve banks) that the difference in income derived from holding bills, yielding in excess of 3/8%, would be paid to the Treasury, so long as the earnings of the Federal Reserve banks are sufficient to cover their expenses and dividend requirements. Treasury financing and credit policy cannot be determined on such grounds.

12. Fear as to the effect of an increase in short-term rates upon the whole interest rate structure are misplaced. The rate structure is under close control, but the short end of the structure has already become untenable in practice. Meanwhile, the very real danger of a further breach in the structure, lies in the tendency of the banks to reach for the longest term securities available to them, in order to protect or enhance income, which will eventually force down (not up) the yield on such securities. The rate of 2 1/2% on long-term securities of restricted marketability is not threatened.

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Question has been raised as to the reserve position of the Federal Reserve banks. We see no need for adjusting the present Treasury borrowing program nor present credit policy, to take account of the possibility that, at some future date, the reserves of the Federal Reserve banks might reach the present legal minimum.

Treasury estimates of reserve funds required during the year 1944 total $8.5 billion. For certain technical reasons this figure appears to be too high, even on the basis of the Treasury's assumptions as to bank and non-bank financing. And these assumptions make a considerable difference in the outcome for the year. If no more than $33 billion of government securities is sold to non-bank investors (other than Federal agencies and trust funds) the increase in member bank reserve requirements would be about $1.5 billion (not $2 billion as estimated by the Treasury). If sales to non-bank investors are increased to $36 billion, the increase in member bank reserve requirements is reduced to slightly over $1 billion; and if such sales are $40 billion, the increase is around $500 million. For these and other reasons, we believe the Treasury estimates of reserve funds required are $1 billion to $2 billion too high.

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The change which this difference would make in the combined reserve percentage of the 12 Federal Reserve banks is only about two points, however, and is really immaterial. The important facts are:

a. That the war financing program cannot be jeopardized by the existence of certain minimum reserve ratios, and that there are a variety of methods by which the situation can be met if it arises.

b. That we should not be diverted from the fundamentals of the financing problem by contemplation of reserve ratios; we must continue to attack the root cause of declining reserve ratios by taking every means to check the accumulation of idle funds in the hands of the public - increased taxation, increased borrowing from non-bank investors, and more effective controls over other factors in our economy tending toward inflation.

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