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To: The Federal Open Market Committee

From: Woodlief Thomas January 30, 1951.

Attached are two memoranda which I have prepared. One analyzes some of the considerations that might govern debt management and credit policies during the next year, particularly in the light of Secretary Snyder's statement, and the other presents for consideration a tentative program for carrying out such policies.

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DEBT MANAGEMENT AND CREDIT POLICIES
Analysis of Secretary Snyder's Views

In his New York speech of January 19th, the Secretary of the Treasury set forth two principal objectives of debt management for the future:

A. Treasury financing (presumably refunding as well as new borrowing) will be done on the basis of a 2-1/2 per cent long-term rate.

B. The maximum amount of securities should be sold to nonbank investors with a minimum of sales to the commercial banking system.

The Federal Reserve position with respect to these objectives may be summarized as follows:

1. Of these two objectives, the second is the overriding one in an inflationary period. The major question is whether both objectives can be attained in the face of inflationary pressures.

2. Treasury financing is a minor aspect of the problem; from the standpoint of inflation and credit policy, the far more important problem is to limit the selling of outstanding securities to the Federal Reserve by banks and other investors.

3. Accomplishment of these objectives should be measured not merely by changes in commercial bank holdings of Government securities but by Federal Reserve holdings and the overall expansion in total bank credit based on reserves created by Federal Reserve operations.

4. The securities sold to nonbank investors should be such that they will continue to be held by investors and not later be resold to banks--particularly not to the Federal Reserve.

Further explanation and discussion of these four points follow.

1. The Major Objective

The Federal Reserve is not committed to the view that interest rates must necessarily be higher or that any particular level or structure of rates should be attained. The primary objective is for the Federal Reserve to avoid purchasing securities and thus expanding bank reserves. Would-be sellers should find buyers outside the Federal Reserve, and interest rates should be permitted to adjust to levels at which these transactions would take place.

There are, however, two important modifications in the application of this principle:

(a) The volume of Government securities outstanding is so large that at any time current offers may exceed bids or vice versa to such an extent that Federal Reserve participation is necessary to maintain an orderly market. This participation, however, should not be at pegged rates nor be prolonged on one side of the market, but should permit some fluctuation in rates in response to market forces in order that Federal Reserve operations would cease to be necessary or could be reversed.

(b) In periods of Treasury financing, particularly when deficit financing is necessary, some Federal Reserve aid may be needed to assure success of the financing. During war when there is a persistent deficit to be financed, prolonged Federal Reserve support may be necessary to assure stability of interest rates in order to induce purchasing and holding of securities. The terms of Treasury offerings, however, should be such as to keep support to a minimum during the period of financing and to safeguard against the need for indefinite support in the future.

It might be possible, although that is somewhat doubtful, for the Treasury to finance its needs during the present emergency outside the banking system on the basis of a 2-1/2 per cent rate. It may even be possible to sell enough securities to nonbank investors within that pattern to permit a reduction in bank holdings. If direct controls over prices and spending are effective, savings may increase, while restrictions on residential and commercial construction would reduce the supply of mortgages. Investors may then purchase more Government securities.

If investors are willing to purchase and hold Treasury bonds with an interest return of 2-1/2 per cent or less, there would be no need for Federal Reserve action to bring about a higher level of rates. But if investors endeavor to sell their securities or do not take issues offered by the Treasury, then bond prices or the absorption of Treasury offerings can be maintained only by Federal Reserve support. In the latter event, rates should be permitted to change in response to market forces rather than create new bank reserves at fixed rates.

2. Importance of Private Credit Expansion

In discussion of the relation of debt management and credit policies, major emphasis is generally placed upon supplying the needs of the Treasury. Far more important from the standpoint of inflation--except, perhaps, during periods of large-scale deficit financing--is the sale of outstanding Government securities by existing holders and their purchase by the Federal Reserve. It is this so-called monetization of the debt which has provided the basis for overall credit expansion and which Federal Reserve policies should be directed toward restricting.

While some shifting in holdings of Government securities should be expected, the high degree of liquidity at rigidly pegged prices which has been maintained since the war is unnecessary for the maintenance of confidence in such securities and has been shown to have inflationary consequences. Investors should run the test of the market in liquidating their securities and not expect a guaranteed price, particularly if that guarantee requires the creation of high-powered bank reserves.

Statistics, which are cited in a later section, show that bank sales of Government securities have provided the basis for expansion in bank loans and in overall increase in the money supply in the postwar period and particularly in recent months. Other important groups of investors have also sold securities on balance while some groups have continued to expand their holdings. Secretary Snyder pointed out that nonbank investors as a group have increased their holdings by 10 billion dollars since 1947. This is not a large amount considering the current accretion of savings and its significance needs careful analysis.

Analysis of changes in holdings of Government securities indicates that, in general, investor demand for long-term Government securities has been slight notwithstanding continued accretions to the supply of invested funds. Since 1947, Government agencies and trust funds have increased their holdings by 5 billion dollars, accounting for half of the total increase in nonbank holdings. Savings bonds held by individuals increased by a total of 3.4 billions reflecting in large part interest accumulations. Holdings of savings bonds by other investor groups and of savings notes (largely by corporations) have increased by about 6 billion dollars. Corporations, other than banks and insurance companies, showed a total increase of over 5 billion dollars--chiefly savings notes and short-term securities. Investors' holdings of marketable bonds have declined considerably, reflecting in part a decrease in the supply of such bonds. In the case of long-term restricted bonds, the supply of which has been unchanged, the Federal Reserve had to absorb about 3 billion on balance, mostly from insurance companies.

While Federal Reserve policies have generally facilitated the liquidation of Government securities by those wishing to acquire other assets, the modest measures of restraint adopted have shown results which indicate that more vigorous actions might have produced greater accomplishments. It should be kept in mind that short-term interest rates have risen considerably since 1947 and also during the past year. In these periods holdings of short-term securities by nonbank investors, particularly corporations, increased notably-- no doubt attracted by the higher rates. Sales of long-term restricted bonds by the Federal Reserve during the first eight months of 1950 also made possible some increase in investor holdings of such bonds, offsetting some of the large purchases made in 1947 and 1948.

If other demands for funds continue strong and more profitable investments are available, it can be expected that investors will sell Government securities at pegged prices in order to shift funds to these other uses. Any general "flight from the dollar", or more precisely, tendency to buy goods or property in anticipation of rising prices, would be accompanied by sales of Government securities. If the Federal Reserve has to buy these securities at pegged prices, additional bank reserves will be created and inflation will be spurred on rather than restrained.

3. Distinction Between Federal Reserve and Commercial Bank Holdings

It is most important to recognize that the noninflationary character of debt management and monetary policy should be measured by the volume of Government securities held by the Federal Reserve and by the overall expansion of bank reserves and bank credit and not by the amount of Government securities held by the entire banking system.

It is true, as Secretary Snyder pointed out, that total holdings of Government securities by commercial banks and Federal Reserve Banks combined decreased about 10 billion dollars from the end of 1947 to the end of 1950. Federal Reserve holdings alone decreased by nearly 2 billion in the period but this reduction was more than offset by other factors, principally an increase in float, a return flow of currency of over a billion dollars, and lower reserve requirements for member banks of possibly 1.5 billion.

On balance banks had over a billion dollars of reserve funds available for credit expansion. These additional reserve funds, together with the reduction in their holdings of Government securities, made it possible for commercial banks as a group to expand other types of credit by about 18 billion dollars. The overall money supply increased by about 7 billion dollars in the period.

During 1950 while commercial bank holdings of Government securities decreased by 4.6 billion dollars, Federal Reserve holdings increased by nearly 2 billion, largely to offset a loss of gold. As a result of other factors, total bank reserves showed an increase of over a billion dollars. This increase in reserves and the reduction in holdings of Government securities provided the basis for an unprecedented expansion in bank loans. The overall money supply increased by over 7 billion dollars.

It should be concluded from this analysis that the decrease in commercial bank holdings of Government securities has on balance been an inflationary influence rather than deflationary. While sales of securities by banks to nonbank investors tend to have a deflationary effect, this was offset by greater expansion in other types of credit made possible by relatively small purchases by the Federal Reserve from banks and others.

4. Importance of Long-time Viewpoint

Even though Treasury financing could be effected at current rates of interest, and without Federal Reserve support, it is important from a long-run standpoint that the securities issued be of such a nature that they will continue to be held by investors when the emergency has ended. They should not be thrown back on the Federal Reserve and create a post-emergency inflation, as was done in 1947-48. To avoid this would require types of securities that investors could not or would not want to liquidate. They might need to be nonmarketable and in any event would probably require higher coupon rates than 2-1/2 per cent.

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POSSIBLE PROGRAM OF CREDIT POLICY AND DEBT MANAGEMENT FOR 1951

During the next four months there should be no requirements for Treasury financing, other than the weekly turnover of bills. In this period, however, inflationary pressures are likely to continue strong, and they could be fed by liquidation of existing holdings of Government securities. The Federal Reserve will probably need to add to its holdings of securities in this period to offset gold outflow and currency demand. This gives an opportunity to exert some restraint particularly if purchases are made at rising rates. If the System is called upon to buy additional securities to expand bank reserves, then rates should certainly be permitted to rise.

If a demand for long-term securities should develop, the Treasury should offer additional bonds to tap these funds.

Beginning in June of this year and extending through next year, the Treasury will not only have a tremendous amount of refunding of issues due or callable but will probably also need to borrow substantial amounts of new money. The actual volume of new borrowing will depend on the rate of increase of defense expenditures and the additional taxes that might be imposed. It is urgent that there be devised a program for financing these needs in a manner that is noninflationary in itself and that will also permit the carrying out of anti-inflationary credit policies.

The following tentative programs of credit policy and debt management during the next year or so are suggested for consideration:

Open Market Operations

1. Purchases of short-term securities by the Federal Reserve should be kept to a minimum needed for orderly market purposes and to offset extraneous drains on bank reserves.

2. System operations should be confined as much as possible to Treasury bills, although moderate purchases of the July and August notes and sales of October and November notes may be desirable for System portfolio adjustments.

3. Market forces should be allowed to express themselves in short-term rates. If offers of short-term securities to the Federal Reserve persist, then rates on Treasury bills should be permitted to rise sufficiently to encourage banks to borrow at the discount rate rather than sell bills. Rates on notes should be allowed to adjust accordingly.

4. A fairly wide spread should be maintained between System buying and selling rates--at least one-eighth of a point on bills--in order to discourage short-term adjustments of reserve positions through selling securities.

5. The long-term notes should not be purchased by the System unless the market threatened to become very disorderly.

6. System purchases of the longest-term restricted bonds should be made at prices of not more than par and one-eighth.

7. If a demand should develop for bonds--as is not unlikely--the System should sell them only at a price at least one-half of a point above its buying price, and should not sell at all if the Treasury would make available additional bonds for nonbank purchase.

Debt Management Measures

1. The Treasury should offer for purchase by nonbank investors additional amounts of long-term bonds--preferably a nonmarketable type--as soon as a demand becomes evident (i.e., when support purchases of long-term restricted bonds are no longer necessary).

2. Proceeds from any such sales during the first half of the year could be accumulated to meet future needs, which may begin to mount around June.

3. A reopening of Series F and G bonds might suffice for a few months but eventually a more attractive and also longer-term issue should be offered. A 30-35 year instalment retirement bond with a yield rate of at least 2-3/4 per cent might meet this need. It should be the aim to obtain practically all new funds through this channel.

4. In the latter part of the year, if sufficient new funds are not obtained from long-term offerings to meet current needs, six-month Treasury bills might be sold. These would provide maturities in the first half of 1952 and bills would not present problems of pricing and allocations of subscriptions that arise in case of public offerings of additional marketable securities. In general, however, financing by means of bank-eligible issues should be confined to refunding.

5. Refunding of maturing and called issues during the latter half of 1951 and 1952 should be of types suitable for banks, corporations, and other holders of liquid funds and be designed to give a well-spaced distribution of maturities during the next five years.

6. If sufficient funds could be obtained through sales of securities to nonbank investors, it would be highly desirable to reduce the volume of bank-eligible issues outstanding by cash redemption of some of the maturing issues.

7. In view of the large volume of restricted bonds becoming eligible for bank ownership from May 1952 through 1954 with call dates within 7 to 12 years, it would seem undesirable to issue any more bank-eligible bonds. Nor would such issues be necessary to attract bank funds if short-term rates should rise further.