March 4, 1947

STATEMENT BY CHAIRMAN ECCLES IN ANSWER TO QUESTIONS REGARDING METHODS OF RESTRICTING MONETIZATION OF PUBLIC DEBT BY BANKS

In connection with my statement to the Banking and Currency Committee of the House of Representatives regarding H.R. 2233, I was asked by a member of the Committee questions with respect to proposals made in the 1945 Annual Report of the Board of Governors of the Federal Reserve System regarding the problem of monetization of the debt by banks and ways of dealing with that problem. It should be made clear that H.R. 2233 is not designed to deal with this particular problem, which is much broader and more far-reaching in scope than the bill now before the House. The following statement gives in essence my answers to those questions:

Nature and cause of debt monetization.--

In connection with financing the war there was a tremendous increase in holdings of Government securities by commercial banks and by the Federal Reserve Banks. To a large extent this increase was necessary in order to facilitate financing of the war and to provide the expanded money supply needed by the wartime economy. These holdings are mostly short-term securities but banks also hold some longer-term bonds.

To maintain a stable market for Government securities, the Federal Reserve System adopted a policy of maintaining the level of interest rates. The supported rates ranged from 2 1/2 per cent on long-term securities, purchased mostly by individuals and savings institutions, down to 7/8 per cent on one-year certificates, generally owned by banks and other holders seeking liquidity. In addition, 90-day Treasury bills, mostly held by Federal Reserve Banks, were kept at 3/8 per cent.

Although some efforts were made to restrict bank purchases of securities, various aspects of war finance made it attractive for banks to increase their holdings. For example, because of the supported market and the differential in rates, banks increasingly adopted the practice of selling short-term low-rate securities to Federal Reserve Banks, thus creating additional reserve funds which were used to purchase longer-term securities in the market. The reserves thus created could provide the basis for an expansion in commercial bank credit of between six and ten times the increase in reserves.

As long as the Reserve System stood ready to purchase short-term securities at the prevailing rates, the short-term rates could not rise. The banks could continue to sell short-term securities and buy longer ones, thus both expanding the amount of bank credit and reducing long-term interest rates. This practice--known as "playing the pattern of rates"--resulted in "monetization of the debt."

Effect of debt-retirement program.--

During the past year, since the preparation of the Board's 1945 Annual Report, these tendencies have been suspended. The reason for this is that the Treasury, in retiring over 20 billion dollars of maturing debt out of war loan deposit accounts with commercial banks, accumulated during the Victory Loan Drive, has put some pressure on the reserve positions of banks. Retirement of securities held by Federal Reserve Banks with funds drawn from commercial banks tends to reduce member bank reserves. In order to maintain their reserve positions, banks have had to sell securities to the Federal Reserve. At the same time banks have been increasing their loans to businesses, to consumers, and on real estate, and they needed funds for this purpose. While banks had to sell securities to meet these needs and have had many of their short securities retired, they have not sold additional amounts in order to buy longer-term Government securities.

Problem for future.--

With the debt-retirement program approaching an end, there may be in the future a resumption of the tendency on the part of banks to sell short-term securities to the Federal Reserve in order to buy longer-term securities. This would mean a resumption of the practice of creating bank reserves through monetizing the debt and expanding credit by many times the amounts sold. It would also mean a resumption of the decline in long-term interest rates. The initiative with regard to this practice rests with the banks, which hold large amounts of Treasury certificates and of Treasury notes and bonds maturing during the next few years. At the same time there are substantial amounts of bonds held by nonbank investors eligible for bank purchase and a number of restricted issues which will become eligible at varying times in the future. The Federal Reserve under present powers and policies could not prevent such a development.

It would be undesirable, particularly in a period of inflationary pressures, to have the long-term interest rates forced down through monetization of the debt. A decline in long-term interest rates resulting from an excess of savings over the demand for investment funds would be desirable, but a decline because of bank credit expansion would be undesirable. Such a development would be an inflationary influence; it would also reduce the return on savings and, therefore, impose a serious burden on individuals and institutions, such as insurance companies, schools, and benevolent agencies, that are dependent on interest returns for their incomes. Should long-term rates decline much lower, many of the functions performed by these institutions would have to be taken over by Government, thus leading in the direction of socialism.

Solutions for the problem.--

There are various ways of dealing with this problem; those generally suggested are as follows:

(1) The proposals made by the Board in its 1945 Annual Report would restrict, by one device or another, the ability of banks to shift from short-term securities to long-term securities and thus limit the extent to which banks could monetize the debt.

(2) The Reserve System could lift the present support level for the short-term interest rate and thus permit that rate to rise to a level at which banks would no longer be induced to sell short-term securities to the Reserve System in order to purchase longer-term securities in the market.

(3) It has been suggested that the decline in long-term rates might be checked by issuance of sufficient amounts of long-term securities.

(4) Monetization of the debt could be permitted to continue until long-term interest rates declined to a level at which it would no longer be attractive for banks to sell short and buy longer securities.

The Board's proposals would offer a solution striking at the basic cause of the problem, which is the great expansion in bank holdings of Government securities that can be readily converted into bank reserves at the will of the banks. A rise in short-term interest rates would remove another cause, namely the differential in interest rates, which encourages shifting short securities to the Reserve Banks and the buying of longer ones and creates premiums on long-term securities. Action to unpeg the short rate would be definitely preferable to the fourth solution of permitting debt monetization and the resulting decline in long-term rates to continue.

As for the third suggestion for checking the decline in long-term rates by issuing more long-term securities, it should be pointed out that if these securities are issues of the conventional market types, even though not eligible for purchase by banks, investors, in order to purchase the new securities, will sell existing holdings of eligible issues to banks. Banks in turn would sell short-term securities to the Reserve System and be able to purchase many times that amount of longer securities. As a result, monetization of the debt would be encouraged rather than discouraged.

Marketable issues, moreover, with Federal Reserve support, can be readily liquidated at par and thus are in effect demand obligations with the high rate of return. Because of the difference between long and short-term rates, prices of long-term bonds rise for many years after their issuance and holders of these bonds can sell them at a premium, thus obtaining not only the 2 1/2 per cent coupon rate but also an additional amount which may give a return of as high as 3 per cent. The use of this solution would raise the interest cost to the Treasury and would encourage debt monetization for years to come by putting out marketable issues which in the future could be sold to banks at a premium. This remedy deals with effects not with causes. A rise in short-term rates would be more effective and less expensive to the Treasury than this method.

Such long-term bonds as need to be issued to absorb the savings of the public should be in a nonmarketable form, redeemable on demand prior to maturity at a discount so as to give a lower yield if not held until maturity. These bonds would be similar to the present Series G savings bonds with broader limits on amounts to be purchased and with substantially longer maturities. A reasonable rate could thus be paid for genuine long-term savings and thus protect individuals and institutions dependent on savings for their income. Holders would also be safeguarded against loss in case of necessary liquidation before maturity, but would not be guaranteed a high coupon rate, plus perhaps a premium, on short-term, highly liquid investments.

Conclusion.--

In summary, my view is that a fundamental solution to the problem of debt monetization rests in some such measure as those proposed by the Board in its Annual Report. In the absence of legislation toward this end, it would be desirable to permit some rise in short-term interest rates if necessary to prevent long rates from declining further as a result of debt monetization by banks. This does not necessarily mean that a rise in short-term rates is imminent. In case there is no resumption of debt monetization and declining long-term rates, then an increase in short-term rates may not be needed at all.

Additional investment outlets for long-time savings should be provided in the form of a nonmarketable obligation of the Series G type, but further issues of long-term marketable securities should be avoided.