Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 2, 1937.

To Chairman Eccles

Subject: The bond situation

From Lauchlin Currie

LBC.

As I have not had an opportunity to discuss the bond situation with you and I have some views on the matter I have written them up in the attached memorandum. Mr. Goldenweiser has read the memorandum.

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Confidential

April 2, 1937.
L. B. Currie
LBC.

COURSE OF ACTION SUGGESTED BY WEAKNESS IN BOND PRICES.

In view of (a) the substantial fall in bond prices that has occurred since the first of the year and (b) the possibility that certain banks will have to make further adjustments to meet the pending increase in reserve requirements, the question arises whether the System should engage in any open market purchases and, if so, of what character and in what degree.

Action must necessarily be based on diagnosis, objectives, and a weighing of the probable consequences, in all of which differences of opinion exist. My own view is as follows:

Diagnosis

While the increase in reserve requirements may have had something to do with the fall in bond prices there are various considerations that suggest that other factors have been more important. For one thing, the movement started back in December. For another, it would seem that the extent of the movement, combined with the fact that it is known that banks will be left with some $600 million excess reserves and that other funds available for investment are abnormally large, indicate that other considerations are paramount. These considerations appear to be a renewed fear of inflation arising from rapid price and wage advances, rearmament, the fall of interest rates in England, and the warnings of various writers. Recently this has been aggravated by a change in the federal budget picture, and a rejection of the proposal to levy additional taxes.

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If this is the correct diagnosis of the present situation there would be danger that open market purchase of government obligations would be interpreted as inflationary in its implications and contribute to increased rather than reduced sales of bonds. This view was expressed in financial editorial comments in both the New York Times and the Wall Street Journal in recent days, following the rumor that henceforth the Federal Reserve would have to support the bond market. In short, it appears hardly proper to adopt "inflationary" measures to cope with a situation which arises from inflationary fears. An affirmation by the President that there will be no boom would be more effective than a reaffirmation of an easy money policy on our part, if the above diagnosis is correct.

Objectives

There appear to be two objectives that would be served by open-market purchases. One would be to support government bond prices by direct purchases. The other would be to prevent forced sales to meet increased reserve requirements, by giving banks more reserves. While related, these two objectives are capable of separate treatment.

The first objective of supporting bond prices implies

(a) that we feel responsibility for the level of government bond prices,

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(b) that we feel that the present levels or any further recessions will be detrimental to the course of business,

(c) that our action would be effective and

(d) that we would have no difficulty in disposing of our purchases and mopping up the additional excess reserves at a later date. I will consider these points in order.

(a) Now that almost all the financing requirements of the government are out of the way, it does not appear that we should feel much responsibility for the level of government bond prices, except to the extent that a decline may be attributable to action on our part. In this case it should be one of the considerations that must be weighed against other considerations. Financial critics of the Administration have repeated again and again that the ship of monetary control would founder on the rock of fiscal policy -- that the Treasury would never permit its interest cost to be raised. Deliberate action to support bond prices might be interpreted as confirmation of this view.

(b) It appears unlikely that the recent movement in bond prices is detrimental to the course of business. A substantial portion of new capital has been raised by new stock issues and

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the bulk of bond financing has been for refunding purposes. The effect of refunding at this stage of the cycle is to increase profits which are already mounting rapidly. The recession cannot be long continued and new capital issues will appear in abundance when prices are stabilized. A temporary slackening of new issues might even be held to be salutary at the present time, tho this is more debatable. Even should bond prices remain at a lower level than before the movement began, a difference of one-half percent or even one percent in bond yields in this phase of the cycle would be a negligible influence in checking expansion. Present conditions, in other words, differ widely from those in 1931, when buying was declining rapidly, or 1934, when the recovery was still uncertain. If, of course, a wide open break occurred, accompanied by dumping of all bonds regardless of price, the situation would be different.

With reference to the position of member banks, we are naturally concerned to prevent bank failures. So far, however, recession has mainly cancelled paper profits and has not resulted in large actual losses. The movement would have to be much more drastic to threaten the solvency of banks.

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(c) As remarked before, there is no guarantee that purchases will be effective in achieving their objective, as this depends on the uncertain psychological repercussions. It is worth noting that the Treasury has expended some $200 million without arresting the decline. A fixed amount of purchases might be worse than ineffective. A bold policy of unlimited support might entail purchases of very large magnitude, undoing much of the increase in reserve requirements.

(d) Finally, there is no guarantee that the additional excess reserves created through Government bond purchases can be absorbed later without affecting bond prices when the securities are sold. This depends on the amount, the future course of the market, confidence, etc. This may not be a serious danger, but it deserves mention. Additional bond purchases, by increasing excess reserves relative to our Treasury bill holdings, would leave us in a less secure position to mop up excess reserves and arrest deposit expansion in the future.

The second objective is to prevent forced sales arising from the adjustments incident to meeting the new requirements. This appears to be a more justifiable objective and does not

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lend itself to the same inflationary implications as would a policy of supporting government bonds. It would be consistent with our general policy of moving toward the absorption of excess reserves as a precautionary measure, while not departing for the time being from an easy money policy. We could adopt the position that while we do not feel that the fall in bond prices attributable to inflation fears justifies a counteractive policy on our part, we do feel that banks should not have to dispose of governments at this time in order to meet the increase in requirements.

There is a real problem in making this distinction clear. The explanation would not be accepted, in my view, if we bought government bonds on balance. It could be pointed out that if we wanted to supply additional reserves we could do so without directly buying long-term government bonds. There is a similar danger in buying Treasury bills. The financial community has got into the habit of lumping together all government obligations held by all the reserve banks. Any increase in the grand total of $2.4 billion of government obligations, even tho attributable solely to increased Treasury bill purchases, might be regarded as indicative of a change in open-market policy and, hence, inflationary.

These objections and difficulties would not apply to increased purchases of acceptances. Variations in acceptance holdings have

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been the traditional means of making temporary and seasonal adjustments and are not generally regarded as indicative of any change in "open-market policy". There would be assurance that the reserves created by additional purchases would go to the large city banks that need additional reserves. Bond purchases, on the other hand, might create reserves for country banks that have plenty of reserves already and are merely selling because they mistrust the future trend of bond prices.

Recommendation

I would favor an immediate reduction in the bill buying rate from one-half percent to three-eighths percent. I do not think this action would be regarded as inflationary and it would have the effect of giving additional reserves to New York banks and forestall the necessity on their part of disposing of bonds at present prices. I believe, moreover, that the present relatively generous yields combined with the knowledge that excess reserves will amount to some $700 or $800 million (depending on our acceptance purchases) and that further forced selling or borrowing will be obviated, would contribute to a cessation of pressure on the market and possibly to a rally. If, however, this does not happen, nothing will have been lost and we will still be in a position to consider whether any further action on our part is required. It is to be expected that the Treasury will continue to work for an orderly market. In the present uncertain conditions prudence suggests that resort to possible dangerous expedients be delayed until after we have given a fair trial to relatively safe expedients.

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Listing the various expedients in order of preference I would suggest:

(1) A vigorous anti-inflationary statement by the President.

(2) Purchase of acceptances by reserve banks.

(3) Purchase of bonds by the Treasury in ways that do not involve the creation of additional excess reserves.

(4) Purchase of bonds by the Treasury thru use of the free gold.

(5) Suspension of gold sterilizing operations by the Treasury for time being.

(6) Use of inactive gold.

(7) Purchase of bonds by the reserve banks.

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