EXHIBIT B

November 6, 1940

TO: Mr. E. A. Goldenweiser

FROM: Victor M. Longstreet VML

SUBJECT: A plan to stabilize prices of bank-held Government bonds

It has been proposed that (1) commercial banks be required to hold a "bond reserve" of Government bonds in an amount not below a fixed percentage of their deposits and (2) such bonds held in excess of the required amounts cannot be sold in the market but can in the future be redeemed at the Federal Reserve banks or Treasury for approximately amortized cost price. This proposal is aimed at (1) protecting banks from losses due to a decline in bond prices and (2) protecting the bond market from the effects of bank selling.

Summary of proposal

Bonds eligible as bond reserves could be defined as Government bonds maturing after a certain period, say 12 or 15 years. There is no advantage in including short-term Governments in the plan because banks run little risk of loss on them and because bank selling of short-term securities is not likely to be disturbing. Another idea is to make use of a consol, or some special type of Government security, which could be held only by banks and would not have a market. This special type of Government bond would be obtained by the commercial banks in exchange for some of their present Governments. To insure maintenance of bank earnings the consols would have to bear about the same interest rate as the banks' holdings of Government bonds that they replaced. Consols held in excess of the required amounts could always be redeemed at the Federal Reserve banks or the Treasury.

The percentage of deposits required as bond reserve would not have to be identical for every class of bank. Different percentages could be established for each class of bank, at levels that would cause the least disturbance in inaugurating the plan.

If changing conditions caused banks to need more consols for the required bond reserve, the Reserve banks and Treasury could always be prepared to issue new ones for cash. Or it might be desirable to lower the percentage bond reserve requirements from time to time.

Aims of the proposal

A plan of this sort would unquestionably reduce the risk of price declines in Government securities. If banks could always redeem the reserve bonds at approximately amortized cost price banks would never have to sustain any losses on these securities regardless

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of how far market prices had fallen. Also, if banks could not sell such bonds in the market, the banks to that extent could not depress prices in the Government bond market.

Presumably the aims of the proposal would be most fully achieved if it embraced all bank holdings of Government bonds. If banks are still permitted to hold some Government bonds that are not redeemable but can be sold in the market, banks could continue to go in and out of the market and sustain heavy losses if prices decline. In the following discussion the questions raised about the proposal are of a general character and are designed to apply to all of the various forms that the plan might assume if actually adopted.

Possible objections to the proposal

Two principal difficulties appear to be inherent in the plan: (1) it permits a high long-term interest rate to be paid on what is in effect a short-term or demand investment and (2) it benefits a particular class of bondholder.

As regards the first point, a bond on which the holder runs practically no risk of loss if he wants his principal before maturity has the characteristic that distinguishes a short-term obligation from a bond. Justification for the Government's paying a high coupon on bonds is that bonds relieve the Government of the necessity of frequent refinancing at whatever may be the current rate. Therefore the Government pays a coupon high enough to encourage investors to accept the risk of any losses they may have to take if they should have to sell on a weak market before maturity. If the Government provides, through the Federal Reserve banks or otherwise, for cash redemption of bonds before maturity, so that banks will not assume any risk of loss, then the bank, or to be more specific the holder of bank stock, is only entitled to a short-term interest rate and not a bond rate. And the Government would be raising funds at a higher cost than the bill rate without obtaining any of the advantages which it pays for when it raises money through a bond issue.

As regards the second point, clearly a proposal that singles out banks for preferred treatment is open to a charge of favoritism. It can be said, of course, that banks are giving up something under the proposal since they would be required to maintain a Government bond reserve requirement. At times this might prevent some banks from shifting into loans or other securities. In view of the large volume of excess reserves of most banks, however, these requirements are not likely to present much hardship.

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Other similar proposals

Similar considerations apply to other proposals for the achievement of the same end. It is sometimes proposed, for example, that the Reserve banks peg the price of Government bonds, offering to buy and sell unlimited amounts at fixed rates with a small spread. This spread would have to be about as small as the one that occurs in the short-term market, otherwise large losses could still fall on investors buying at the top of the spread and selling at the low.

Let us assume that this were the policy and that the Reserve authorities had convinced the market that they were able and determined to pursue it. To be able to liquidate bonds always at not more than a slight discount from a predetermined, fixed price, would make such bonds the equivalent of short-term investments, both for the Government, which would always be subject to demands for redeeming or buying the bonds, and to the investor, who could always get his principal. Under these conditions large new demands would come into the bond market. Many holders of idle bank deposits would then be willing to hold bonds.

For the Reserve banks to prevent these demands from pushing up bond prices, the Open Market Committee would have to sell bonds. In fact the Committee might sell all its bonds without successfully keeping prices from rising. Those that bought early, before prices rose appreciably above the pegged price, would be obtaining in effect a short-term investment with no risk but bringing a long-term return.

It would be undesirable to place such holders in a favored position. If the Government or some agency thereof is willing always to buy a Government investment at a stated price it would seem proper to put a low rate on the investment commensurate with the absence of risk to the investor.

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