3. Bonds for Sale

SOME MONTHS before the Nazis moved on Poland, the Reserve System, as I have said, took steps to cushion the impact of the war abroad on the government's security market. In April 1939 and then again in June of the same year the executive committee of the Open Market Committee was authorized to buy government securities in amounts necessary to stabilize the market. Since government securities are the dominant factor in the market for capital, it was expected that the stability given to these securities by open-market buying in the event of war would bolster nongovernment securities as well.

The real test of the Open Market Committee's effectiveness to do the pivotal work assigned to it arose, of course, during the war years proper. We were fortunate to enter those years with the Banking Act of 1935 on the statute books; the Open Market Committee as it existed prior to this act could not have carried out its war-financing job. With the Reserve System committed both to support the bond market according to a pattern of rates set by the Treasury and to get such money as was needed at these rates, the System had to operate as a central bank without limitation on its ability or authority to purchase Government securities in the open market. Acts of obstruction that were possible in the open-market arrangement before the Banking Act of 1935 could not be tolerated. Had the bitter-end opponents of that act succeeded in blocking its passage or mutilating its vital parts, their victory would have been a costly one to the government in the war years. More than likely, the pressure of war needs would have led the government to take over the Federal Reserve System, or at least would have forced the needed changes brought about by the Banking Act of 1935.

Still, neither the Open Market Committee nor the Reserve System could by itself control the volume of money created by bank credit. There were deep-rooted defects in the machinery of credit control that had to be remedied. But any effort to do so met steady opposition from the banking system as well as from the Treasury and other banking agencies in the government.

While those of us in the Reserve System examined this recurrent problem of responsibility for maintaining stable economic conditions without the power to discharge our responsibilities, the Federal Advisory Council took an independent line of action. It unanimously endorsed a statement in the fall of 1940 that raked Administration and Reserve policies from stem to stern. Publication of the Council's attack would have proclaimed an open breach in the Reserve System, but thanks to the agreement reached in November 1934, the Board of Governors had a chance to review the statement before it was released to the press.

After several months of argument a substitute statement was drafted. It was unanimously agreed to by the Council, the Reserve Board, and the presidents of the twelve Reserve banks, and was thereafter sent as a special report to Congress. This was the first time in the history of the Reserve System that anything of the sort had occurred. The report, we explained to Congress, was for the purpose of drawing attention "to the need of proper preparedness in our monetary organization at a time when the country is engaged in a great defense program that requires the co-ordinated effort of the entire nation."

Following a general statement describing the economic effects of the defense program, the report submitted for congressional consideration a proposed course of action that would tend to reduce potential inflationary pressures. It called for a grant of additional powers to the Federal Reserve System to raise reserve requirements, along with changes in the way those powers could be applied; measures that would eliminate or reduce potential additions to bank reserves through gold and sil-

ver acquisitions; adoption of a fiscal policy by which the larger part of government expenditures would be met by tax revenues, combined with the attainment of a balanced budget as the nation's economy approached a full use of its capacity; and borrowing procedures designed to draw upon existing savings rather than the creation of additional deposits through bank purchases.

When this statement was made public, it was called in some quarters "a typical banker's play to get higher interest rates." Others interpreted it as a slap at the President in that it proposed to curb his power to issue greenbacks or devalue the dollar. Within the Administration, Leo T. Crowley, as head of the FDIC, opposed it because it would have put all state banks under the reserve powers of the Federal Reserve System. Jesse Jones, as Federal Loan Administrator, opposed it on the reported ground that he saw no signs of inflation, nor did he "see why we should expect any such tendency." He added: "I am trying to get the banks to lend more. I want to see as much bank credit available as possible."

Henry Morgenthau had read a copy of the report in advance of its release. He held it for ten days, declined to assume any responsibility for it, but made no objection when it was sent to Congress. This last was surprising. Uncontrolled excess reserves offered the Treasury an easy way to dispose of government bond issues. As long as bonds were sold, Treasury officials showed little concern over the inflationary consequences arising from the means used, though the inflation that followed forced them to sell more bonds to finance the government and in the end made everything more costly during the war years.

There was a strange and uneasy silence in the Treasury Department for eight days after the report was made public. Rumors that the Treasury and the Reserve Board were engaged in another of their vendettas were temporarily checked by Steve Early. But then on January 9, 1941, in the course of a press conference, Morgenthau broke the truce and the sniping was on.

A few days before, the price of government bonds had dropped on the market, and accordingly Morgenthau was asked whether he attributed the decline to the issuance of the report.

To this he replied: "I do entirely. It is a fact, not an opinion. Notice the date when he [Eccles] gave out his plan and notice what happened. From the day the statement came out, money started to go up. The decline was absolutely not warranted. There is no reason I know of for interest rates to harden at this time unless some such proposal as that of the Federal Reserve Board should be put into effect."

A correspondent present mentioned talk to the effect that the Federal Reserve plan was "an attempt to take control of the money market from the government and give it to the New York bankers."

Instead of quashing this implication, Morgenthau gave it further currency by answering: "It raises an interesting thought."

He ventured the final opinion that it was doubtful whether Congress would take any steps to implement the proposals presented to it by the Reserve System. In this case, if not in others, events were to prove him right.

Until that press conference all of us on the Reserve Board felt we had done a decent job in the public interest. Following Morgenthau's comments a mood of impotence and frustration settled over us.

Long before the report was made public, I had shown it to the President and explained it was a substitute for the blast the Federal Advisory Council wanted to issue. The substitute draft was in no way critical of the Administration; it was designed instead to assure the public that the Reserve System was on the alert to inflationary dangers, but needed congressional authority to deal with them in advance of the time they became real.

Following what Morgenthau said, it seemed necessary to remind the President of the genesis of our report and of what was done by the Board to protect the Administration and the public

from the unsettling charges present in the original draft by the Federal Advisory Council. We had, in fact, been surprised at how far the Council and the Reserve Bank presidents were willing to go, not only in abandoning the positions they had taken but in embracing the Board's view on any number of important points. They granted it powers to increase reserve requirements of nonmember as well as member banks to as much as 28 per cent in the country banks, 40 per cent in the Reserve city banks, and 52 per cent for banks in New York City and Chicago. They agreed, furthermore, that *when the country approached a condition of full utilization of its economic capacity, the budget should be balanced by increasing revenues from taxation.* Their pet idea had been that the budget should be balanced by slashing to the bone all but defense expenditures, regardless of the level of economic activity.

The Federal Advisory Council never would have agreed to these proposals had the Board ignored the underlying causes of inflationary monetary conditions that were developing or could develop if the huge increases in excess reserves and deposits on hand were further flooded by the President's use of his power to devalue gold and silver, issue greenbacks, and utilize silver seigniorage. The Board wanted the President to surrender these latent powers so as to improve his strategic position vis-à-vis Congress in case he asked for a stronger central-banking mechanism.

It was the foregoing considerations that led me to write this explanatory note to the President on January 17, 1941, following Morgenthau's attack on our report:

> The situation is such on the whole banking and monetary front that unless some planning is done and direction given by the Administration, it will result in still greater confusion and unnecessary friction. The problems and issues cannot be put off, not only because of the urgency of the times and the changed economic outlook, but because the so-called Wagner questionnaire and contemplated hear-

ings by the Senate Committee on Banking and Currency require that we, as well as all other Federal agencies having banking and monetary powers, express our views in great detail and take definite positions on the whole range of problems involved. All of this inevitably points up to the necessity for some common purpose in approach and in developing a realistic program.

Unless I have the benefit of guidance that only you can give to us here, the confused situation makes for complete frustration and discouragement. After seven years of battling for New Deal objectives, I do not propose to give in to the banker viewpoint, and I feel a deep sense of injustice at any such false imputation. It has taken the utmost restraint to refrain from publicly repudiating such intimations from certain hostile quarters.

In his reply to my request for an appointment, Roosevelt set a date in the following week so that we could "have a preliminary talk about this whole subject." He added: "I am confident that it is going to work out all right." I saw the President on January 29 and we discussed the whole subject in detail. But despite Roosevelt's buoyant optimism, matters were very, very slow in "working out all right."

In the course of 1941 we were able to stabilize the government security market by open-market purchases and to curtail consumer demand for durable goods by making installment credit more restrictive. The excess reserves of member banks were reduced as a result of a rapid expansion in bank deposits, money in circulation, and bank credit. A further reduction was effected in the autumn by an increase in reserve requirements of about one seventh for all member banks, effective November 1, 1941. At this time I joined with Morgenthau in issuing a meaningless statement in which we pledged our "co-operation" with each other and with other government agencies in meeting the economic problems ahead.

But as Senator Paul H. Douglas was to say in later years, when Treasury and Reserve Board officials meeting before

him reviewed the record of their "co-operative" policies: "Co-operation! Co-operation! What crimes are committed in thy name!"

An example of this occurred in the early part of the war period. Though excess reserves of member banks had been cut in half during 1941, at the beginning of 1942 the volume of these reserves created by gold inflow that the Federal Reserve sought to control was still close to $3.5 billion, of which $1 billion was held by New York City banks alone. Treasury officials, on the other hand, insisted that the Federal Reserve should do everything in its power to maintain a large volume of excess reserves at the banks, and in fact they argued at one time that the excess reserves of New York City banks should be kept at $2 billion. All this was for the purpose of facilitating the sale of short-term Treasury securities to the banking system at rates of interest approaching zero.

The Treasury's proposal, of course, would have led to absurd results if it had prevailed. It would have put the banks under constant pressure to lend or invest surplus funds that the Federal Reserve would be forcing upon them. It would increase the amount of inflationary financing by the banking system instead of by nonbankers. It would hold interest rates down to a negligible figure and, all in all, would be the most inflationary action that the Federal Reserve System could possibly take.

But as I've said, it was the policy of establishing and maintaining a set pattern of interest rates that was a primary source of difficulty in financing the war and has since led to recurrent disputes between the Treasury and the Reserve System. The full details of the disagreement would fatigue the reader, but perhaps a sense of what was at issue can be gained from the following generalizations:

There were three pivotal rates of interest upon which the pattern of rates for government issues was maintained. They were ⅜ per cent for Treasury ninety-day bills; ⅞ per cent for one-year certificates; and 2½ per cent for the longest-term marketa-

ble government bonds. The rates on all other government securities were maintained in relationship to the foregoing rates. This meant, for instance, that as the ⅞ one-year certificate came closer to maturity, the interest rate it yielded went down and the price of the security went up. Likewise, as all other intermediate and longer-term securities approached maturity, the pegging of the short-term rates forced their rates down and their prices up. This policy of maintaining the pattern of rates lent itself to an abuse that will be described in a moment.

From the very outset of the war-finance effort the Reserve System argued that the rates set for certificates were too low, but especially was that true of bills. We wanted an increase in the rate of these bills so that banks and other investors would be induced to buy and hold them. To the extent that they did not do so, it was the Federal Reserve that would have to buy, and this, of course, would create excess reserves for the banking system. But the stand taken by the Reserve System did not prevail, though the rate set for bills, while still low, represented a compromise with an even lower figure originally set by the Treasury.

What the Reserve System feared might happen did in fact happen. In due course the System came to hold practically all bills outstanding, though the volume of bills was increased enormously from $1.3 billion in 1941 to $17 billion in 1945. They ceased to be a market instrument and became a major factor in creating and maintaining excessively easy money conditions.

By increasing the amount of bills that the Federal Reserve had to buy, the Treasury was automatically able to create excess reserves, without the advice or consent of either the Federal Reserve or the banking community as a whole. The existence of these excess reserves in turn put the banks under pressure to buy Treasury certificates and bank eligible government securities at premium prices, thereby creating the basis for "free riding" by nonbank investors.

Since the banks, and particularly the large nonbank investors,

understood the government's program of requiring the Federal Reserve to support government securities at a fixed pattern of rates, the banks took advantage of the situation by "playing the pattern of rates," and the large investors did likewise in the process of "free riding." The banks played the pattern of rates by selling to the Reserve System (which was the principal buyer) some of the short-term, low-yielding securities as they went to premiums (in line with the pattern of rates) and then purchased the longer-term, higher-yielding securities. This action created high-powered reserve money, out of which the banking system was able to buy six times as many securities from nonbank investors as it sold to the Federal Reserve, and thereby to create a like amount of deposits.

Had the banks been able to sell securities outside of the Reserve System to nonbank investors, the results would have been beneficial because the nonbank investors would withdraw money from banks and, by investing it in government securities sold by the banks, would reduce the amount of bank deposits. Since the short-term securities were ultimately sold to the Reserve System instead of to nonbank investors, the effect was a multiple expansion of money, with a consequent increase in inflationary pressures.

The method used by the Treasury in pricing and selling market securities in each of the war-loan drives, and especially in the Victory drive, was responsible for the outrageous profits made by numerous individuals and corporations who took advantage of "free riding." The Treasury priced securities in relation to the pattern of rates maintained by the Federal Reserve, so that they would sell at a small premium when offered. This naturally brought about heavy oversubscriptions. Moreover, the oversubscriptions were encouraged by banks who lent billions of dollars to their customers for the purchase of new securities, especially bonds. The interest rates on the loans were less than the yield on the bonds.

Since the securities purchased in previous drives were of

shorter maturity than the newly offered securities of a like rate, they had to go to a premium in relation to the new securities, which were held at par. Thus the premiums induced investors to sell to the banks the bank-eligible securities they bought in previous drives, and to buy new securities, which in time also went to handsome premiums, and so on in an endless chain. While the Treasury would not permit the banks to subscribe directly to war-drive offerings, the banks nevertheless secured indirectly at premium prices the eligible securities they wanted to hold.

Countless corporations as well as individuals made a great show of their patriotism in subscribing heavily to each of these war-loan drives; but the process I've been describing, whereby they sold their holdings to the banks or to the Federal Reserve on the eve of drives or between them gave them a substantial profit for their patriotism. It created the further illusion that Treasury efforts to get nonbank investors to buy the various offerings were highly successful, as witness the fact that all loan drives were heavily oversubscribed. Why should they not have been oversubscribed when the purchaser was guaranteed a profit for taking no risk?

All these practices were officially frowned on by the Treasury as well as by the Federal Reserve banks. The war-loan drives were policed with a view of discouraging purchases in excess of amounts that could be paid for without borrowing. But the war-loan organization of the Treasury that actually sold the securities was anxious to reach or exceed established quotas; in actual practice it showed no enthusiasm for checking speculative buying. It also vigorously opposed any attempt to eliminate from the drives the type of securities that were most susceptible to "free riding." Thus it was impossible for the Federal Reserve banks to do an effective policing job.

An analysis of the amount of securities sold in all of the eight war-loan drives to different groups of investors and the changes in the amounts they actually held over the period as a whole

points up the true picture of war finance. Whereas all nonbank investors during drives bought about $147 billion of government securities, the actual increase in their holdings of all types of publicly held government securities was only $93 billion. The latter amount included (in addition to purchases during drives) savings bonds, savings notes, and other securities that were bought between drives. The commercial banks, on the other hand, which were permitted to subscribe for only $10 billion during drives (all of which were in the first two war-loan campaigns) increased their holdings by $57 billion in the period, and the holdings of Federal Reserve banks increased by $18 billion. Clearly, then, various nonbank investors subscribed for securities during the war-loan campaigns which they did not long retain. This was true of all groups of investors, but corporations and associations (other than insurance companies) appear to have been the greatest culprits. While they subscribed during the drives for something like $60 billion of securities, their holdings actually increased by only $19 billion, or about one third. Insurance companies retained about two thirds of their subscriptions, and savings banks over one half.

The shifting operations reached a climax in the last Victory Loan drive. This campaign started off modestly. It had a goal of only $11 billion and an objective of offering securities that would be taken primarily by nonbank investors. The total sales to nonbank investors in this drive were approximately $21 billion. But in the period between December 1945 and February 1946, covering the Victory Loan drive, total holdings of nonbank investors increased by $10.7 billion, whereas the holdings by banks increased by $8.1 billion. (The difference between the total sale of $21 billion and total holdings of $18.8 billion was represented by cash redemptions.) It is clear once again that the drive actually resulted in a large increase in government-security holdings by banks—which was unnecessary, because the Treasury did not need the funds and used them later to retire debt.

To sum up, the Treasury's much-heralded success in financing

the war is open to serious challenge. The bankers, of course, were delighted with most aspects of Treasury financing, as were government bond dealers and the brokers. The practices followed ensured them a windfall of profits, as they did to countless corporation and insurance companies. A substantial part of the buying did not come from genuine savings; it came from money created by the banking system through the very process of buying the securities held by nonbank investors. This method was as inflationary as a sale of securities directly to the banks. Moreover, it carried with it undue profits to groups of speculators, who, in effect, violated the principles upon which war finance was supposed to be conducted.

Those of us in the Federal Reserve made suggestions to remedy the evils connected with war-loan drives. We did not propose to raise the *general* level of interest rates during a period of large deficit financing. On the contrary, we believed that if our proposals were adopted, the result would be a lowering in the over-all interest cost to the Treasury. What we wanted to do specifically was to end the speculative and demoralizing effect of "free riding" and to limit the amount of indirect purchases banks could make. Certain members of the Federal Open Market Committee were particularly helpful and constructive in developing plans the System recommended to the Treasury for financing the war and in managing the public debt. They were Allan Sproul, president of the Federal Reserve Bank of New York and vice chairman of the Federal Open Market Committee; Dr. E. A. Goldenweiser, the economist for the committee and the distinguished director of research for the Federal Reserve Board; Dr. Woodlief Thomas, the Board's able assistant director of research; and Robert Rouse, the manager of the government bond portfolio for the System's Open Market Committee.

It should be said of Sproul that we sometimes disagreed over policy matters, but our differences were never marked by personal acrimony. Despite the fact that he had been elected to his

post at the head of the New York Reserve Bank by the action of its board of directors, six of whom were elected by the banks of the district, Sproul was and is first and foremost a representative of the public interest. He has sometimes argued the case of the banks, but he has just as often argued against them. He has been and is a tower of strength in the Reserve System.

As for Dr. Goldenweiser, the Reserve System had in him a man of great imagination and independence of thought. He was highly respected and his influence was felt not only within the Reserve System but in all other quarters.

The principal suggestions we made to revise the wartime system of finance were these:

First: We urged that no bank-eligible securities should be offered during drives. This would have largely, if not entirely, prevented "free riding" and playing the pattern of rates, since there would have been a much more limited market for resale of securities at premiums.

Second: We urged time and again that nonmarketable issues of securities be offered for large investors. This was to be in addition to the Series E, F, and G bonds, which were available for small and medium-sized investors, and the tax savings notes, which appealed primarily to corporations. It was in December 1941 that I first urged that this be done. A similar suggestion was formally submitted to the Treasury by the Open Market Committee in January 1942. At the same time the suggestion for a short-term nonmarketable, redeemable issue was made, and this was later adopted in the form of the savings notes.

The proposal for a long-term nonmarketable issue, however, was not adopted. After it became evident that bank-eligible issues being offered in war-loan drives—though not available for purchase by banks at the outset—later came into the banks through resale, we suggested that the nonmarketable issues be offered in the drives in lieu of marketable issues. The advantage of such an issue was that it could not be shifted. The disadvantage from the standpoint of those who wanted large sales

during drives was that these issues would be more difficult to sell, or at least so it was claimed. But the ones that were easy to sell—the marketable securities that could be resold to banks—were precisely the ones that defeated the main purpose of the war-loan drives.

Third: As I've said, the Federal Reserve recognized that some additional securities had to be purchased by banks. We therefore suggested that bank-eligible securities should be offered to banks between war-loan drives, with the subscriptions limited to the amounts actually needed by the Treasury. We further suggested that there should be fewer 10-year 2-per-cent bank-eligible bonds and more shorter-term lower-yielding issues. There was considerable pressure, however, from the banks themselves, not only for 2-per-cent but also for 2¼-per-cent longer-term bonds. The program suggested by the Federal Reserve would have made it possible to limit the earnings of banks from government securities more nearly to what the banks needed to maintain reasonable earnings after all expenses were met. This could have been accomplished by offering securities of such maturities and rates as would have assured the banking system reasonable profits, but would have prevented the excessive profits which many banks were able to make through their operations in the government securities market. Under practices that were actually followed, they obtained large profits not only by buying and holding 2-per-cent bonds from nonbank investors who had purchased them during drives, but also by buying shorter-term issues and later selling them to the Federal Reserve at premiums as they approached maturity.

The question has been asked whether the Federal Reserve proposals, if adopted, would have resulted in raising as much money as the Treasury needed or whether they would have been effective in reducing bank purchases of securities. There are those who say that if more restrictions had been placed on purchases, sales would have been smaller and in the end the Treasury would have had to resort to the banks to get the vast sums

of money that were needed. They also say that the Treasury's method did in fact induce many more nonbank investors to buy securities and retain them than would have been the case if some other procedure had been used.

This conclusion seems highly questionable to me. During the war nonbank investors had limited opportunity for the favorable investment of their money except in government securities. Nonmarketable, redeemable issues, if offered, would have provided protection against price fluctuations at a time when there was no definite assurance that marketable issues would be permanently protected against price declines. Those issues, therefore, would have been popular. Besides, it is demoralizing to finance the government by depending upon the opportunity for speculative gain in violation of stated rules.

All this apart, there was no reason whatsoever to question the ability of the Treasury to sell securities in amounts that were needed. The Reserve System had a tremendous capacity to purchase securities and to supply banks with reserves that would provide the basis for manifold purchases by them. We believed that a much more vigorous effort should have been made to sell securities to nonbank investors, and to sell them in such a way as to discourage resales to banks. In the absence of that effort, Treasury procedures set the stage for speculative profits. They encouraged investors to sell to the banks, and thus they indirectly forced the Federal Reserve System to buy more than would have been necessary had the System's proposals been adopted. This added to the money supply and the postwar inflationary pressures.