October 29, 1943

Chairman Eccles

L. M. Piser

I have had copies made of the attached letter and memorandum for distribution to the Board if you approve. Is there anything further that you would like me to do about this question?

10/30/43
Approved

Chairman Eccles

COPY

FEDERAL RESERVE BANK OF NEW YORK

October 27, 1943

Hon. Marriner S. Eccles, Chairman,
Federal Open Market Committee,
c/o Board of Governors of the Federal
Reserve System,
Washington, 25, D. C.

Dear Marriner:

At the recent meeting of the Federal Open Market Committee, there was a continuation of the discussion of credit policy and Treasury financing which began at the meeting of the Executive Committee of the Federal Open Market Committee on October 13th. In the light of this latest discussion, and of the memorandum on "Treasury Bills and Certificates" which you distributed at our latest meeting, I have set down my further views in outline form. A copy of memorandum containing these views is enclosed.

Yours sincerely,

Allan Sproul, Vice Chairman,
Federal Open Market Committee.

Enc.

FURTHER NOTES ON CREDIT POLICY AND TREASURY FINANCING

1. Rise in short-term rates will validate present long-term rate, which must be maintained. Main reason for low short-term rates is the belief that a rise in long-term rates is likely.

2. Some validation of long-term rates is, in fact, taking place in market. Fear of stability of longer-term rates is declining and funds are going out of shorter securities into longer-term securities in order to obtain higher yields. In other words, short-term rates are already tending upward and intermediate term rates are tending downward.

3. Financing and credit program should now permit rise in short rates and offer more securities of longer term (notes, short, intermediate and long bonds).

4. Have to take account of fact, however, that market and public do not clearly understand these rate relationships. Too drastic or sudden changes at short end of maturity schedule would run the risk of disturbing or shaking confidence in longer-term rates.

5. Suggested that bills now be issued having 120 days to run and buying rate be fixed at 5/8 of 1%.

6. This would have the following advantages:
   (a) Maintains existing pattern of financing and types of securities. Too much monkeying with the machinery, which on the whole is working successfully, is undesirable unless the risk is offset by great prospective gains.
   (b) Will permit some adjustment in amount of weekly bill offerings, if necessary, without change in aggregate amount now outstanding. There will be some mechanical difficulties involved in going from a 13-week bill cycle to a 17-week bill cycle, but these difficulties can be overcome.
   (c) Will help obtain wider distribution of short-term securities among smaller banks which have existing excess reserves and whose deposits are increasing most rapidly - combination of a 5/8% bill and 7/8% certificate would unquestionably have wider distribution than one intermediate issue such as a nine months 3/4% bill.
   (d) It would raise cost to banks of "borrowing" through bill window above cost of advances at differential rate of 1/2%. Advantage of being able to borrow (by means of purchase and repurchase agreement) without showing bills payable would offset disadvantage of cost for enough banks to keep bill afloat. Meanwhile, however, a desirable incentive for increased and admitted borrowing would be created.

      One of the weaknesses of the 3/4% bill, proposed to replace outstanding bills and certificates, is that, while it also would increase the cost of concealed borrowing, it would greatly increase the volume of securities which could be used for "borrowing" without showing bills payable.
   (e) It would narrow the spread between short and long-term rates which is now desirable from the standpoint of:
      (1) Validating the stability of the long-term rate.
      (2) While at the same time reducing the incentive for banks to invest at the longest term (and highest yield) possible.
      (3) Moderating abuse of the pattern of rates. Nothing which has been suggested, nor which can be suggested, will eliminate abuse of pattern of rates (which, up to the present, has been relatively minor in

volume), so long as an artificial pattern of rates is maintained, based on gradually rising yields as maturity lengthens (which means gradually rising prices as maturities shorten).

The proposed 3/4% bill would do nothing more to abate this abuse. It would eliminate the steep forepart of the rate curve by making the rate from one day to nine months, 3/4 of 1%, but equal or greater profits would be obtainable at the higher yields farther out on the curve. Playing of the pattern of rates could go on just as before, based on this new peg, and in whatever maturities suited the risk-taking desires of the players.

The only cure for abuse of the pattern of rates would be a further narrowing of the spread between short-term and long-term interest rates. This the 3/4% bill fails to do - it merely picks a new place in the existing rate curve at which to put in our peg.

* * * * *

Note: The argument that the System is encouraging the expansion of bank credit at a 5 to 1 ratio by purchasing bills from banks which, in turn, buy certificates and longer-term securities, seems to be based on a misapprehension, to wit: that the System has been making more reserves available than was required by the increase in currency in circulation and the increase in deposits requiring reserves. This is not the case. During the present year currency circulation alone has increased $3,635,000,000 while System holdings of Government securities (in all accounts) have increased only $2,652,000,000.

A.S.

10/26/43