December 13, 1945

Honorable Daniel W. Bell,
Under Secretary of the Treasury,
Washington 25, D. C.

Dear Dan:

I am enclosing herewith a copy of a letter, sent to the Secretary today, with reference to the preferential discount rate. You will recall that I talked with both you and the Secretary about this matter on the telephone.

Sincerely yours,

M. S. Eccles, Chairman,
Federal Open Market Committee.

Enclosure.

LMP:pb

December 13, 1945

Honorable Fred M. Vinson,
Secretary of the Treasury,
Washington 25, D. C.

Dear Mr. Secretary:

The enclosed is the letter with reference to the preferential discount rate about which I spoke with you on the telephone on Tuesday.

Very truly yours,

M. S. Eccles, Chairman,
Federal Open Market Committee.

Enclosure.

LMP:pb

December 13, 1945

Honorable Fred M. Vinson,
Secretary of the Treasury,
Washington 25, D. C.

Dear Mr. Secretary:

You will recall our exchange of correspondence last summer with respect to the increase or elimination of the preferential discount rate of 1/2 per cent on member bank borrowings at the Federal Reserve Banks collateralled by Government securities due or callable within one year. At that time, action, upon which all of the Federal Reserve Banks and the Board of Governors were agreed, was deferred in deference to your wishes in a period when we were still at war and a large program of war financing still loomed ahead.

With the completion of the Victory Loan, and with Treasury needs for funds during the coming year or longer largely anticipated, it seems to me, and to the other members of the executive committee of the Federal Open Market Committee, that an especially favorable opportunity is provided to eliminate this preferential discount rate. The preferential rate was established as a war measure at a time when an increase in bank holdings of Government securities was necessary and some encouragement of bank borrowing to obtain reserves or to adjust reserve positions was desired. The establishment of the rate was a temporary measure designed to meet a special situation, and it was felt at the time that the rate should be eliminated when need for it had passed. This feeling has been strengthened by the increasing tendency of banks to purchase larger amounts of Government securities than are required to assure the success of Treasury financing and by the tendency of some banks to maintain larger holdings of Government securities than they could hold with their own funds by borrowing from the Federal Reserve Banks at the preferential rate.

Now that war financing has been completed and the Treasury will not need to raise new funds for a considerable period of time, the conditions that prompted the establishment of the preferential rate no longer exist, and the continuance of the rate can no longer be of service to the Treasury's financing program nor to the maintenance of credit policy. The elimination of the rate need have no influence on the aggregate cost of future Treasury refunding, however, because that will be determined by Federal Reserve support of the Government security market through open market operations.

The preferential rate not only has passed its period of usefulness, but is an element of weakness in our battle against inflation, because it serves as a continuous invitation to banks to bid away from nonbank investors the bank-eligible Government securities previously acquired by nonbank investors or purchased by them in war loan drives. The preferential rate encourages and makes it profitable for banks to borrow in order to purchase Government securities. As a result it encourages the expansion of bank credit, particularly through purchases from nonbank investors of the longer-term, higher-rate obligations. I think that we are all agreed that a further expansion of bank credit is to be avoided at this time, if at all possible. Now, a step can be taken in this direction by the elimination of the preferential rate with little or no disturbance to the banking system, because member bank borrowings are small and their excess reserves are large. The reasons for abandonment of the rate seem compelling, since it is no longer required in the interest of war financing.

I am writing you about this matter, for your information, because I am sure that all of the Federal Reserve Banks will soon be reconsidering the elimination of the preferential discount rate and that the Board of Governors will wish to approve such action.

Very truly yours,

M. S. Eccles, Chairman,
Federal Open Market Committee.

THE SECRETARY OF THE TREASURY
WASHINGTON

DEC 29 1945

Dear Mr. Eccles:

I have read with interest your letter of December 13, 1945, in which you state that the Federal Reserve Banks are considering eliminating the preferential discount rate of 1/2 percent on Government securities maturing or callable in one year or less, and that the Board of Governors may wish to approve such action.

Last July, when the Reserve Banks and the Board of Governors were contemplating the elimination of the preferential discount rate, I wrote to Acting Chairman Ransom and said in part:

> "I recognize, of course, that the fixing of discount rates is a statutory prerogative of the Board of Governors and of the Federal Reserve Banks. We have both always recognized, however, that it is necessary, for the duration, to work as a single team in financing the war in the best possible manner. I am sure, therefore, that you will be willing to continue the present preferential discount rate and the present policy with respect to short-term rates as long as it is required in the interest of sound war finance."

Since that time the war has ended, and the Victory Loan campaign has been successfully concluded. It seems to me, however, that the continuation of the preferential rate is as important to the successful financing of the transition period, and to the maintenance of full production and full employment in the postwar period after the close of the transition as it was to the successful conclusion of war finance. I feel sure that upon considering the matter further you will agree with me.

The primary effect of eliminating the preferential discount rate would be to increase short-term rates of interest. This is the principal purpose attributed to it in the financial press, and, as you know, the rumor last July that the rate was to be eliminated or increased was immediately followed by a decline in the prices of Government securities of all maturities.

It seems to me that a rise in short-term interest rates at the present time would be unfortunate. It would increase the already large interest charge on the public debt, and most of this increase would go to increase the already high earnings of banks in the principal financial centers, where short-term securities are largely held.

Moreover, it is by no means certain that an increase in short-term rates would not spread to long-term ones. As I have already mentioned, the rumor last July that the preferential rate was about to be eliminated, or increased, resulted in a decline in the prices of Government securities of all maturities. Also, you will recall that the restrictive actions taken by the Federal Reserve authorities in 1937, although designed to increase short-term interest rates only, actually increased all rates. An increase in long-term interest rates, while it would be of no assistance in combating inflation during the transition period, would make it much more difficult for the economy to attain full production and full employment in the later postwar period after the present backlog of consumer demand and urgent investment projects has been worked off.

The statistics indicate that member banks have not abused the preferential rate by borrowing in order to carry Government securities bearing a higher rate. At the present time total member bank borrowings from the Federal Reserve Banks are equal to only about 1/2 of one percent of member bank holdings of Government securities. At no time during the war have they risen as high as 1-1/2 percent of these holdings. This is not surprising, since, as we both know, commercial banks in the United States have a strong and healthy tradition against borrowing from the central bank for the purpose of obtaining an interest differential.

For the reasons which I have just given, it is my sincere hope that the Reserve Banks and the Board of Governors will not see fit to eliminate the preferential discount rate at this time. I shall be glad to discuss the matter with you.

Sincerely yours,

Fred M. Vinson

Honorable M. S. Eccles
Chairman, Board of Governors
of the Federal Reserve System
Washington 25, D. C.