

FEDERAL RESERVE BANK
OF NEW YORK

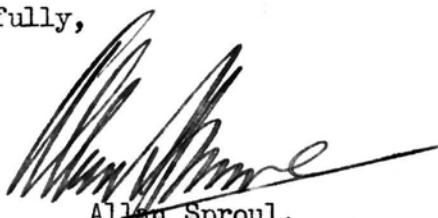
January 2, 1942.

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

Dear Chairman Eccles:

Enclosed are two memorandums on Treasury financing. One is an aide memoire covering the meeting of the Executive Committee of the Federal Open Market Committee with certain members of the Treasury staff on December 18, 1941. The second is an outline of a proposed Treasury financing program, which, I think, naturally follows up our discussions with the Treasury, and is tailored to the present situation. Would it not be desirable to send copies of these memorandums to the members of the Federal Open Market Committee, for their information, preparatory to an early meeting of the Committee.

Yours faithfully,



Allen Sproul,
Vice Chairman.

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TREASURY FINANCING

The entry of the United States into the war makes necessary the adoption of a financing program which will be recognized as equal to the task imposed by our expanded programs of industrial production and military action.

Our experience in the last war, the experience of other countries in this war, and our present capacity for the management of the monetary and credit resources of the country, all indicate that this program should not be cast in the old pattern of rising rates of interest as the war progresses. Some measure of price fixing is required in the field of credit, just as in other fields, when the government is the principal borrower in the market and the cause of its borrowing is the defense of our national existence.

It is, therefore, desirable, and the existing situation in the money market and the government security market makes it practicable, to determine, establish, and make known a pattern of rates for United States government securities which will fix, for the present, the general terms of Treasury financing. The main outlines of a financing program embodying this general idea are as follows:

- I. The maximum rate on Treasury borrowings (obligations other than Series E Savings Bonds) should be fixed for the present and for the foreseeable future at $2 \frac{1}{2}\%$.
- II. A security should be offered at tap, bearing a $2 \frac{1}{2}\%$ coupon, which will be available to institutional and individual investors in unlimited amounts and to banks in proportion to their time or savings deposits, until the tap is closed by the Treasury. It must be possible to maintain the price and yield of such an issue without giving it demand status, and such an issue must be sufficiently differentiated from outstanding open market issues so that the tap issue and open market issues can exist side-by-side without large scale arbitrage. This calls for either the fixing of minimum prices at which such a tap issue could be traded (British practice) or restrictions on negotiability and provision for redemption as in the case of our Series E, F and G Savings Bonds. It is not believed that the structure of our widespread markets lends itself, at least for the present, to the fixing of minimum prices. On the other hand, the market has been conditioned to offerings of restricted negotiability with provision for redemption, although it has expressed concern over the

amount of the demand liabilities which the Treasury might assume if such issues were continued and expanded. 10

It is suggested that a tap issue having the following general features would meet the needs of the present situation:

coupon: $2 \frac{1}{2}\%$;
maturity: 15 years;
redemption: at face value with interest adjustment (as in the case of Series E, F and G Savings Bonds) on one year's notice after bond has been held for six months;
negotiability: may be used as collateral for loans at Federal Reserve Banks, discount rate to be the coupon rates of the bonds. This facility would be provided in order that unforeseen but urgent demands for funds, on the part of investors, could be met pending redemption of the bonds.

III. In so far as it is necessary to use bank credit in financing the Treasury's needs, new money should be sought from banks with short-term issues. The amount of Treasury bills outstanding should be increased presently to \$2,600,000,000, with further increases contemplated. Other issues offered for subscription should be notes and bonds with maturities not exceeding ten years. It would be contemplated that rates in this area could rise somewhat without interfering with the maintenance of a $2 \frac{1}{2}\%$ ceiling on long-term rates, but that a generally easy money situation would be maintained. This does not contemplate the continuance of the excessive volume of excess reserves which has characterized recent years. It does contemplate that when excess reserves have shrunk to more manageable proportions, they will be maintained in sufficient volume to enable banks to assist the Treasury's financing to whatever extent is necessary.

IV. The Defense Savings bond program should continue to be pressed on a voluntary basis. If the system of voluntary pledges does not produce the required results, however, some system of forced savings should be devised.

This program, to be successful, must have its counterpart in further increased taxes and, if possible, in reduced non-defense expenditures of the government. It also requires for success, particularly in the face of declining excess reserves

1. that there be a change in attitude on the part of banks as to the need for, and desirability of, large excess reserves which have really only been a part of the banking position for the past ten years. In the case of individual banks, this should extend to restoration of the respectability of borrowing from the Federal Reserve Banks;

2. that the fluidity or use of all funds which are available in any part of the country be facilitated so that they may be brought to bear on the government security market;
3. that the determination of the monetary and credit authorities to see to it that ^{an}adequate supply of funds is always available to permit Treasury financing at satisfactory rates be unquestioned.

The general outlines of the program must, therefore, be made clear to the public. Fortunately, the public in general, and the investing public in particular, is prepared for this transition to wartime financing. A statement by the Secretary of the Treasury correlating his tax program with such a financing program should be made as promptly as possible, and should be supported by a statement from the Federal Reserve System pledging a credit policy which will be consistent with the Treasury's program.

1/2/42.

MEETING OF EXECUTIVE COMMITTEE OF FEDERAL OPEN MARKET COMMITTEE
WITH TREASURY STAFF, DECEMBER 18, 1941.

By arrangement between Chairman Eccles and Under Secretary of the Treasury Bell, the Executive Committee of the Federal Open Market Committee held a meeting with certain members of the Treasury staff (Messrs. Morris, Haas and Murphy) on Thursday morning, December 18, 1941. Mr. Bell was unable to attend the meeting, having been called to appear at a Senate Committee hearing, subsequent to his having arranged the meeting. A meeting scheduled with the Secretary of the Treasury for the afternoon of the same day was cancelled at the request of the group, inasmuch as there had been no agreement on a policy or program which might be submitted to the Secretary. It was the expressed attitude of the representatives of the Federal Reserve System, who were present, that their views, both when they agreed and when they differed with one another, had been fully presented; and that the Treasury, which in any case bears the final responsibility should now formulate a program might then be further discussed.

Discussion at the meeting centered about the idea that our entry into the war and the existing situation in the money market and the government security market made it desirable and practicable to determine, establish and, as far as possible, to make known a pattern of rates for United States government securities. This was presented as the unanimous view of the Federal Reserve System. The range of rates included in such a pattern of rates was considered to be from about 3/8 or 1/2% to 2 1/2%, although it was believed that the lower limit of rates could have some flexibility without disturbing the long term rate. The establishment and maintenance of such a pattern of rates, in the face of declining excess reserves, was recognized as involving:

1. Financing the war effort as far as possible through taxation, through sales of securities to investors and investing institutions other than banks, and through sales of savings bonds to individuals of relatively small means, which siphon off increased consumer purchasing power and reduce the demands of the Treasury on the open market.

2. Some change in attitude on the part of banks as to the need for and desirability of large excess reserves which have really only been a part of the banking position for the past ten years. In the case of individual banks, this should extend to a restoration of the respectability of borrowing from the Federal Reserve Banks.
3. Promotion of the fluidity or use of all funds which are available in any part of the country so that they may be brought to bear on the government security market.
4. Acceptance of the view that in one way or another the monetary and credit authorities will see to it that an adequate supply of funds is always available to permit Treasury financing at satisfactory rates.

Much of the time of the meeting was taken up with a discussion of how the recent issue of $2\frac{1}{2}\%$ bonds of 1967-72 should be treated in establishing a pattern of rates, it being recognized that, while this might not be the most important aspect of the program, it is the one which is most likely to demand an early decision. One view was that the $2\frac{1}{2}\%$ bond of 1967-72 should be supported at par indefinitely. A second view was that we should drop back to the 20-year range for long term borrowing at $2\frac{1}{2}\%$ which would mean, roughly, that the new issue might be supported at about 98, a 20-25 year $2\frac{1}{2}\%$ bond would sell at par, and a 15-20 year $2\frac{1}{2}\%$ issue would sell at a premium of perhaps $1\frac{1}{2}$ points. A third view was that there must be some possibility of fluctuation in price downward as well as upward and that support should be given in such a way as to make this possible. This latter view was allied with the problem of keeping a pegged market from becoming a demand market, so that, in effect, purchasers of the long term $2\frac{1}{2}\%$ Treasury bonds would not obtain $2\frac{1}{2}\%$ interest on an obligation which they could "redeem" at any time, on demand, without risk of loss of principal.

The further analysis of the problem which was afforded by the discussion should make it possible for us to recanvass our views and to propose a financing program which draws upon this discussion and earlier discussions for its main outlines.