C O P Y

Federal Reserve Bank of New York

Copy

October 13, 1942

Mr. A. H. Williams, President,
Federal Reserve Bank of Philadelphia,
Philadelphia, Pa.

Dear Mr. Williams:

Thank you for sending me a copy of your bank's memorandum on the "Supply of Reserve Funds and Change in Discount Rates." It is a good job.

As you might expect my only real difference with its findings is on the question of preferential, or, as I now prefer to call them, differential discount rates. I would agree that differential rates may not be soundly used under ordinary peace time conditions, with bank credit being extended for a variety of purposes (as distinguished from the present situation in which credit expansion is almost wholly related to war needs), but they seem to me to be quite suitable to the present situation. In other words, it would be a war measure with no necessary long range implications.

In other words, I see little likelihood of the abuse of a differential rate at this time and the possibility of some advantage - more particularly the encouragement of investment in short term Treasury obligations by banks which still have substantial amounts of excess reserves. I question such statements, therefore, as that on page 10 of your memorandum that "to emphasize very short maturities under these conditions is to speculate upon a rise in the rate on longer term Governments." I think it may better be argued, as we have in the case of Treasury bills, that it is desirable to hold short governments rather than idle cash and that the danger is not of a speculation against a rise in interest rates, but of a speculation against a "pattern of rates" which enables the buyer, if he wishes, to buy long term securities, take the long term rate of interest, and sell them out at will with our protection against market risk. I am not alarmed, either, by the possibility of "unwise spacing of maturities through excessive emphasis on short term securities." I think it is more likely that the banks, and particularly the smaller banks, will continue to place the most emphasis upon high rates of income rather than maturities. They will have in mind the cost of time deposits and will not be unduly rushed or forced into short term securities by a differential discount rate. Finally, there is the question of favored treatment and discrimination. I cannot see why it is discrimination to have a lower discount rate available to a bank which has reduced the average rate of return on its government security portfolio by investing some of its funds in short governments as contrasted with a bank which has kept up its earning rate by buying all intermediate or long governments. And even in the latter case, government securities originally of longer maturity will regularly be coming within the period of one year to call or maturity, so that almost all banks will have some of the paper carrying the lower rate.

There are one or two other points in the memorandum which I might mention. The statement on page 6 that "the reduction can be accomplished only through sales of such securities" overlooks the possibility of allowing securities to run off at maturity without replacement. The conditions under which this might be appropriate, namely, a boom situation in which maintenance of high taxes and curtailed government expenditures should produce a surplus of Treasury income, would make use of the method possible. Similarly, our experience indicates that the sentence starting at the end of page 7 regarding changes in discount rates is not wholly accurate. We have found that the process of extending credit cannot be reversed in short order through increases in discount rates. A more likely development is a rise in money rates which only gradually has a retarding effect on the expansion of bank credit and consequently on the need for Federal Reserve credit. Finally, it is indicated I think in the text, and certainly in appendix B, that the effect of purchases of securities in the open market are confined primarily to money market centers. This is not necessarily the case, although a considerable part of the funds made available through open market operations ordinarily do go into money market centers in the first instance. In the recent past, however, substantial amounts of government securities have been sold to the System Open Market Account from all parts of the country, benefitting banks outside of the money market centers as well as those in the centers.

I think we have sent you as we prepared them any memoranda which we have written on this general subject.

Yours faithfully,

ALLAN SPROUL (signed)