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Background for Treasury Financing

In order to approach present financing and Government security market problems in a rational way it is necessary to have clearly in mind certain developments which have changed the situation radically from the way it was when the easy money policy and later the pattern of rates were adopted. Briefly stated the situation at the present time looks as follows:

(1) Monetary ease is no longer reflected by the outstanding volume of excess reserves. The reason for this is that money market banks have been persuaded by us that bills are as good as cash. For this reason they will hold no excess reserves, but will put all their idle funds into Government securities with the assurance that the bills that they already hold provide them with such liquidity as they may require.

(2) We have educated the banks to consider bills as cash and very rapidly they are beginning to think of higher yielding securities as cash also. It has spread so far only to certificates but the hesitancy about longer-term securities will probably also begin to weaken. Once the banks have been persuaded by the System and by the Treasury that Government securities are cash, that will become a commitment from which the Government could not recede in good faith. It will raise serious problems after the war because it will make it completely impossible to tighten the money market in any way at any time while a huge public debt is held by banks, insurance companies, trusts, etc.

(3) The existing spread from three-month bills to long-time bonds is too wide. It represents the freezing of an entirely unusual situation-- one characterized by the fact that money was extremely easy, reserves were plentiful, and demands small, and assurance that long rates will remain low was not established. The spread is completely inconsistent now and attempts to sustain it result in giving banks more and more reserves with which to buy higher yielding securities with the consequence that longer-term rates are declining. The chart shows that bond rates have been working down while yields on notes started upward in 1942 and went up throughout that year. Bills tended the same way, but were frozen at 3/8. Since that time the floor has been levelled, but the ceiling has been sagging. The pattern cannot be sustained by anything we can do. The question is shall we let the spread diminish through a decline in the long rate or through an advance in the short rate? The argument that stiffening the short rate would result in stiffening the long rate is out of touch with the facts. What would happen if the short rate stiffens is not that the long rate would advance but that it would no longer sag.

(4) It is consequently not realistic to say that the volume of excess reserves must be maintained in the market. As already stated, that cannot be done. Nor is it good sense to give the market more bills when

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the market is refusing to buy what is being offered and to do so on the ground that this would provide enough bills not only to meet existing maturities, but to pass on to the Federal Reserve a constantly increasing volume of them. At the present rate the banks would be foolish to and would not buy the bills. They would use the reserves so created to buy higher yielding securities with the consequence that the ceiling would continue to sag. Since last summer the banks have reduced their bill holdings by $1,400,000,000 and have increased their holdings of certificates by $2,300,000,000 and of bonds by $2,000,000,000

(5) There is only one rational approach to this problem, unless we want to have the long-term rate go still further down, and that is to let the short rate advance by adopting one or the other of the proposals made by the System. Direct increase of the rate on short bills with some increase in length of maturity, as proposed by the New York Bank, or elimination of 3-month bills and of certificates and the substitution of 9-month bills, as proposed by the Board, would both have the effect of establishing a higher minimum rate in the market. The arguments on the various points involved in the two plans were discussed in another memorandum.

(6) It is, of course, recognized that the Federal Reserve will have to supply all the reserves that the banks may need. Some of the reserves supplied during this year were for the purpose of meeting the demand for currency. Increase in reserve requirements due to growth in deposits has not occurred because of the exemption of war loan accounts from reserve requirements. The best way for the Federal Reserve to supply the market with the reserves it needs is to keep its buying rate and its option agreement on bills, provided the bill rate is adjusted upward. This would encourage the banks and some others to buy bills, rather than search for higher yielding securities with a consequent depressing effect on these yields.

(7) In order to eliminate from the discussion the question of the expansion of Federal Reserve revenue that would be an incidental result of an increase in short-term rates, arrangements should be made by which the bills that will be allotted to the Federal Reserve on direct bids would carry a rate no higher than the present 3/8 per cent. Federal Reserve Banks should arrange to bid every week for at least the amount of bills in their portfolios that mature each week.

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