BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

CONFIDENTIAL

Office Correspondence

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To Chairman McCabe

Subject: Rumors about Treasury views on current refunding

From Woodlief Thomas

Reports indicate a growing feeling in the Government securities market that the Treasury will not offer a 1-1/2 per cent issue in March, that likely issues are a 16-month 1-1/4 per cent note and a 1-3/8 per cent note. These reports are based on conversations between investment bank representatives and Treasury staff, in the absence of Secretary Snyder.

The result has already been an increase of interest in bonds by banks. Many of them were in the market on Friday. It is questionable whether new issues of the types indicated will be well received. Banks will increase their efforts to find bonds and will endeavor to sell short-term securities. The Federal Reserve will either have to purchase short-term securities or let the short-rate rise. In other words System support would be needed to make the proposed issues successful.

For the System to endeavor to supply the demand for bonds by sales from its account would not be justifiable under the circumstances. In the first place these sales would prevent corrective downward adjustments in bond yields and, if accompanied by purchases of short securities to prevent upward adjustments in those rates, would only perpetuate the cause of the portfolio shifts by banks, which is the rate differential. Secondly, and of greater importance, the more bonds the System sells, the more short securities it would be called upon to buy to maintain bank reserves, i.e., the more System support will be needed to maintain the market for the new short-term issues.

Selling of bonds recently when additional reserves needed to be absorbed was reasonable, but there is no justification for the System to engage simultaneously in sales of one type of security and purchases of another. Such operations mean merely System interference with adjustments within the market and have little effect on reserves. They are not consistent with a flexible money market policy.

The System should vigorously oppose being forced into the position of having to maintain a market for the new issues. To follow such a policy would simply mean attempting to maintain an artificial structure of rates and preventing the corrective forces of the market from operating. It is difficult to see how that would ever end. Such a situation would be a repetition of that existing during 1946 and the first half of 1947.

<u>What should Federal Reserve policy be?</u>

Dealing with this problem is independent of the matter of policy with respect to bank reserves and also with respect to the general <u>level</u> of interest rates. Three alternative lines of policy with respect to reserves could be followed by the System under existing conditions as follows:

(1) A policy of neutrality, in which case the System should neither purchase nor sell any Government securities, except to the extent needed to offset changes in the supply of reserves, resulting from other factors. This policy would very probably result in rising short-term rates and possibly some decline in long-term rates.

(2) A tightening policy, in which case the System would either endeavor to sell securities if vigorous measures are needed, or would refrain from buying any securities and let market forces bring about higher rates. Some purchases might be made to moderate extreme or temporary reserve shortages. In any event short-term rates would rise.

(3) An easing policy, as during last summer, in which the System would buy securities if necessary to supply reserves and keep money rates down and would not sell bonds, but permit bond prices to rise.

In none of these cases should the System simultaneously buy one type of security and sell another as a matter of regular practice. A few such transactions might occasionally be needed for orderly market purposes.

Meaning for immediate Treasury refinancing.—From the standpoint of the above-outlined policy position and the current market situation, the Treasury at this time should offer either:

(a) A 13-month 1-1/4 per cent note, or

(b) A 1-1/2 per cent obligation of around 5 years.

Banks are going to seek higher interest rates and if such rates are not available on short-term securities, they will buy longer ones. If the Treasury does not meet this demand by a higher rate issue, then banks will bid up prices (and bid down the rates) on existing longer-term bonds and endeavor to sell lower rate issues.

The Federal Reserve should refuse to be put into a position of endeavoring to prevent these normal market forces from expressing themselves.

The basic problem is again the artificial term structure of interest rates. Is the System going to permit the market to determine interest-rate relationships or is it again going to try to maintain the existing pattern by inconsistent operations in the market?

It is not necessarily a question of the level of rates. Short rates are tending to rise while long rates tend to fall. We do not know at what levels they might be considered in balance. It is probably true that from a general viewpoint the level of long-term notes is as low as it should be. Hence short-term rates should be permitted to rise.

The Treasury should recognize this situation and not endeavor to force the continued maintenance of an artificial rate structure. It is not possible for the Federal Reserve to follow flexible policies adjusted to changing economic needs if it has to maintain such a structure of rates regardless of market demands.