CONFIDENTIAL

February 17, 1947.

CHANGES IN TREASURY BILL POLICIES

Treasury and Federal Reserve policies and procedures followed during the war with respect to Treasury bills need to be reviewed now that the period of heavy war finance has passed, with the view of reaching agreement as to ~~a possibility of~~ adjustment of these policies ~~ing them~~ to changed conditions. Two aspects of these policies should be considered:

(A) Weekly replacement of Federal Reserve maturities, and
(B) Elimination of the posted buying rate and repurchase option.

(A) Replacement of Federal Reserve Bill Maturities

Existing arrangements through which the Reserve System purchases the new weekly issues of Treasury bills involve cumbersome procedures and unnecessary expense in order for the System to comply with the law against direct purchases from the Treasury. Since most of the bills are held by the Reserve System, it seems unnecessary to continue the procedure of buying through dealers in order to maintain the formality of a market operation.

The weekly refunding operations could be simplified by permitting holders of maturing bills to exchange them for the new issue of bills. Under this procedure the Treasury would provide that bills awarded on tenders could be paid for either by cash or by surrender of a like face amount of the maturing issue of bills, with an adjustment for the discount. Pending any other change in policies, the rate could continue to be determined as at present. The Federal Reserve System would offer tenders for the amount of maturing bills held in the System and option accounts and would not need to continue the present arrangement whereby dealers bid for the bills and sell them to the System.

This change in refunding procedure could be introduced immediately and without other changes in bill policy but in connection with it, a general revision of policy on Treasury bills may also be considered.

(B) Elimination of Posted Buying Rate and Repurchase Option

The posted rate of 3/8 per cent on the buying and repurchase of Treasury bills by the Federal Reserve Banks was a wartime measure designed to influence market rates for Government securities and encourage banks to make full use of their reserves. Under current conditions these arrangements no longer serve their original purpose. With a pegged certificate rate and only 2 billion dollars of bill holdings outside the Federal Reserve Banks, certificates have replaced bills as the principal market instrument for investment of short-term funds and for the adjustment of reserve positions of banks.

In considering the termination of the buying rate and repurchase option, decisions need to be made with respect to:

(1) Timing of the actions
(2) New policy regarding amounts of bills issued and rates
(3) Added cost to Treasury and effect on System earnings

(1) Timing -- Because of the emphasis that the market may place on the elimination of the buying rate, the change should be made when it is desired to exert some pressure or restraining influence. Accordingly, it might be postponed until there is a curtailment in the debt retirement program to the point of lifting the pressure on member bank reserve positions, which has prevailed during the period of large-scale debt retirement, or until private credit expansion appears to be proceeding at too rapid a rate. April might be a propitious time for such action. The change whenever made would apply only to bills issued subsequently; existing privileges would continue to apply to issues of bills outstanding at the time of the change until they mature.

(2) Bill policy -- If the posted buying rate and repurchase option on Treasury bills are eliminated, there are various possibilities as to policies that may be followed in issuing bills and establishing rates.

(a) One possibility would be to permit the bill rate to rise toward the certificate rate which the Federal Reserve System would continue to maintain at the Treasury issuing rate of 7/8 per cent, and bills would be permitted to find their level in the market. The System would continue to refund its holdings of bills into new bills to the extent that they were not taken by the market. In view of the higher rate, the market probably would take more bills than at present.

(b) Another possibility would be for the Treasury to discontinue entirely the issuance of bills and replace maturing bills with additional issues of certificates. With the certificate rate supported at a fixed level and the bill rate permitted to rise to approximately the same level, it may be said that there is little reason to have outstanding two short-term instruments serving essentially the same purpose.

(c) A third possibility would be for the System to stabilize the market for bills not at 3/8 but at approximately a rate which would permit the Treasury to continue to issue one-year certificates with a 7/8 per cent coupon. The certificate rate would be maintained largely and indirectly through the supported bill rate.

Since bills do not carry a fixed-rate coupon, their rate could be supported without public announcement of a fixed rate; this would have the advantage of permitting some flexibility within a narrow range. The System would engage in open-market operations in bills for the purpose of stabilizing the bill rate at the desired level and would refund its weekly maturities through exchanges as proposed under (A) above. The Treasury would continue to issue bills weekly in amounts required to supply the market demand for bills at the rate maintained and also such amounts as the Reserve System would need to hold. In view of the higher rate, banks and other holders might take more bills than at present. The System might replace some of its holdings with certificates sold by the market.

If at any time in the future, conditions should make it desirable to permit short-term rates to rise, any change in the rate at which bills & certificates are supported by the System would be made only after consultation ~~with and concurrence by~~ the Treasury.

These changes in policies and practices would make the Treasury bills again a useful market instrument and would permit greater flexibility in monetary and debt management policies, without interfering with the policy of stabilizing interest rates.

(3) <u>Federal Reserve earnings and interest cost to the Treasury</u> -- Elimination of the buying rate and repurchase option on Treasury bills raises questions of Treasury financing costs and System earnings. The rise in the bill rate or the substitution of certificates for bills would increase Federal Reserve earnings, which are already very large, and would also increase the interest cost to the Treasury. Federal Reserve earnings will continue at a high level indefinitely, as it is very unlikely that there will be any substantial reduction in the total amount of the System's holdings of Government securities in the foreseeable future.

In order for the System to pass on to the Treasury any earnings above its requirements for expenses and surplus, two approaches may be considered:

(a) Use may be made of a heretofore dormant provision of the Federal Reserve Act. Paragraph 4 of section 16 of that Act authorizes the Board of Governors to charge the Federal Reserve Banks interest on whatever amount of Federal Reserve notes they issue in excess of the amount of gold certificates held by the Federal Reserve Agent as collateral security for such notes. The rate of interest charged could be fixed by the Board from time to time so as to absorb the excess earnings of the Reserve Banks, and the amounts collected could be turned over to the Treasury. This would require no legislation and could be made effective by Board action immediately.

(b) Another possibility is to impose a tax on the earnings of the Federal Reserve Banks (similar to the old franchise tax). This would require legislation.

Either provision would make it possible to return to the Treasury not only the additional earnings obtained by the System from higher rates on Treasury bills (perhaps 50 million dollars or more a year) but also some of the earnings of the System on its portfolio at existing rates (from 50 to 75 million dollars a year).