Reorganization

December 15, 1949.

PERSONAL AND CONFIDENTIAL

Honorable Paul H. Douglas,
United States Senate,
Washington, D. C.

Dear Senator Douglas:

In accordance with your reiterated suggestion that I give you for your own personal information some of the material which specifically illustrates the difficulty in the relationship between the Treasury and the Reserve System, I am setting forth below, as briefly as possible, excerpts from the record on one typical episode, namely, the over-long struggle of the System to discard the so-called preferential discount rate when it was no longer appropriate but, in fact, was wholly inconsistent with a policy of monetary restraint in the period of postwar inflation.

Let me preface the citations from the record by pointing out that this particular episode came to a climax when Fred Vinson was Secretary of the Treasury. I am sure that most people would regard him as a man of broad tolerance and judicial temperament, easy to work with and entirely fairminded. Yet, the attitude he adopted toward the System was one of ill-disguised irritation that can only be explained satisfactorily on the ground that it was instigated by those staff advisors in the Treasury who had been there many years, antedating the war, and are still there.

The bias toward cheap money in this group of advisors is so strong as to exclude, for all practical purposes, any other consideration in connection with debt management policies. It would require an intimate knowledge of money market operations, beyond what could reasonably be expected of the Secretary, especially one who had not long been in office, and it would take remarkable fortitude for any Secretary to overrule this clique in making policy decisions.

One of the greatest difficulties in trying to better the relationships between the Treasury and the System or in undertaking to write a directive to that end, arises from this little-understood influence of staff veterans who are neither elected nor selected by the President with the approval of the Senate. As I sought to point out in my letter of December 1, it is misleading to talk about consultation between the Treasury and the Board or the Federal Open Market Committee unless it is realized that, for the most part, this so-called consultation has in the past consisted of

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our taking the initiative to make recommendations without adequate information as to what the Treasury's thinking might be and often, it appears, after their minds are already made up. Moreover, it has been my experience that our recommendations, if not treated in a perfunctory manner, are analyzed by the Treasury staff more for the purpose of refuting our contentions than for weighing them on their merits. I cannot regard this process as genuine consultation.

Let me recount, as illustrative of the problem, this matter of the preferential discount rate for your personal and confidential information. I am constrained to put that limitation on it because it is necessary to cite excerpts from official correspondence which I am doing on my own responsibility. While it was correspondence that took place at a time when I was Chairman of the Board, I do not feel that I am at liberty to divulge it publicly. I am sure that you will appreciate this situation.

This particular episode dates back to the beginning of the postwar period. On July 9, 1945, I wrote to the Secretary of the Treasury, who was then Henry Morgenthau, Jr., in order to put on paper the arguments which had led the Board of Governors and the twelve Federal Reserve Banks to the unanimous conclusion that this rate should be discontinued since the reasons for introducing it to encourage war-time bank financing no longer existed. It should be borne in mind that this matter was strictly within the province and was a responsibility of the Reserve System. In that letter I said:

> "I am writing to advise you that the Board of Governors and the Federal Reserve Banks are considering the discontinuance at an early date of the preferential discount rate of 1/2 per cent on Government securities maturing or callable in one year or less. The preferential rate was established at all of the Reserve Banks in October 1942. At that time banks were being called upon to take a larger proportion of the debt than now is necessary. The preferential rate was designed to encourage banks to participate in the financing program by borrowing temporarily when necessary and to avoid holding an unreasonably large amount of excess reserves. We felt at the time that the privilege of borrowing at the preferential rate would be used to only a limited extent and that such use as was made of it would be largely by banks that did not hold Treasury bills.
>
> "The principal reasons for establishing this rate no longer exist, since the problem now is to retard the growth in bank holdings of Government securities. In fact the elimination of the preferential rate is long overdue. The longer it is maintained the more it tends to become frozen into the system.

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"Continuance of the preferential rate would result in further indirect bank financing and in further speculation. Moreover, the preferential rate has become subject to abuse. It affords a substantial profit to banks, which can borrow at 1/2 per cent and thereby can obtain a profit of 1/4 per cent on most issues of certificates and a larger profit on longer-term securities.

"Member bank borrowings in June reached a peak of about 900 million dollars, and practically all of this amount was at the preferential rate. About 600 million dollars of the borrowings were at New York City, where earnings already are large and where speculation is most prevalent. Although to some extent these borrowings were incurred for the purpose of obtaining reserves between drives, there is evidence also that banks borrowed in order to increase their holdings of Government securities and particularly of medium-term bonds. Another purpose of borrowing was to reduce excess profits tax liabilities. It is likely that these abuses of the preferential rate will continue to grow as banks become more and more willing to borrow.

"In addition this low rate, by sustaining a low rate on loans that banks make to dealers and to others, has encouraged speculative buying of Government securities on bank credit. In June loans on Government securities to dealers and brokers reached a peak of 1.8 billion dollars, and such loans to others reached a peak of 2.2 billion, a total of 4 billion.

"Discontinuance of the preferential rate would eliminate the profit that can be made by borrowing and using the funds to purchase certificates and would reduce the profit that can be made by borrowing in order to purchase longer-term securities. This change would serve thereby to retard the growth in bank credit at a time when inflationary tendencies are strong. In addition, it probably would result in an increase in the rate on bank loans to dealers and others, which would discourage such loans and thereby would reduce speculation and indirect bank financing.

"The existence of the preferential rate has had no effect on the cost of Treasury borrowing, which has been influenced rather by Federal Reserve open market operations. Discontinuance of the preferential rate, therefore, would have no influence on the cost of Treasury borrowing.

"The present is the best time to make this change. The large expansion of bank credit in the recent drive indicates

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that continuance of the preferential rate is undesirable. The Treasury will need to borrow no additional funds for several months. Member bank borrowings are now at a low level, and excess reserves are large. Accordingly the change probably would have little or no effect on the Government security market. Any effect that it might have could be handled easily by open market operations. The Treasury would be assured, therefore, of a ready market for any refunding or any cash offering of certificates that the Treasury may desire, at the present rate of 7/8 per cent."

Shortly thereafter Secretary Vinson took over and, in a letter of July 27, 1945, to the then Acting Chairman of the Board, Ronald Ransom, indicated concern "that such action, particularly if it occurred at this juncture, might be interpreted by the market as an indication that the Government had abandoned its low-interest-rate policy and was now veering in the direction of higher rates." I referred to this subject in a letter to the Secretary on December 13, 1945, and said:

"* * * The elimination of the rate need have no influence on the aggregate cost of future Treasury refunding, however, because that will be determined by Federal Reserve support of the Government security market through open market operations.

"The preferential rate not only has passed its period of usefulness, but is an element of weakness in our battle against inflation, because it serves as a continuous invitation to banks to bid away from nonbank investors the bank-eligible Government securities previously acquired by nonbank investors or purchased by them in war loan drives. The preferential rate encourages and makes it profitable for banks to borrow in order to purchase Government securities. As a result it encourages the expansion of bank credit, particularly through purchases from nonbank investors of the longer-term, higher-rate obligations. I think that we are all agreed that a further expansion of bank credit is to be avoided at this time, if at all possible. Now, a step can be taken in this direction by the elimination of the preferential rate with little or no disturbance to the banking system, because member bank borrowings are small and their excess reserves are large. The reasons for abandonment of the rate seem compelling, since it is no longer required in the interest of war financing."

In a letter of December 29, 1945, which I think remarkable for its insistence that elimination of the preferential rate would mean an increase in short-term rates of interest, notwithstanding our assurances to the contrary, Secretary Vinson said, among other things:

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"It seems to me that a rise in short-term interest rates at the present time would be unfortunate. It would increase the already large interest charge on the public debt, and most of this increase would go to increase the already high earnings of banks in the principal financial centers, where short-term securities are largely held."

My files contain a memorandum dated January 28, 1946, of a staff meeting between our economists and eight Treasury officials and staff members. In this memorandum, Mr. Woodlief Thomas, head of our Research Division, stated:

"The Treasury economists questioned the need for any action and also felt that nothing could be done that would have any effect upon inflation. Mr. Murphy [of the Treasury] made a strong case for lower interest rates and indicated belief that long-term rates should go lower than they are now. He thought long-term rates might in the near future reach 2 per cent and later might approach zero. His case for low interest rates is that they not only reduce the cost of carrying the public debt, but also that they encourage consumption and investment and result in a more equitable distribution of income. Although admitting the desirability of discouraging spending during a period of inflation, he preferred to use other methods and not permit interest rates to rise, because that would delay the desirable long-run downward adjustment of rates."

My files also contain a memorandum, dated January 31, 1946, of a conference which Allan Sproul, President of the Federal Reserve Bank of New York and Vice-Chairman of the Federal Open Market Committee, Mr. Thomas and I had with Secretary Vinson and four of the Treasury staff, in which I stated:

"* * * We ended up by finding that there is a basic, fundamental, difference between the System and the Treasury. Messrs. Murphy, Bernstein and Haas [of the Treasury staff] have completely sold the Secretary on the philosophy of low and lower rates of interest, that low rates can have little effect on inflation, that inflation has to be dealt with by direct, rather than monetary, measures, that it does not make any difference whether banks or nonbank holders own Government securities, and that the lower the interest rate goes the higher the standard of living of the masses because it will make for a much better distribution of income, and stimulate consumption. They do not segregate in their minds the immediate inflationary problem from the long-range problem. We had difficulty in bringing out the point that when there is an adequate supply of goods

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low rates may be used to discourage saving and encourage spending which would keep goods from piling up, but such a situation as that is not in prospect for a year or two. They believe that they should sell all the series E, F, and G bonds they can but at the same time take the position that the banks and corporations get the benefit of the market issues which they apparently feel makes for greater concentration of wealth and that is not where earnings from Government securities should go. They feel that if the Treasury got its money at low rates that would reduce taxes and to that extent would be helpful in the picture.

"There appeared to be confusion in their thinking and I did my best to try to get the Secretary to see our position. They have told him that we have always stood for higher interest rates and they have picked out what we have recommended on that."

The memorandum added:

"Secretary Vinson stated that if we change the preferential discount rate that would be the signal that rates were going higher. He is going to write us a letter setting forth the Treasury's position. I finally said to the Secretary that it looked as if the System and the Treasury were at an impasse; that the Board was an agent of Congress with statutory responsibilities and that while the authority that the System had with which to meet the situation was not given at a time when the Government debt had reached $275 billion they were the only powers that the System had and that they could be exercised for the purpose of meeting the inflationary conditions to some extent. I said that we're not proposing to put interest rates up or increase the cost of financing to the Treasury even though the inflationary conditions that exist and the amount of money that was being created by further monetizing of the public debt indicated that under the statute that is the action that the System should take. I said that power was given to us to meet an entirely different situation than when 2/3 of the debt was Government debt and that that being the case the suggestion had been made that the System go to Congress and point out the entire problem and let them know that the Board and the Open Market Committee are not in a position to deal with the problem except through the medium of interest rates and suggest that legislation is needed to meet the problem in another way, by segregating bank investment in Government securities from nonbank investment. I pointed out that the reason for the monetization of the Government debt by the banking system is

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the wide-open door that the banks have to the Federal Reserve Banks through the preferential rate, the buying rate on Treasury bills and the support which the System is committed to give to certificates. We automatically provide a mechanism that was designed to finance the Government during the war but which is not designed to meet the situation when we do not want the banks to purchase additional securities. Therefore, we should block off bank purchases of securities. The one alternative is to let things go with a further drop in interest rates and further monetization of the public debt with the Federal Reserve having no control whatever. The other alternative is for the Federal Reserve to exercise such control as it has by increasing interest rates and the cost of carrying the public debt as well as the earnings of banks, both of which are undesirable.

"Secretary Vinson disagreed completely with our position."

The memorandum added further:

"We have a very difficult problem ahead of us. I told the Secretary that we thought the System had a responsibility under the statute and it might have to take action to meet the issues and might not be able to go along with the Treasury. He replied that we were implying, in this time of crisis and emergency, that we were going to insist upon our rights even though the Treasury did not feel that we should take action. He said it looks like a sit-down strike on your part and that when we got right up to the issues that he did not think we would have a sitdown strike. So we really have an issue - we either do nothing or we take action. I think we should meet this by getting a report to Congress as quickly as possible, pointing up the whole problem, the difficulty we have in meeting it, the consequences of trying to meet it with our present powers, and suggesting legislation that will enable us effectively to meet it. We might go so far as to have it brought out in Congress that the pattern we have established for war financing, the Treasury is insisting we maintain in the postwar period, and that we hesitate, because of the responsibility of the Treasury, to take action while the Treasury feels that no action should be taken and that, therefore, the matter was one of such far-reaching importance that it should be clarified by Congressional action.

"I told Mr. Vinson that it appeared that the Treasury wanted us to be a rubber stamp and he said that he did not think we would want to take action when we received his letter.

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"Our entire conference was friendly and on a nonpersonal basis and when we left we all shook hands.

"I met Secretary Vinson later in the evening at the dinner which Mr. Delano gave for Mr. Harl, the new Chairman of the Federal Deposit Insurance Corporation, and he was very pleasant. I said to him that we appreciated the time he had given us to discuss the matter; that he had given us every opportunity to present our position, and that if we had not succeeded in persuading him it was not because he had not given us that opportunity."

As is illustrated again in the foregoing, the issue is not one of personalities. It is institutional. Cordial personal relationships prevailed, as the memorandum indicated, but the issue persisted.

On March 22, 1946, I advised the Secretary in a personal and confidential note that the question of the preferential discount rate was necessarily a subject of discussion at a meeting which had just been held of the Presidents of the Reserve Banks with the Board. I advised him that:

"At the conclusion of the discussion, the Presidents initiated and unanimously approved a motion requesting me to advise you informally that I 'could not give the Treasury the assurance that the Federal Reserve Banks would not act on the preferential rate in the near future.'"

I reminded the Secretary that the law requires the boards of directors of the Reserve Banks to act every two weeks on all rates and that the Board here in Washington has to approve or disapprove whatever action is taken and, moreover, the Board here is required, by law, to state in its policy record, in its formal report to the Congress, the reasons for the Board's approval or disapproval.

In a letter of March 28, 1946, the Secretary replied, reiterating at some length the Treasury's opposition to the discontinuance of the preferential discount rate but stating that he had decided not to send a letter which he had had on his desk, and to which reference is made in the above memorandum. In this letter, he said:

"Now I have your note of March 22, referring again to the question of increasing the preferential rate. I still feel that this action should not be taken at this time, primarily because it does not seem wise to rock the boat in the middle of our transition to what I hope will be a full production peacetime economy. Accordingly, I am writing at some length to give you the Treasury's position on this matter.

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"The elimination of the preferential discount rate at this time would be interpreted by the market as — and would, in fact, be — a first move in the direction of higher short-term interest rates. Higher short-term rates would raise the cost of carrying the public debt and would be of principal benefit to commercial banks, most of which are now enjoying very high earnings.

"Whether an increase in short rates would spread to longer-term rates could be determined only by the event — by which it might be too late to avert serious unfortunate consequences, both to the cost of Government financing and to our hopes of achieving full production and full employment in the postwar period.

"I should, therefore, like to renew my request, made to you on previous occasions, that the Federal Reserve System refrain from eliminating the preferential discount rate on short-term Government securities at this time. This request is, of course, without prejudice to the possible elimination of the preferential rate at some future date when such action would be part of a whole policy orientated in the direction of continuing low interest rates, rather than, as it would be now, part of a policy directed toward higher rates.

"The significance of the preferential discount rate at the present time is almost entirely psychological. Total borrowings under it are not high in relation to total Federal Reserve credit, member bank reserves, or any other relevant measure. The principal significance of the rate is, as Mr. Sproul so aptly put it in our meeting on January 30, that of a signal to the market for the continuance of the official policy of low interest rates. Mr. Sproul wants to haul this signal down, and you concur. I do not. The Administration policy on low interest rates and the reasons for it were ably restated in the President's Budget Message. If it takes the action you suggest, the Federal Reserve System would be flying one signal and the President another. We cannot afford thus to act at cross purposes during this most critical year in the reconversion of our domestic economy."

The letter added:

"I was greatly surprised by your statement at the meeting that the proposal to eliminate the preferential discount rate was not really part of a program to increase short-term interest rates."

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On April 19, 1946, in a confidential letter to the Secretary, I stated:

"My associates and I were surprised by your letter of March 28, not because we were in doubt as to your attitude concerning the elimination of the preferential discount rate, but because of the fundamental misconception of our views which your letter contains * * *

"While we are reluctant to burden the record with further discussion of this matter, we think it important to emphasize that there is nothing in the record to justify the statement in your letter that the proposal to eliminate the preferential discount rate is 'really part of a program to increase short-term interest rates.' That is not the purpose. The purpose is to avoid giving further impetus to the inflationary forces which now exist in our economy, among which must be included the supply of money in the hands of the public, particularly in its most active form — currency and bank deposits. We must refuse, therefore, to be ranged on the side of the advocates of a higher interest rate policy. That is not the question here and should not be permitted to confuse the real issue.

"The question is simply whether we propose to perpetuate a wartime measure which no longer serves the purpose for which it was designed but, quite the contrary, tends to aggravate the inflationary pressures which the Government is properly trying to combat. We are at present flying a signal — to borrow your metaphor — which is the direct opposite of the declared policy of the Government. We are, in effect, inviting member banks to come to the Reserve Banks and borrow at a preferential rate on Government securities due or callable in not more than one year, thus encouraging these banks to purchase Government securities as well as to make loans to others for the purpose of purchasing Government securities. This process has made for speculative profits, but it could not reduce the cost of Government financing unless the intention is to countenance and then take advantage of a further lowering of the entire interest rate structure of the country. That, as we understand it, would be contrary to your policy. It would certainly be contrary, in our judgment, to the best interests of the country.

"When the preferential rate was adopted in 1942, the Board felt, and so stated, that in ordinary circumstances such preferential rates should not be established. It was recognized, however, that the war financing program would require substantial purchases of Government securities by the banks and it

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was the belief of the Board that, if there were a preferential rate for advances secured by Government obligations, that fact would encourage member banks, particularly outside the financial centers, to invest more of their then existing excess reserves in short-term Government securities, and that the preferential rate could be eliminated when the need had passed. Today it serves a wholly undesirable purpose, namely, that of facilitating further monetization of the public debt through the commercial banking system. We think you are flying the right signal of discouraging further creation of bank credit, but we find ourselves signalizing through this special rate exactly the opposite course.

"You express the opinion that the elimination of this rate would be interpreted by the market as a first move in the direction of higher short-term interest rates. You will agree, we feel sure, that the adoption of what is the right policy should not be avoided for fear it would not be correctly understood. The boat can be rocked in this critical transition period by failing to do things which ought to be done as well as by doing things which ought not to be done. The important point, however, is that we have assured you that we would maintain the market for the 7/8 per cent certificates of indebtedness so that there would be no question about refunding or refinancing at this rate. Accordingly, if the elimination of the preferential discount rate were misinterpreted, official action through open market operations would promptly disabuse the market of its mistaken interpretation.

"We wish to emphasize with all the force we can command that our purpose and policy are based not on a desire for a higher level of interest rates and hence increased costs of carrying the public debt, but entirely on grounds of discouraging further needless monetization of the debt through a wartime mechanism. Elimination of the rate, far from indicating that the Treasury and Federal Reserve were flying opposite signals, as you put it, would signify that we were in accord instead of working at cross-purposes as we appear to be doing now.

"We do not believe that, when the question is reviewed in this light, the Treasury would wish to ask us to continue following a policy which is unquestionably inflationary and wholly at variance with the President's stabilization program. The Treasury, of course, is properly concerned with any measure that might affect the cost of Government financing. However, we have given assurance that we will not permit elimination of

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the preferential discount rate to increase the present certificate rate or other rates now paid by the Treasury. Having thus been assured that its interest in the matter will be fully protected, the Treasury, it seems to us, would not wish to be put in the position of objecting to the System's discharge, in accordance with its best judgment, of a statutory responsibility placed upon it by Congress.

"The incorrect premise upon which your letter is based is illustrated by your statement that we made no case as to how increasing short-term interest rates would help in combating inflation. We made no such case, of course, because our argument was not based on an increase in short-term rates. The case we sought to make and thought we had demonstrated clearly was based on our earnest desire to stop further creation of inflationary bank credit, both directly and indirectly.

"It should be borne in mind that our increasing production will generate an increasing income that will currently provide means of purchasing what is produced. If this newly created income has to compete not only with the existing excessive supply of liquid funds, but also with further increases in the money supply resulting from bank credit expansion, we can have a destructive inflation no matter what our production may achieve.

"Finally, we believe that an impartial review of the recommendations made by the Board and Open Market Committee to the Treasury from the inception of the defense and war financing programs will demonstrate beyond any possible question that we have consistently advocated policies and measures for financing the war at low and stable rates of interest. The pattern of rates on market issues agreed upon by the Treasury and the Reserve System ranged from the 7/8 per cent rate on certificates to the 2-1/2 per cent rate on the longest term Treasury bonds. There was also the 3/8 rate on 3-month Treasury bills. The only official recommendations the System has made at any time for any higher rate related exclusively to the bill rate. It became evident early in the war that the banks were less and less interested in buying bills and increasingly disposed to buy the longer-term, higher-yield issues, with the result that they sold the bills to the Reserve System and concentrated more and more in the longer-term securities, thus increasing the overall cost of Treasury financing. Our recommendations were made with the expectation that a somewhat improved bill rate would result in the banks holding more of the bills and hence fewer of the longer-term, higher-yield issues, thus reducing the overall cost of Treasury financing. Time has served to confirm the view that the banks would be increasingly uninterested in bills at the 3/8 rate, for at present the Federal Reserve System holds nearly all of the bills outstanding. To construe our suggestions on

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the bill rate as signifying a purpose on the part of the Federal Reserve authorities to increase the rate structure and the costs of carrying the debt is to misread completely the plain purpose of the proposals."

My letter added:

"We are embarked on a joint enterprise. We are all seeking to solve the difficult postwar problems of fiscal policy, monetary policy and debt management in the public interest, and in no other. We know the course that has been set by the Government. We want to discharge our responsibilities effectively as part of the general program of the Government. We believe that the elimination of the preferential discount rate would be in accord with the request of the President in his recent Executive Order, when he said:

"'For the duration of the existing emergency all departments and agencies of the government shall, in any matter affecting the stabilization of the economy, in which they have discretion in the use of their powers, exercise such discretion in such manner as will best promote the continued stabilization of the economy.'"

Subsequently, beginning with action taken by the directors of the Federal Reserve Banks of New York, Philadelphia, and San Francisco on April 25, 1946, all twelve of the Federal Reserve Banks recommended elimination of the preferential rate. The Board of Governors approved and announced this action. This is the only instance that I know of when the System has taken a step — and this, after all, was a very minor step — over the objection of the Treasury. This clearly was a matter fully within the statutory discretion of the System. It was a step which could be taken without impinging on the cost of Treasury financing. It is all the more surprising, therefore, that we encountered such strong resistence for such a prolonged period.

However, I think it is clear from the foregoing correspondence that the Treasury either did not understand or did not believe what we said. Above all, it vividly illustrates the persistent easy money bias on the part of the Treasury staff, in which the Secretary concurred. This Treasury personnel, much the same now as it was then, continues to brush aside or to depreciate the influence of interest rate changes on the availability of credit. Beyond that, the episode illustrates the inherent conflict in policy and the necessity for having Congress more clearly define the respective roles which it expects the Treasury and the Federal Reserve System to play unless one is to be altogether subordinated to the other. I think that would be a grave mistake.

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Let me take this opportunity to thank you once more for your patience and courtesy to me. I do not think I need assure you that my great interest in this complex and important matter rises above personalities or personal considerations. Since I expect sometime to return to my private business and banking interests I cannot benefit directly from the solution which I earnestly hope your inquiry will find, or help to find, for this problem of institutional relationships.

Sincerely yours,

M. S. Eccles.

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