January 13, 1937.

MEMORANDUM TO MR. UPHAM:

In accordance with telephone conversation, I am handing you herewith three copies of a memorandum, "Prospect for Money Rates." As explained to you on the telephone, Mr. Eccles was under the impression that he had until noon today to get these memorandums over to the Secretary, but in view of the fact that the meeting is being held now, the enclosed copies are being sent to you with the understanding that the memorandum has not been fully checked for changes, and that corrected copies will be furnished you later.

Secretary to Mr. M. S. Eccles.

January 12, 1937

PROSPECT FOR MONEY RATES

Money rates have been exceptionally low in recent years as a consequence principally of two factors: (1) the large supply of funds seeking profitable use, and (2) the small demand from acceptable borrowers. During the past year the commercial demand for funds has increased and at the same time funds at the disposal of banks have been reduced by Federal Reserve action. Further changes in this direction may be expected this year, but the supply of funds in the hands of banks and of investors is so large that the increased demand can be met without a marked advance in rates.

Further reduction in excess reserves of member banks, if it occurs, will probably result in some stiffening of short-term open-market money rates, but even after this advance the rates will be below levels which in earlier years would have been considered abnormally low. While the demand for capital funds by corporations may be expected to increase, Treasury offerings will be small and the supply of funds held by institutions and individuals awaiting investment is large. It is to be expected, therefore, that long-term money rates, as reflected in bond yields, will show little or no increase in the next ~~six months.~~ year

Short-term rates

In recent years the principal open-market short-term rates, as shown in the following table and on the chart, have been below 1 percent, with bankers' bills and Treasury bills generally at below ½ of 1 percent. The lowest level reached by bankers' bills before 1930 was 2 percent in 1924. The rate on call loans with stock exchange collateral, until recent years the most important open-market rate, declined to 1/4 of one percent in 1935, but has been pegged since last May by New York City banks at one percent. There were only six scattered years in the period from 1890 to 1930 when this rate averaged below 2 percent and it was never below one percent. Commercial paper, which for more than half a century has been a popular medium for investment of short funds by country banks, now sells at a rate of 3/4 of one percent; the lowest quoted rate prior to 1930 was 3 1/8 percent in 1924.

MONEY RATES IN NEW YORK CITY

	Dec. 1936	Jan. 1934
Bills, 90-day unendorsed	3/16	1/2
Prime commercial paper, 4-6 months	3/4	1 1/4 - 1 1/2
Stock exchange call loans	1	1
Federal Reserve funds (interbank loans)	1/8	1/8
U. S. Government obligations - yields		
Treasury bills	0.21	0.67
Treasury notes, 3-5 years	1.04	3.11
Treasury bonds, long-term	2.27	3.50
Customers' loans	2.43	3.58
Federal Reserve bank		
Rediscount rate	1 1/2	2
Buying rate for 90-day endorsed bankers' bills	1/2	1/2

It is clear that prevailing short-term open-market money rates are abnormally low. These low rates have been largely the result of the large volume of excess reserves held by banks. Absorption of a large part of these reserves will eliminate this cause of low rates and will probably result in a moderate rise of open-market money rates.

But the rise should not be large. Even after an increase in reserve requirements by the full amount permitted under the law there will still bd about $700,000,000 of excess reserves. It is probable that the call money rate will not rise above ~~one or~~ 1 1/2 percent, because at ~~such~~ that rate~~s~~ outside funds which are plentiful will be attracted. The plentiful supply of outside funds will also act as a check on the increase in commercial paper rates.

The rate on bankers' acceptances, which is now 3/16 of one percent on 90-day bills, will not rise above the buying rate of the Federal Reserve bank which is 1/2 of one percent. Any higher market rate would make it profitable to sell bills to the Reserve banks.

Treasury bills, which now provide the most important medium for liquid investment in the money market, are largely held by New York City banks. The rate on these bills might be expected to rise above the prevailing extremely low level. A slight increase has already occurred in recent weeks, reflecting in part increased offerings by the Treasury and in part anticipation of higher money rates in case of increased reserve requirements. It is doubtful, however, whether this rate would rise above 3/4 of 1 percent, in view of the popularity of the bills as a short-time investment, especially in view of the fact that bankers' bills cannot go above ½ of 1 percent.

Some increase in yields on Treasury notes has occurred in recent weeks, partly because of the likelihood that exchange rights on future issues will be smaller in coming years than they have been in the past and perhaps partly because of adjustments of reserve positions. The shorter-term Treasury bonds, which have been selling on a yield basis of about 1 percent, have also been affected somewhat, but in view of the large amount of liquid funds that will still be held by banks outside of New York and by others than banks, no substantial rise in these rates is anticipated.

Rates charged customers by banks should not be in the least affected by increased reserve requirements. These rates have been slow in coming down and may continue to show a downward tendency, notwithstanding increased borrowing by customers.

It appears, therefore, that only moderate advances in short-time rates may be expected in the near future, even if reserve requirements are further advanced. Beyond the next six months the course of rates will depend chiefly on the rate of business activity and the need for further restraining action by monetary authorities.

<u>Long-term rates</u>

Yields on high-grade long-term bonds have in recent years been at the lowest levels of this century. Long-term United States Government bonds have sold on a yield basis of less than 2 ½ percent, notwithstaning the largest volume of Government debt on record. The lowest level reached by these bonds in the 'twenties was 3 ¼ percent; pre-war rates are not comparable because all bonds then bore the circulation privilege, which was of considerable value. The highest grade corporate bonds are selling on a 3 1/8 percent basis, compared with a low level for the 'twenties of ~~about~~ 4 to 4 1/2 percent, and ~~about 4~~ 3 1/8 to 3 1/4 percent in the years around the turn of the century.

Long-term rates have been affected in recent years by the volume of excess reserves held by banks. With the abundant supply of available funds and the small demand for loans banks have bought large amounts of securities, particularly Government obligations, and bank holdings of securities are now the largest on record not only in total amount but also in proportion of total bank assets. Member bank holdings of Treasury bonds and other securities amount to about 40 percent of their total loans and investments.

Reduction in excess reserves, together with increased demands for bank loans, might be expected, therefore, to lead to some sale of securities by banks and this would tend to depress their price and increase the yield. There are, however, other factors in the situation which might offset this influence.

The first of these is the abundant supply of investment funds still available outside of banks. Insurance companies, other institutional investors, corporations, and individuals are holding large idle deposits awaiting investment. Restoration of confidence and improved corporate earnings resulting from continued business recovery should lead to active investment of these funds. Many investors, who have been awaiting the return of what they might consider as normal interest rates, are gradually deciding that it is better to put funds to use at prevailing rates than to hold them idle.

Another factor tending to prolong low bond yields is the likelihood of a reduction in the supply of United States Government obligations available in the market, because of purchases by the Treasury for investment of special funds, especially the social security funds, and eventually because of debt retirement.

It is not likely that long-term rates will rise substantially until short-term rates approximate or exceed long-term rates. So long as banks can obtain larger yields on long-term obligations than on short-term paper they will not be anxious to switch. Records of the past indicate that long-term rates may decline or show little change while short-term rates are increasing. Since a substantial rise in short-term rates is not anticipated in the next few months and a rise to the present level of long-term rates is not to be expected until the credit situation requires vigorous action by the Federal Reserve authorities, little or no increase in long-term rates may be expected within the next ~~few months~~ year.