THE UNDER SECRETARY OF THE TREASURY

WASHINGTON

November 10, 1943.

Dear Marriner:

Here is a copy of Mr. Haas' memorandum dated July 19, 1943, which is referred to on page 8 of his memorandum of October 29th, which I previously sent you.

Sincerely,

Dan

Honorable M. S. Eccles
Chairman
Board of Governors
Federal Reserve System
Washington, D. C.

Enclosure

C
O
P
Y

July 19, 1943

Secretary Morgenthau

Mr. Haas

Subject The Proposal of the Federal Reserve Board for the Issuance of 9-Month Treasury Bills

The Federal Reserve memorandum of July 13 recommends that the entire outstanding amount of bills and certificates combined be stabilized, for the time being, at its present level and be refunded into a new series of 9-month bills, for which a buying rate of 3/4 of 1 percent would be established. The new bills would be issued as the outstanding securities mature, but at a rate not to exceed $1 billion a week. The memorandum also recommends that the maturity of new 2 percent bonds be extended from 7-1/2 - 9-1/2 years to 8-10 years and, if necessary, to 9-11 or 10-12 years.

The purpose of these changes is to narrow the total spread in the pattern of rates of securities available for bank purchase by increasing short rates and decreasing long rates (or at least increasing the term of long securities of the same rate). Such a reduction in the spread between short and long rates is stated to be necessary in order to maintain the existing pattern to which the System is committed.

As evidence of the necessity of a reduction in the spread of rates, the memorandum points out (1) that the Federal Reserve System has had to absorb the entire increase in the supply of Treasury bills (about $2 billions) since the end of April, and (2) that the 2 percent sector of the market has been very strong during the same period and has now absorbed the entire Federal Reserve portfolio of long 2 percent taxable bonds.

In our opinion, the proposed consolidation of outstanding bills and certificates into new 9-month 3/4 percent bills would be an unwise move for the following reasons:

(1) The pattern of rates is a means and not an end. It was generally agreed by the Treasury and the Federal Reserve System a long time before Pearl Harbor that this war, if it

should occur, should not be financed upon the basis of rising interest rates, as was the case in World War I. Rising rates during a wartime period not only increase war costs directly, but also discourage subscriptions to Government securities as purchasers tend to await more favorable terms on later issues. This desire to avoid a progressive increase in interest rates during the wartime period is the cornerstone for the mutually-agreed-upon policy of the Treasury and the Federal Reserve System. In order to implement this policy, the Federal Reserve System has established and maintained a "pattern of rates" in the Government security market. This pattern of rates, however, should be viewed strictly as a means and not as an end. The end is orderly and economical war finance, not the maintenance of any particular pattern of rates.

(2) <u>The difficulty alleged to exist in the present pattern of rates is not new</u>. The difficulty inherent in a rigid "pattern of rates" has been recognized by both the Treasury and the Federal Reserve System from the beginning and, in consequence, the Treasury has consistently urged that the rigidity of the pattern be de-emphasized and that the pattern be kept as fluid as consistent with the underlying objectives of financing the war as cheaply as possible and of maintaining the demand for Government securities.

The fundamental difficulty of a pattern of rates is, of course, that if confidence in the pattern becomes perfectly established in the market, buyers will tend to crowd into the longer maturities where the return is higher, while the shorter maturities at lower returns will find no purchasers. The effect of this would be to increase substantially the average cost of borrowing without reducing the real obligation of the Government to maintain the liquid character of the outstanding debt.

This difficulty is a long-run difficulty, however. It has existed ever since the pattern of rates was established, and its importance at the present time is unduly magnified in the Federal Reserve memorandum. Actually, the spread between short and long rates is much less now than it was during most of the Thirties, and the profits from "rolling down the curve" are consequently smaller. While it is true that such profits are more certain than they were in a free market, it must be recognized that a great many investors have not adapted their market policy to the existence of a pattern of rates; and others, who have thought the matter through, are simply unwilling to take a chance on the permanence of the pattern, and consequently prefer the contractual protection of a short-term obligation. Such frictions and doubts will probably continue for a long time to come and will make possible the continuance of a substantial spread between short and long rates.

(3) The recent absorption of Treasury bills by the Federal Reserve System is not conclusive evidence of unwillingness of the market to absorb additional short securities. The fact that the Federal Reserve System has absorbed the entire increase in the amount of Treasury bills since the end of April does not mean that the market wants no more short securities. The market for certificates and notes continues very strong -- in fact, as strong, relative to the pattern of rates, as that for bonds. The current situation in bills does indicate that the market has enough, at least for the time being, but this situation does not extend to short paper generally. Treasury bills have become a sort of secondary excess reserves, and commercial bank holdings of them vary inversely with their need for reserve funds. It is not surprising, therefore, that commercial bank holdings of Treasury bills have run off during the past two months as their required reserves have risen, due to the drawing down of War Loan Deposits, while the Federal Reserve System was supplying additional reserve funds in no other way than by purchasing bills at the posted rate. As of July 14, the most recent reporting date, 65 percent of the outstanding amount of Treasury bills was still held outside of the Federal Reserve Banks.

The evidence submitted in the Federal Reserve memorandum seems to indicate that the bill market needs a rest, but goes no further.

(4) The Federal Reserve Banks ought to purchase at least enough bills to cover the increase in Federal Reserve notes outstanding. The Federal Reserve Banks must acquire some asset dollar-for-dollar for every increase in Federal Reserve notes outstanding. Sound central banking policy dictates that the assets so acquired should have a low earning rate, or none at all. During the Thirties the asset acquired by the Federal Reserve Banks per contra to the increase in Federal Reserve notes was gold. During the war period 3/8 percent Treasury bills provide a satisfactory alternative. Fifty-four percent of the increase in Federal Reserve holdings of bills so far this year can be set off against the increase in

Federal Reserve notes outstanding. If the proposal to issue 9-month bills were adopted, the lowest rate in the market and the rate against which currency would be issued would be 3/4 of 1 percent. This is an unconscionable rate to pay for issuing paper money.

(5) The proposed bills would reduce the effectiveness of Federal Reserve control of the money market. As was pointed out above, Treasury bills are being used to an increasing extent as quasi-reserves. Treasury bills are now outstanding in the amount of about $12 billions, thus providing potential quasi-reserves of this amount. Certificates of indebtedness, which are not at the present time considered equivalent to reserve funds, are outstanding in the amount of more than $16 billions. If the present amount of bills and certificates were converted into 9-month Treasury bills with a posted rate, the potential amount of quasi-reserves would be increased to about $28 billions, or more than double the present amount. Obviously, the existence of such an increased amount of instruments available for use as quasi-reserves would increase the difficulty of changing the reserve position of member banks by the use of the customary instruments of Federal Reserve policy.

(6) The issuance of the proposed bills would weaken the position of the New York and Chicago money markets. The proposed use of 9-month Treasury bills would create an important incentive for the removal of bankers' and other balances from New York City and Chicago by providing an alternative employment for these balances at a guaranteed rate of 3/4 of 1 percent. Such withdrawals might well be sufficiently large to remove the New York City and Chicago banks from the market for Government securities for some time to come. This would have consequences beyond its dollar amount, because of the position of leadership in the Government securities market customarily exercised by central reserve city banks.

(7) Bank earnings are adequate. The Federal Reserve memorandum states that one reason for the proposed change is " . . . an extension of maturities by commercial banks because of the need for larger earnings, particularly by the smaller banks." A press release by Mr. Crowley, dated June 22, referring to all insured commercial banks, states:

> "At $441 million, net profits after taxes but before dividends represented a return of 6.3 percent on total capital funds. This rate of return has

> been exceeded only twice since the establishment of the Federal Deposit Insurance Corporation: in 1936 when unusually large profits and recoveries on securities were reported, and in 1941. It is estimated that net profits before income taxes were higher than in any other year of deposit insurance except 1936."

As far as the situation of small banks is concerned, the net profit for 1942, after income taxes, for all insured commercial banks with deposits of under $1 million amounted to 6.5 percent of capital funds.

(8) <u>The issuance of the proposed bills would itself constitute a substantial "breach" in the pattern of rates</u>. Finally, it is important to note that, although the stated purpose of the issuance of the proposed bills is to preserve the existing pattern of rates, such issuance would, in fact, breach the existing pattern very materially. The argument seems to be that it is necessary to change the pattern in order to maintain it. We see no merit in this argument. The whole business of maintaining a pattern with a substantial difference between short and long rates is essentially a rear-guard action, in which it is unwise for the rear guard to retreat any faster than necessary -- since, when it does, it must recommence the action all over again on the new line. The longer the retreat from 3/8 to 3/4 can be postponed, the longer it will be before a new action will have to be started to defend the 3/4 line against a further retreat to 1 or 1-1/4. There is no point in taking time by the forelock, for time is of the essence, and a successful rear-guard action will greatly reduce the ultimate cost of war finance.