December 16, 1944

Honorable Daniel W. Bell,
Under Secretary of the Treasury,
Treasury Department,
Washington, D. C.

Dear Dan:

I am enclosing a copy of the memorandum regarding a Treasury financing program about which I spoke to you last evening on the telephone. At the meeting of the Federal Open Market Committee on December 11, I presented the proposals contained in this memorandum, not as a recommendation but for consideration by the Committee. While there was some discussion, no position was taken by the members of the Committee with respect to the program, and it was decided that the Executive Committee would meet again about the middle of January for further discussion. The Committee would like also to meet with you and members of your staff for the purpose of exchanging ideas on the subject of Treasury financing preliminary to such meeting with the Secretary as might be arranged.

Sincerely yours,

M. S. Eccles, Chairman,
Federal Open Market Committee.

Enclosure

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TREASURY FINANCING PROGRAM

After giving further consideration to the declining demand for Treasury bills, the continuing difficulties with maintaining a structure of yields on certificates, and the increasing earnings of commercial banks, the following suggestions are presented for consideration:

(1) That the maturity of Treasury bills be extended to four, five, or six months and the rate increased to 1/2 per cent,

(2) That such part of Federal Reserve holdings of bills as will not be needed for future sale in the market be refunded by the Treasury into special issues yielding 1/4 per cent,

(3) That the coupon rate on future issues of certificates be 3/4 instead of 7/8 per cent, and

(4) That the Treasury issue no additional 2 per cent bonds available for purchase by commercial banks.

An increase in the rate on Treasury bills, combined with a decrease in the rate on certificates, would make bills more attractive to investors in relation to certificates than they are at present. This would help to restore bills to their former position as a medium for the adjustment of the reserve positions of individual banks. The longer maturity would not detract from the bills so long as the Federal Reserve would purchase all bills offered at 1/2 per cent, and the Federal Reserve would do this.

There would be no need for the Federal Reserve to benefit from an increase in the bill rate from 3/8 to 1/2 per cent. Earnings could be maintained at an adequate level if the rate on a substantial part of Federal Reserve holdings of bills were reduced from 3/8 to 1/4 per cent. Under the proposal, the Federal Reserve each week would be permitted to exchange such part of its bill maturities as it considered advisable for a special issue with a rate of 1/4 per cent. There would be no point in extending this offer to holders other than the Federal Reserve, because no other holder would be willing to make such an exchange. To the extent that the Federal Reserve replaced its maturing bills by exchanging them for a new issue of 1/4 per cent securities, the Treasury could reduce the weekly bill offering to the market. It would no longer be necessary, therefore, for the Treasury through the New York Reserve Bank, as fiscal agent, to make arrangements with dealers to place tenders for new issues.

In estimating the amount of bills that the Federal Reserve would exchange with the Treasury each week, consideration should be given to the amount of marketable bills that the Federal Reserve would need to sell during the subsequent drive, since Federal Reserve holdings of marketable bills should not be permitted to decline below the level necessary to provide for subsequent sales. At least in the initial stages, the amount of the exchanges should be considerably below this level. A reduction from the present 1/2 per cent to the suggested 1/4 per cent in the spread between the rates on bills and on certificates might

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result in a large shift in demand from certificates to bills. Federal Reserve holdings of marketable bills should be maintained, therefore, at a relatively high level, until such time as a more precise estimate could be made of the amount of bills that the Federal Reserve would need to hold. Over a period of time, of course, the Treasury could adjust for this development by retiring certificates on maturity and increasing the weekly offering of bills, but it would not be able to provide entirely for a large and sudden shift in demand.

The suggested reduction in the spread between the rates on bills and on certificates would solve the present difficulty of the Federal Reserve in maintaining proper yields on certificates. If the Federal Reserve should maintain on certificates a yield structure between 1/2 per cent on three-month certificates and 7/8 per cent on one-year certificates, it would increase the incentive to play the pattern of rates. If the Federal Reserve should continue to maintain a yield structure such as the present, it would continue to discourage investment in Treasury bills. The Federal Reserve, therefore, would maintain certificates at yields ranging between perhaps 5/8 per cent on four-, five-, or six-month certificates and 3/4 per cent on one-year certificates. There probably would be little difficulty in maintaining such a structure. Speculators would be given little incentive to play the pattern of rates, and bills again would become attractive. It would be expected that, shortly after the Treasury's announcement of this program, yields on outstanding certificates would decline to the new structure ranging between 5/8 and 3/4 per cent, but if this development did not materialize the Federal Reserve would purchase a sufficient amount of certificates to establish and to maintain the new structure.

One reason that certificates at times need support in the market, despite the fact that yields are higher in relation to maturity than the 3/8 per cent rate on bills, is that certificates are the principal obligations available to commercial banks for adjusting their reserve positions. Consequently, banks at times find it necessary to make substantial sales of certificates. In addition, corporations sell certificates in preparation for making subscriptions in the drives, since certificates are the lowest-yielding securities that they hold.

A decline in the coupon rate on new issues of certificates from 7/8 to 3/4 per cent would not materially reduce purchases in the drives by corporations. Corporations purchase certificates because, despite the low yield, these securities have a ready marketability, which is provided by their short maturity and by Federal Reserve support. Any reduction in such purchases probably would be replaced by additional purchases of savings notes. There is no need, moreover, for paying as high a rate as 7/8 per cent on certificates purchased by commercial banks because of the high level of commercial bank earnings.

For the same reason, there is no need for the Treasury to continue the issuance of 2 per cent bonds that are available for purchase by commercial banks. Banks probably would attempt to improve their earnings, however, by purchasing outstanding 2 per cent bonds at increasing prices. Yields on these issues might decline to 1 3/4 per cent. A decline below this level could be prevented if the Treasury issued to commercial banks 1 3/4 per cent bonds of similar maturity. This decline in yields would result in an increase in the

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price of the latest issue of 2 per cent bonds to 102. This might create a disorderly market if the increase in price should occur very suddenly. To some extent, the transition could be smoothed by sales by the Treasury from its various investment accounts and by the Federal Reserve.

Another consideration is that banks might acquire a large amount of the present 2 per cent bonds by purchasing from the present holdings of these securities by nonbank investors, although the high premium would be some deterrent to such purchases. Nonbank investors probably would be willing to sell large amounts from their existing holdings only if they were able to replenish them by subscribing for restricted issues of similar maturity. It might be necessary, therefore, for the Treasury to issue no 2, 2 1/8, or 2 1/4 per cent bonds either to commercial banks or to nonbank investors in the next drive, although perhaps 1 3/4 per cent, 8-10 year bonds might be issued. If higher-coupon bonds were issued, however, the yields on outstanding 8-10 year bonds might not decline to 1 3/4 per cent. As part of this program, in view of increased bank earnings, the Treasury might also discontinue offering restricted issues to commercial banks on the basis of their time deposits.

The interest cost on the debt would be reduced by the decline in the rate on certificates from 7/8 to 3/4 per cent. There would be a further reduction of interest cost to the extent that banks shifted their holdings from certificates to bills, since the Treasury could issue additional bills and retire some of the outstanding certificates. Interest on the portion of the debt involved in these transactions would be reduced to 1/2 per cent. In addition, interest on a considerable part of Federal Reserve holdings of bills would be reduced from 3/8 to 1/4 per cent. Finally, any subsequent offering of medium-term bonds to banks would be at perhaps 1 3/4 per cent or less, rather than at 2 per cent. This latter change, together with the decline in the certificate rate, the shift from certificates to bills, and the discontinuance of the offering of restricted issues on the basis of time deposits would hold down the earnings of commercial banks. There would be no reduction, however, in the 2 1/2 per cent rate on long-term bonds or in the rates on savings bonds, the types of securities held by individuals, and therefore no diminution in the incentive to save.

To summarize, this program would result in a much more logical structure of yields. It would increase the demand for Treasury bills. It would reduce playing of the pattern of rates. It would hold down the earnings of commercial banks and of the Federal Reserve. Consequently, it would reduce the interest cost of the debt. This would be accomplished without any reduction in the rates for true savings.

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