

Chairman Cedes

"C O P Y"

R&S 100-1443
March 9, 1945

Hon. Daniel W. Bell,
Under Secretary of the Treasury,
Treasury Department,
Washington 25, D. C.

Dear Dan:

Referring to our conversation of yesterday with regard to the maturities to be placed on the issues included in the drive, I have discussed the matter with other members of the Executive Committee, and they concur in the position that I took. We agree that the 1 1/2 per cent bonds should be callable in five years and should mature in seven years. There is some feeling, however, that they should have a definite maturity placed in the neighborhood of 5 1/2 or 6 years.

We feel strongly that the maturities of the 2 1/4 and 2 1/2 per cent bonds should not be extended. On the basis of yesterday's close, 2 1/4 per cent restricted bonds of March 1960-65, which I understand is the maturity being considered, would sell in the market at par. In order to maintain them at par, it would be necessary for the System to maintain the existing market of 102 on the 2 1/4 per cent bonds of 1956-59 and the existing market of 102 1/32 on the 2 1/2 per cent bonds of 1962-67.

With a premium of 2 points, holders would be encouraged to take profits by selling. Since commercial banks could not purchase these bonds, it would be necessary for the System to purchase them. The sellers would use the funds thus acquired to increase their subscriptions for new 2 1/4 per cent bonds in the drive. This would be contrary to the announced policy of the Treasury to discourage selling from existing holdings. By adding unnecessarily to the outstanding amount of high-coupon bonds, it also would add unnecessarily to the interest cost of the debt. In addition, the System in effect would be supplying reserves at a cost of 2 1/4 per cent to the Treasury.

The same situation applies with respect to 2 1/2 per cent bonds. On the basis of yesterday's close, 2 1/2 per cent restricted bonds of 1967-77 would yield 2.49 per cent and consequently would sell at a premium of 5/32. Since they would be valued at par at the time of the offering, outstanding 2 1/2 per cent bonds would decline by only 5/32, leaving the 2 1/2 per cent bonds of 1966-71, the latest issue, at a premium of 28/32. This premium also would encourage profit-taking, resulting in increased subscriptions in the drive, an unnecessary increase in the interest cost of the debt, and the supplying of reserves at a cost of 2 1/2 per cent.

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It is our understanding that the System is committed to maintain a pattern of rates of 2 1/2 per cent on long-term bonds. Originally, this rate applied to 20-25 year bonds. Already it has been extended to apply to 21-26 year bonds. It appears that the proposal to extend the maturities on both the 2 1/4 and the 2 1/2 per cent bonds is part of an effort to bring about a decline in long-term rates. If this were accomplished, it would reduce the incentive to save at a time when the Treasury's policy is to encourage saving as a part of the fight against inflation.

We believe also that it would be undesirable to extend the call periods on these issues. During the war, the Treasury has issued long-term bonds with periods of five years between the first date on which the bonds could be called by the Treasury for redemption and the maturity date, medium-term bonds with call periods of two or three years, and short-term securities with no call periods. Issues with call periods are advantageous to the Treasury. If on the first call date interest rates are low, the Treasury can refund into a new issue at a low rate. If interest rates are high, the Treasury can leave the issue outstanding and await a more favorable time for refunding. For this reason, the advantage of call periods to the Treasury is a disadvantage to investors. In effect, it shifts part of the risk of changing interest rates from the Treasury to the public.

Sincerely yours,

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

LMP:msk