July 9, 1945

Honorable Henry Morgenthau, Jr.,
Secretary of the Treasury,
Washington, D. C.

Dear Mr. Secretary:

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 reason for establishing this rate no longer exists, 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.

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 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.

Sincerely yours,

(Signed) M. S. Eccles

M. S. Eccles,
Chairman.

LMP:ij