MAR 10 1947

CONFIDENTIAL

Honorable John W. Snyder,
Secretary of the Treasury,
Washington, D. C.

Dear John:

When Mr. Sproul and I met with you and Messrs. Wiggins and Bartelt on February 17, we presented a memorandum which had been approved by the executive committee of the Federal Open Market Committee as a basis for preliminary discussion with representatives of the Treasury of changes that might be made by the Treasury and the Federal Reserve System in policies with respect to Treasury bills.

As you know, the full Federal Open Market Committee met in Washington last week at which time the memorandum referred to above was presented and the questions of policy with respect to Treasury bills were thoroughly reviewed. Following the Committee's discussion, the attached revision of the earlier memorandum, which has been changed somewhat in its phraseology, was approved with the understanding that it would be used in connection with further discussions at the Treasury which it was expected would take place shortly.

Sincerely yours,

(Signed) Marriner
M. S. Eccles, Chairman,
Federal Open Market Committee.

Enclosure

SRC/mg cc: Mr. Bartelt
Musgrave

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February 28, 1947.

CHANGES IN TREASURY BILL POLICIES

Treasury and Federal Reserve policies and procedures followed during the war with respect to Treasury bills need to be reviewed, now that the period of heavy war finance has passed, with a view to reaching agreement for an adjustment of policies and action to changed conditions. Two aspects of these policies should be considered:

(A) Weekly replacement of Federal Reserve maturities, and
(B) Elimination of the posted buying rate and repurchase option.

(A) Replacement of Federal Reserve Bill Maturities

Existing arrangements, through which the Federal Reserve Banks replace their maturing holdings of Treasury bills, involve a cumbersome procedure initiated by the Secretary of the Treasury (Mr. Morgenthau) which is unsatisfactory, at least now that most of the bills are held by the Reserve System.

The weekly refunding operations could be simplified by permitting holders of maturing bills to exchange them for the new issue of bills. Under this procedure the Treasury would provide that bills awarded on tenders could be paid for either by cash or by surrender of a like face amount of the maturing issue of bills, with an adjustment for the discount. Pending any other change in policies, the rate could continue to be determined as at present. The Federal Reserve System would tender for the amount of maturing bills held in the System and option accounts (at a price it would determine--currently 99.905 for ninety-one day bills), and would not need to continue the present arrangement whereby dealers bid for bills and sell them to the System to replace its maturities. It would still be necessary, of course, to see that the total of each weekly offering of bills is covered by bids at the determined rate.

This change in refunding procedure could be introduced immediately and without other changes in bill policy but in connection with it, a general revision of policy on Treasury bills may also be considered.

(B) Elimination of Posted Buying Rate and Repurchase Option

The posted rate of 3/8 per cent for the purchase and resale of Treasury bills by the Federal Reserve Banks was a wartime measure designed to influence market rates for Government securities and encourage banks to make full use of their reserves. Under current conditions these arrangements no longer serve their original purpose. With a pegged certificate rate and only 1½ billion dollars of bill holdings outside the Federal Reserve

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Banks, certificates have replaced bills as the principal market instrument influencing short-term rates, and as a medium for investment of short-term funds or the adjustment of reserve positions of banks. Affirmatively, the reinstatement of the Treasury bill as a money market instrument would provide increased flexibility in debt management and reserve adjustment.

In considering the termination of the buying rate and repurchase option, decisions need to be made with respect to:

(1) Timing of the actions
(2) New policy regarding amounts of bills issued and rates
(3) Added cost to Treasury and effect on System earnings

(1) Timing -- Because of the emphasis that the market may place on the elimination of the buying rate, the change should be made when it is desired to exert some pressure or restraining influence. Accordingly, it might be postponed until there is a curtailment in the debt retirement program to the point of lifting the pressure on member bank reserve positions, which prevailed during the period of large-scale debt retirement last year, and has been accentuated by net tax receipts in the first quarter of 1947; or until private credit expansion appears to be proceeding at too rapid a rate. April might be a propitious time for such action. The change whenever made would apply only to bills issued subsequently; existing privileges would continue to apply to issues of bills outstanding at the time of the change, until they mature.

(2) Bill policy -- If the posted buying rate and repurchase option on Treasury bills are eliminated, there are various possibilities as to policies that may be followed in issuing bills and establishing rates.

(a) One possibility would be to permit bills to find their level in the market. It is assumed that the bill rate would rise toward the certificate rate which the Federal Reserve System would continue to maintain at the Treasury issuing rate of 7/8 per cent. The System would continue to refund its holdings of bills into new bills to the extent that they were not taken by the market. In view of the probable higher rate on bills, the market probably would take more bills than at present.

(b) Another possibility would be for the Treasury to discontinue entirely the issuance of bills and replace maturing bills with additional issues of certificates. With the certificate rate supported at a fixed level and the bill rate permitted to rise to approximately the same level, it may be said that there is little reason to have outstanding two short-term instruments serving essentially the same purpose.

(c) A third possibility would be for the System to stabilize the market for bills, not at 3/8 per cent but at whatever rate or rates would

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permit the Treasury to continue to issue one-year certificates with a 7/8 per cent coupon. The certificate rate would be maintained largely and indirectly through the supported bill rate. Since bills do not carry a fixed-rate coupon, their rate could be supported without public announcement of a fixed rate; this would have the advantage of permitting some flexibility within a narrow range. The System would engage in open-market operations in bills for the purpose of stabilizing the bill rate at the desired level and would refund its weekly maturities through exchanges as proposed under (A) above. The Treasury would continue to issue Treasury bills weekly in the same amounts now outstanding or increase or decrease the amount to suit its needs. The Reserve System would tender for new bills to replace its maturities and be prepared to buy through the market any additional amount of bills that might be necessary to complete the sale by the Treasury of its weekly offerings at satisfactory rates. Under such conditions, it is likely that the market would take more bills than at present, which would result in partial allotments on our exchange subscriptions. Any such increase in holdings of Treasury bills by other than the Reserve System would probably be accompanied by a decrease in holdings of certificates of indebtedness and, conversely, any reduction in the Reserve System's holdings of Treasury bills would probably be accompanied by an increase in holdings of certificates.

These changes in policies and practices would make the Treasury bills again a useful market instrument and would permit greater flexibility in monetary and debt management policies, without interfering with the general policy of stabilizing interest rates.

(3) Federal Reserve earnings and interest cost to the Treasury -- Elimination of the buying rate and repurchase option on Treasury bills raises questions of Treasury financing costs and System earnings. A rise in the bill rate, or the substitution of certificates for bills, would increase Federal Reserve earnings, which are already large, and would also increase the interest cost to the Treasury. Federal Reserve earnings will continue at a high level indefinitely, as it is unlikely that there will be any substantial reduction in the total amount of the System's holdings of Government securities in the near future.

In order that the System may pass on to the Treasury its earnings in excess of requirements, two approaches may be considered:

(a) Use may be made of a heretofore dormant provision of the Federal Reserve Act. Paragraph 4 of section 16 of that Act authorizes the Board of Governors to charge the Federal Reserve Banks interest on whatever amount of Federal Reserve notes they issue in excess of the amount of gold certificates held by the Federal Reserve Agent as collateral security for such notes. The rate of interest charged at each Federal Reserve Bank could

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be fixed by the Board, from time to time, so as to absorb some of the earnings of the Reserve Banks, and the amounts collected could be turned over to the Treasury. This would require no legislation and could be made effective by Board action immediately.

(b) Another possibility is to impose a tax on the earnings of the Federal Reserve Banks (similar to the old franchise tax). This would require legislation.

Either provision would make it possible to return to the Treasury not only any additional earnings obtained by the System from higher rates on Treasury bills (perhaps 50 million dollars or more a year) but also some of the earnings of the System on its present portfolio at existing rates (from 50 to 75 million dollars a year).

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