BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 13, 1947.

To Chairman Eccles

From Richard A. Musgrave RAM

Subject: Mr. Wiggins' Proposal on Bills.

The following summarizes some developments with respect to the bill discussion which occurred during your absence.

The Proposal

Mr. Wiggins, according to Mr. Sproul's report on their luncheon meeting on May 2, indicated that (a) action on bills should be gradual; (b) an announcement that the buying rate is being discountinued should be avoided if possible; (c) changes in bill policy should be such as to facilitate the handling of the certificate problem later on. Regarding the certificate rate, Mr. Wiggins expressed concern about the decline below par in the price of outstanding certificates, which would result if the certificate rate were permitted to rise. Apparently, he objects to policies which will reduce the price of any coupon security below par.

In applying these ideas, Mr. Wiggins recommends that the Treasury replace maturing three-month bills with six-month bills. I understand from Mr. Sproul that he told Mr. Wiggins that the Committee would consider the proposal and let him know their conclusion.

How it Would Work

The proposal might be interpreted in several ways:

(1) One procedure would be to do all bill refunding with six-month bills which would not become subject to the option.

This would eliminate the three-month bill after a period of thirteen weeks. There would then follow a three months period in which no bills mature, and after this period the volume of weekly maturities would again be as it is now.

Assuming that the new six-month bills will not become subject to the buying rate at any time, this proposal combines the System's recommendation for discontinuation of the buying rate on new bills with a policy of substituting a bill maturing six months from issue date for the present bill maturing three months from issue date. Since both these changes are desirable, their combination makes for a good plan.

It is doubtful, however, whether this is the plan which Mr. Wiggins has in mind. It does not get around the need for announcing discontinuation of the buying rate at the outset. At the time the six-month bill is introduced, it would be necessary under this version to indicate clearly that the buying rate will not become applicable to such

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bills even after they have run for three months. If the announcement was delayed for three months it would be objected at that time that investors purchased the six-month bills in good faith that the buying rate would come to apply.

(2) Another interpretation of the Wiggins plan is again to do all bill refunding with six-month bills but to apply the buying rate to these six-month bills when they are within three months from maturity.

The yield of six-month bills at three months to maturity would then remain at 3/8 per cent. The yield on six-month bills at the time of issue would be above the 3/8 level, but not as much as under (1), since the bill would become eligible for option at a 3/8 rate after three months. A "pattern of rates" problem would arise as the banks might make profits from selling the bills at the three-month point.

This plan merely provides for the introduction of six-month bills but it does nothing toward unpegging the three-month rate. Rather, the plan introduces a new rigidity. In the present situation, liquidation of the option account will take three months after announcement of a decision to terminate the buying rate on new bills. Under the new system it would take six months.

(3) A third possibility would be to replace only a fraction of each maturing bill issue with six-month bills, which would not become subject to the option, and to continue the issuance of some three-month bills.

The buying rate would then continue to apply to three-month bills but there would be an announcement that it will not become applicable to six-month bills, even after they have only three months to run.

Under this system, the three-month bills might be permitted to run out more gradually; that is, the option privilege could be abolished over a period of six or twelve months rather than over a period of three months as under plan (1). If, for instance, 1/2 of each maturing three-month bill issue was refunded in six-month bills and 1/2 in three-month bills (while all maturing six-month issues are refunded in six-month issues) the amount of three-month bills outstanding would decline within three months to about 7.5 billion and within six months to 3.7 billion.[1] Within a year the three-month bill would have virtually disappeared. Also, the fraction of three-month bills replaced with six-month issues could be increased monthly, to speed up the transition.

Under this system there would be bills with three months to maturity, some of which would carry the option privilege while others would not. This situation would develop after three months, and continue until

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1/ The figures assume an initial bill level of 15 billion and no change in the amount outstanding.

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the three-month bills had disappeared. There would be a rate differential between the two, measuring the advantage of the option. This might create some confusion in the market, but this difficulty is not such as to rule out the plan. Even now there are certificates, notes and bonds with three months from maturity which have no option; to avoid confusion, the name of the three-month bill might be changed to "option bill".

Conclusions

The Wiggins plan as interpreted under version (1) is wholly compatible with the views of the Open Market Committee.

Version (2) is not acceptable. Introduction of a six-month bill is desirable but not if it is to be given the option privilege.

Version (3) looks complicated, but may be acceptable. If the main effect of the bill action on the market is in the uncertainty which it creates, much might be said for stringing out such action as proposed under (3). While (3), like (1), requires an announcement that the buying rate will not apply to six-month bills, such announcement might be more acceptable to Mr. Wiggins in this connection, where three-month bills subject to option are continued for some time. This version also appears to be the one which Mr. Bartelt has in mind.

Relation to Certificate Rate

The introduction of a six-month bill might make it possible gradually to replace certificates by bills. After the certificates have disappeared, the short-term instrument would then be in the form of a discount security. It would then become possible to permit a moderate increase in the short rate without permitting the price of any coupon security to decline below one hundred. The coupon rate on notes and bonds is sufficiently high so that a slight rise in short rates would not reduce their prices below par. However, a rather drastic refunding program would be necessary to transfer the bulk of market-held certificates into bills. At best it could be completed in one year. Considerable time would have to lapse before an increase in the short rate would become possible.

In other words, if the dictum of "no price of coupon securities below par" is subscribed to, it will be very difficult to raise short rates. The substitution of a discount security at the short end offers a technical way out, even though the market (according to Mr. Rouse) would dislike it.

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Mr. Thomas has seen this memorandum and I am sending a copy to Mr. Rouse. Mr. Thomas is going to be at the New York Bank on Friday and might discuss the matter further.

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