BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 29, 1947

To Chairman Eccles

Subject: Treasury Finance

From R. A. Musgrave

Developments Since your Departure

(1) At the Executive Committee Meeting of May 2, the Committee repeated its previous proposal for bill retirement of 600 million dollars during May and also recommended retirement of 200 million dollars of bills maturing June 5. The recommendation for May retirement has since been carried out; the recommendation for the June 5 retirement was changed in accordance with our discussion last Wednesday.

At the same meeting Mr. Sproul reported on his preceding discussions with Mr. Wiggins. In respect to the Committee's three point program submitted before your departure, Mr. Wiggins indicated that the first two points (interest charge on Federal Reserve notes and direct exchange of maturing Federal Reserve held bills) were acceptable, but that the Treasury wanted to think about procedural aspects regarding the discontinuation of the buying rate.

(2) The same day Mr. Sproul and the Board members of the Executive Committee lunched with Mr. Wiggins. I understand that Mr. Sproul reported to you in a memorandum on this discussion. Also, Mr. Wiggins' proposals are discussed in my memorandum to you dated May 13. (Copy attached)

Very briefly, Mr. Wiggins argued (a) that action on bills if possible should be gradual; (b) that the program should be handled, if possible, so as to avoid any direct announcement of discontinuation of the buying rate; and (c) that changes in bill policy now should be adapted to facilitate handling of the certificate problem later. With respect to the certificate problem, his main concern appears to be that with an increase in rates, the price of outstanding certificates might fall below par and that this might destroy confidence in the public debt.

No specific solution was proposed by Mr. Wiggins but he wondered whether the need for announcing discontinuation of the buying rate might be avoided by issuance of a 6-months or 9-months bill which would replace the 3-months bill and which would not be subject to option. Also he wondered whether replacing bills and certificates with a 9-months discount security might not solve the problem of avoiding a decline in price below par if and when the certificate rate should be raised.

Mr. Wiggins requested the Committee to comment on these suggestions but as far as I know, no formal reply was made.

Our reaction to the two points is as follows: (a) The issuance of a 6-months bill would not avoid the need for announcing discontinuation of the option because it would have to be made clear at the time of issue that such 6-months bills would not become subject to option after three months; (b) Issuance of a 9-months discount security would solve the problem of preventing a decline in certificate prices below par in case the certificate rate is unfrozen. However, this would be so only after all certificates have been refunded and this would take time. Mr. Rouse argues that the market would feel very hesitant to accept a discount security in place of the present certificate and that, therefore, this approach is objectionable; Dave Kennedy, on the other hand, feels that the market would be pleased to have a discount security and that this approach would be feasible; (c) As to the principle that "certificate prices must not fall below par", little can be said in its favor. If temporarily the price of very short certificates was permitted to go to a slight discount, this certainly would not reflect on the determination of authorities to maintain bond prices above par. Also, the effect of a slight rise in the certificate rate to 1 1/8 or even 1 1/4 would not be such as to lower the price of outstanding bonds and notes below par. The principle of "not below par" as applied to certificates seems to be a red herring. However, Mr. Wiggins places great emphasis on it.

My impression is that there is no strong Treasury opposition to action on bills as such but that they wish to view the matter in relation to the certificate problem and that there is considerable opposition to raising the certificate rate.

(3) I understand from Mr. Rouse that he has had repeated discussions with Treasury people on the restricted long-term issue and that the Treasury (including Mr. Wiggins) appeared to favor it up to a point, when some objection arose. This was discussed in my memorandum of May 26. (Copy attached). However, chances for fairly prompt action on a restricted tap issue, sold on a limited quota basis should seem fairly good. My impression is that institutional investors would be pleased to take it after they realize that no marketable issue will be available. Also, a limited amount of, say, 1 billion should be sufficient to meet the main pressure.

Financing Outlook

The attached Table I shows the Treasury financing picture as we now see it. The expenditure figures are on the optimistic side since we have assumed a 2.5 billion dollar reduction in the budget figure for fiscal 1948. The receipt figures allow for income tax reduction as provided for in the Senate bill. If the bill does not become law, receipts in the second half of calendar 1947 will be 1.3 billion higher and receipts in the first half of 1948 will be 2.2 billion higher.

It is evident from our figures that the retirement program is about over. Assuming retirement of 1 billion dollars of certificates maturing on

June 1 and no additional bill retirement during June, the balance at the end of the fiscal year will be about 2.5 billion including 1 billion of free gold, 900 million of war loan deposits and 600 million of cash deposits with the Federal Reserve.

We expect budget deficits in July and August and some surplus in September. Assuming that 500 million dollars of certificates are retired on July 1 and allowing for only voluntary cash redemptions on August and September maturities, the balance by the end of September will be 1.8 billion. Also, we estimate that there will be a budget deficit during the last three months of the year. Allowing for changes in nonmarketable debt and again assuming some voluntary cash redemptions of maturing issues, it will be necessary during this quarter to raise approximately 1.5 billion dollars in the market if the Treasury balance is not to fall below 1.7 billion dollars. (Since this includes 1 billion dollars of free gold, it is about as low as the balance can fall unless the gold is monetized). The outlook for the first quarter of 1948 is better, as a surplus of about 4 billion is anticipated. For the first half of the calendar year 1948 redemptions of about 3 billion (including about 1.5 billion voluntary cash redemption will be possible.

Thus, there will be no cash retirements but probably new financing in the second half of this calendar year. At the same time there will be 4.4 billion of note maturities on September 15. (See Table II). Also, there will be 700 million dollars of bond maturities each on October 15 and December 15. This raises the question whether we want to continue to refund maturing notes and bonds into certificates as has been done since the beginning of 1945, or whether we want to bring out some new medium or longer term issue. It is evident that refunding policies will have to depend closely on what is done along the other lines, for instance:

(1) If a nonmarketable restricted issue is brought out, more cash will be available to retire some of the bank held maturing debt and some of the pressure on the long rate will be relieved.

(2) If the certificate rate is permitted to rise, the need for replacing the maturing longer term issues held by banks in order to maintain their earnings will be less serious than it if the certificate rate remains unchanged.

Market Developments

The Federal Reserve Bank of New York, since the beginning of April has sold for Treasury and System Account 418 million dollars of bonds in the open market, comprising 255 million of restricted bonds and 163 million of bank eligible bonds. (See our memorandum of May 20, copy attached). This sales program has been a factor in holding down prices but nevertheless some price advance has been resumed. (Table III) At the beginning of the program of sales for Treasury Account, the market was very sensitive to a small show of bonds, as it had been made cautious by the cash redemption of bills out of war loan balances and by the Treasury-Federal Reserve discussions on changes in credit policy. Since April 30, sales for Treasury Account have increased greatly in momentum. The effectiveness of the sales program has been lessened, however, but without the additional supply of bonds, prices would have risen substantially.

Moderate outright purchases by savings banks and shifting out of eligible issues sufficed to exert a strong pressure on prices of restricted 2 1/2 per cent bonds because of the complete absence of a market supply. There is, however, a growing underlying demand based on bank shifting and there is reason to expect that the price rise may be accentuated in the near future. Banks under pressureof reduced earnings have begun to carry out their buying program, they are beginning to feel that with an impending recession no rise in short rates will be effected in the next six months and that bond prices will not fall significantly even if a slight rise in short rates should be permitted.

The supply of bonds from System Account is strictly limited and there is no way of determining how much additional long-term bonds will be made available for sale by the Treasury. (Total holdings of 2 1/2 per cent bonds in trust accounts amount to 5 billion dollars.)

War loan deposits are rapidly approaching a minimum working level so that war loan calls which exerted the main pressure on reserves are nearing their end. In short, indications are that bank shifting into longer term securities which has not been a very strong factor since spring of 1946 now gives indication to become of real importance.

Conclusions

1. Consideration of the financing outlook, especially in conjunction with the growing pressure in the market, make a strong case for vetoing the tax bill.

2. The market has probably by now discounted the effects of unfreesing the bill rate, if unaccompanied by action on certificates.

3. The argument that bill action must necessarily preceed action on certificates has some merit but is frequently over-done.

4. Therefore, if no early certificate action is anticipated, there is no excessive hurry about completing discontinuation of the option account. That is, we might consider the Treasury approach of doing away with the option more gradually.

5. With respect to the certificate rate: As an anti-inflation device, it is rather late in the day for letting the certificate rate rise. As a measure of meeting bank earning needs and preventing shifting and further monetization it may or may not be effective. The result will depend in part on whether the rate will have to be re-frozen at a higher level (in which case the effect will be slight) or whether some flexibility and thereby increased uncertainly (which will make longer issues less attractive) can be maintained.

What bothers me most about permitting the certificate to rise in order to "offer the banks a bribe", is that the first bribe may well lead to a second and so forth without accomplishing much. Some other approach is needed; or, at least, the banks must be told effectively that the game can not develop into a spiral.

6. There is a good case for bringing out a long bond on a restricted basis. But to the extent that the main pressure comes from the banks this will take care of only a small part of the problem.

ESTIMATED TREASURY CASH BALANCE[1]
(In billions of dollars[1])

	Fiscal year 1947		1947							1948		Fiscal yrs.	
	July-Dec. '46*	Jan.-June '47	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.-Mar.	Apr.-June	1947	1948
Treasury cash balance, start of period	14.0	3.1	3.5	2.5	1.7	1.6	1.8	2.6	2.4	1.7	3.7	14.0	2.5
Net receipts	18.5	24.0	4.7	2.4	2.3	4.1	2.0	2.1	3.4	12.2	8.0	42.5	36.5
Expenditures 2/	18.9	22.6	5.1	3.6	2.6	3.4	2.7	2.3	3.5	8.2	9.1	41.5	35.4
Surplus or deficit	- .4	+ 1.4	- .4	-1.2	- .3	+ .7	- .7	- .2	- .1	+4.0	-1.1	+ 1.0	+1.1
Change in nonmarketable debt	+ 2.7	3/ + 5.6	+ .4	+ .9	+ .3	--	+ .1	+ .1	- .1	+ .4	--	+ 8.3	+1.7
Retirement of marketable debt 4/	-13.0	- 7.7	-1.0	- .5	- .1	- .5	+1.4	- .1	- .5	-2.4	- .5	-20.7	-3.2
Net change: General fund balance 5/	-10.7	- .7	-1.0	- .8	- .1	+ .2	+ .8	- .2	- .7	+2.0	-1.6	-11.4	- .4
Cash balance	-10.9	- .6	-1.0	- .8	- .1	+ .2	+ .8	- .2	- .7	+2.0	-1.6	-11.5	- .4
Treasury cash balance, end of period 6/	3.1	2.5	2.5	1.7	1.6	1.8	2.6	2.4	1.7	3.7	2.1	2.5	2.1

* Actual.

1/ Estimates are based on certain assumptions with regard to expenditures, tax legislation, and retirement policies; (1) expenditures for fiscal 1948 are assumed reduced by 2.5 billion dollars from the President's Budget, (2) personal income tax rates are assumed reduced by 20 per cent beginning July 1, 1947.

2/ Including net expenditures in trust accounts.

3/ Including 1.7 billion dollars of securities held by the International Monetary Fund and 600 million by the International Bank.

4/ For the third quarter of 1947, the reduction in marketable debt is assumed to equal 500 million of cash retirement of July 1 certificates plus voluntary cash redemptions in August and September, notwithstanding full exchange offerings for maturing issues. For the fourth quarter of 1947 the increase allows for some new financing which will be offset by assumed cash retirements in the following quarter.

5/ The Treasury's surplus or deficit plus changes in debt may not necessarily add to changes in the cash balance due largely to estimated or actual differences in timing of receipts and expenditures.

6/ Beginning with February 1947, consisting of deposits with the Federal Reserve Banks and in war loan deposits as shown on Table II, and 1.0 billion of free gold of which 832 million gold transferred to the cash balance as a result of payments to the International Monetary Fund.

Table III

BID PRICES OF SELECTED ISSUES
OF TREASURY BONDS

(Dollar premium above par of $100)

Statement week ended	Unrestricted, taxable		Restricted	
	December 1952-54	September 1956-59	June 1959-62	December 1967-72
April 9	3.07	5.15	2.26	3.16
April 16	2.29	5.06	2.15	3.04
April 30	2.30	5.08	2.19	3.08
May 27	3.02	5.10	2.25	3.10

Table IV

NET SALES OF TREASURY BONDS FOR
TREASURY AND SYSTEM ACCOUNTS

(In millions of dollars)

Period	Restricted	Bank Eligible	Total
April 3 - April 30	41.1	38.2	79.3
May 1 - May 28	214.0	125.2	339.2
Total	255.1	163.4	418.5

Table II

STRICTLY CONFIDENTIAL

Detailed Table 12

DEBT RETIREMENT FOR 1947 AND JANUARY - JUNE 1948

PUBLIC MARKETABLE SECURITIES OTHER THAN TREASURY BILLS

(In millions of dollars)

May 23, 1947

Issue	Held by: Commercial banks	Held by: F. R. Banks	Held by: Nonbank investors	Total outstand-ing	Redeemed for cash: Total	Redeemed for cash: Commercial banks	Redeemed for cash: F. R. Banks	Redeemed for cash: Nonbank investors	Amount exchanged
1947: Jan. 1, 7/8% certificates	1,789	401	1,140	3,330	196	105	--	91	3,134
Feb. 1, 7/8% certificates	1,721	1,685	1,548	4,954	1,007	350	303	354	3,947
Mar. 1, 7/8% certificates	1,429	547	1,157	3,133	991	452	153	386	2,142
Mar. 15, 1 1/4% notes	885	93	970	1,948	1,948	885	93	970	--
Apr. 1, 7/8% certificates	986	817	1,017	2,820	1,499	524	425	550	1,321
June 1, 7/8% certificates	773	243	1,759	2,775	1,000	279	88	633	1,775
July 1, 7/8% certificates	1,116	665	1,135	2,916					
Aug. 1, 7/8% certificates	527	260	436	1,223					
Sept. 1, 7/8% certificates	655	878	808	2,341					
Sept. 15, 1 1/2% notes	1,848	46	813	2,707					
Sept. 15, 1 1/4% notes	733	10	944	1,687					
Oct. 1, 7/8% certificates	600	233	607	1,440					
Oct. 15, 4 1/4% bonds	367	12	380	759					
Nov. 1, 7/8% certificates	699	333	743	1,775					
Dec. 1, 7/8% certificates	674	209	2,398	3,281					
Dec. 15, 2% bonds	540	--	161	701					
1948: Jan. 1, 7/8% certificates	1,512	637	985	3,134					
Feb. 1, 7/8% certificates	1,240	1,523	1,184	3,947					
Mar. 1, 7/8% certificates	* 977	351	* 814	2,142					
Mar. 15, 2% bonds	766	40	309	1,115					
Mar. 15 2 3/4% bonds	860	101	262	1,223					
Apr. 1, 7/8% certificates	* 462	320	* 539	1,321					
June 1, 7/8% certificates	* 494	*155	*1,126	*1,775					
June 15, 1 3/4% bonds	2,179	25	858	3,062					
Total: 1947 - Jan.-June	7,583	3,786	7,591	18,960					
July-Dec.	7,759	2,646	8,425	18,830					
1948 - Jan.-June	*8,490	*3,152	*6,077	*17,719					

* Estimated.

Note: Holdings of commercial banks are taken from Treasury Survey of Ownership of U. S. Government Securities for February 28, 1947. Holdings of Federal Reserve Banks are as of April 30, 1947. Cash redemptions of commercial banks are estimated.

GOVERNMENT FINANCE SECTION, BOARD OF GOVERNORS