

Form F. R. 511

TO \_\_\_\_\_

FROM \_\_\_\_\_

REMARKS:

Used at meeting with A.B.A. Committee  
on Government Borrowing.

CHAIRMAN'S OFFICE

July 9, 1947.

STATEMENT OF VIEWS OF ALLAN SPROUL

(Edited by R. G. Rouse)

The reasons advanced, heretofore, suggesting the desirability of an increase in rates on Treasury certificates of indebtedness and of introducing some flexibility into the short-term rate structure, become more compelling in the face of the refunding problem facing the Treasury during the fiscal year, 1947-48. Present estimates indicate that during the first six months of the fiscal year, surplus cash will not permit substantial debt retirement other than the unexchanged portion of maturing debt. Meanwhile, the tendency of banks to reach for longer term securities, and the downward pressure on long-term interest rates, which are the inevitable consequences of maintaining the wartime pattern of short-term rates, continue. The former is obscured in the figures by changes in maturities with the passage of time, but it is apparent in market transactions. (Based on the increase of over \$350 million in holdings of Treasury bonds by reporting banks in 101 cities since April 9, 1947, it is estimated that holdings of Treasury bonds by all banks increased between \$500 and \$600 million during that period.) The latter, that is, the downward pressure on long-term interest rates, has been obscured by Treasury sales, but the sale of more than \$750 million 2 1/2 per cent restricted issues and \$170 million bank eligible issues since April 10th has served to move prices down only 1/2 to 1 point for the restricted issues and less for the bank eligible issues. The action of the market indicates that this loss would be quickly recovered if sales diminish or cease.

Because the Treasury will have to refund a substantial amount of notes and bonds during the fiscal year now beginning, it is faced with the necessity

of deciding whether to perpetuate this undesirable situation, with its encouragement to debt monetization, for a further extended period. A refunding issue of notes or intermediate bonds priced on the present rate pattern would freeze that pattern into the rate structure for another term of years, probably expressing itself through an excessive and unwanted premium on the new issues. Similar refunding issues priced on the present market which, in terms of yield, is below the rate pattern, would actually impose a reduction in that pattern. Refunding of maturing notes and bonds with certificates, at present rates, would intensify existing undesirable pressures. It seems to me almost imperative, therefore, to narrow the spread between short and long-term rates and to introduce some flexibility and uncertainty into the rate structure if the refunding program is to be geared to a sound policy of debt management and credit policy. The way to proceed, it seems to me, is immediately to adopt a program which will consolidate outstanding issues of certificates into four or six issues, with a gradual increase in the rate. With such a program, refunding into certificates should be possible, at least until a better rate structure has developed.

BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date July 10, 1947

To Chairman Eccles

Subject: Refunding Program

From Richard A. Misgrave RAM

## The Market Situation

The present situation in the security market is one of growing latent pressure on the long-term yield and there is an increased tendency for banks to shift into longer-term issues. A decline in yields has been avoided during the last few months mainly because the Federal Reserve has sold for Treasury Account a substantial amount of bonds totaling one billion dollars and including 800 million dollars of restricted issues. (See Table I). Sales of bonds for System Account were negligible. With this source of additional supply, yields of restricted bonds are now just slightly above the end of February level. (See Table II). While the sales program was carried out, bank holdings of bonds have been expanded. During the last three months holdings increased by an estimated total of 525 million dollars, including 200 million dollars during the last six weeks. (See Table III).

The market outlook is for an increased demand for securities from both bank and nonbank sources and a continued decline in the supply of longer issues, as outstanding issues move closer to maturity. Unless proper steps are taken and in the absence of a supply of new issues from other sources, a decline in the long-term yield and increased debt monetization are in prospect.

## Debt Refunding

Any remedial action will have to be closely related to the Treasury refunding program. Total maturities of certificates, notes and bonds from August 1 to December 31 will amount to 16 billion dollars including 4.4 billion of notes maturing September 15. The budget outlook is such that all or nearly all of these maturing issues will have to be refunded. Available cash will be just sufficient to pay for voluntary cash redemptions if full exchange offers are made. The kind of refunding which is undertaken will be a crucial factor in yield developments.

## Issuance of Marketable Bonds or Notes Undesirable

The argument is being made that the problem should be met by having the Treasury issue new marketable bonds and notes in connection with the fall refunding. This would be a mistake, for several reasons:

(1) If additional supplies of marketable long-term issues are made available, they will tend to be reflected in an increased supply of bank eligible issues being made available to banks. Thereby the process of debt monetization would be encouraged rather than checked. The recent program

of sales for Treasury Account has been equivalent to the issuance of new marketable long-term bonds. It has contributed to further debt monetization and has been an entirely unsatisfactory stop gap, *even though sales on a basis of 7 1/2% instead of the 2 1/2% pattern*

(2) Issuance of new marketable long-term bonds ~~or~~ of intermediate term securities at this time would create serious pricing difficulties. This is due to the fact that the present pattern of market yields is out of line with a long-term coupon rate of 2 1/2 per cent. If the new issues were given a 2 1/2 per cent coupon an undesirable premium would result. If on the other hand, the new issues were given a coupon rate and terms which are in line with the present yield curve, this would mean lower coupon rates and thereby an official departure from the 2 1/2 per cent policy. Also, it might ~~well~~ *erect* obstacles in the way of possible later upward adjustments *in coupon rates* on certificates or other issues because such rate increases *would* then depress the price of the recent issues below par.

#### A Two-fold Program

These difficulties can be avoided by adopting the following program which deals with the situation of both institutional investors and commercial banks, and which will serve to check a further decline in the long-term yield as well as discourage further debt monetization.

(1) An additional supply of nonmarketable ~~long-term~~ *long-term* issues of the general G bond type should be made available to institutional investors. Such an issue would meet their legitimate investment requirements and reduce pressure on the long-term yield arising from these quarters. The issue would be placed on tap but proper precautionary measures would be taken to prevent its being purchased out of funds obtained by the sale of other issues to commercial banks. The danger of roll over into commercial banks would thus be considerably less than with a marketable issue. Finally, the restricted issue would not raise the pricing difficulties ~~encountered~~ *in the case of a marketable issue.*

(2) Quite likely ~~a truly~~ *an entirely* satisfactory solution to the problem of bank investment in Government securities can not be found without some direct control over their security holdings. In the meantime, we must do as well as we can along other lines. Refunding policy must recognize that banks will lose some high coupon securities in connection with the September maturities and that they will attempt to compensate for such earning losses by shifting into longer issues. For reasons previously stated (i.e., difficulties of pricing) such compensation should not be facilitated under present conditions by supplying the banks with new bank eligible issues. *of notes or bonds* It should be met rather by a gradual upward adjustment in the certificate rate. This upward adjustment would meet the bank earning problem. Also, it would narrow the spread between the yield on short-term and other bank eligible issues and thereby check debt monetization. *all other* Somewhat higher certificates rates would also tend to strengthen the rates on ~~commercial~~ *all other* loans. A slight increase in certificates rates would be a more effective and less costly way of dealing with the problem than an increased supply of notes or bonds.

Table I

Sales for Treasury Accounts, April 3 to July 9, 1947  
(In millions of dollars)

Period	Restricted			Unrestricted		Partially tax- exempt	All issues
	Total	June and Dec. 1967-72	Other	Callable after 1955	Callable before 1956		
April 3-30	41.1	24.4	16.7	5.1	16.0	17.1	79.3
May 1-28	213.7	87.6	126.0	40.8	37.8	29.0	321.2
May 29-June 25	273.2	123.8	149.4	17.6	12.0	3.0	305.8
June 26-July 9	277.7	157.3	120.4	12.9	5.5	—	296.0
Total	805.7	393.1	412.5	76.4	71.3	49.1	1002.3

July 10, 1947

Table II

Yields to Earliest Call on Selected Treasury Bonds in 1947

Issue	Jan. 3	Feb. 28	March 29 (Per cent)	April 30	May 29	June 30	July 8
2% Dec. 1952-54 (Unrestr.)	1.49	1.45	1.41	1.45	1.41	1.44	1.42
2-1/4% Sept. 1956-59 ( " )	1.67	1.63	1.62	1.64	1.63	1.66	1.65
2-1/2% Sept. 1967-72 ( " )	2.13	2.14	2.13	2.17	2.16	2.16	2.15
2-1/2% Dec. 1967-72 (Restr.)	2.33	2.31	2.30	2.30	2.30	2.33	2.33

Table III  
 Net Market Purchases of U. S. Treasury Bonds by Commercial Banks  
 (In millions of dollars)

1947	Reporting Member Banks			Other Banks <u>2/</u>	All Commercial Banks
	New York City and Chicago	Other	Total		
April 3-30	+185	-10	+175	+25	+200
May 1-28	- 1	+52	+ 51	+75	+126
May 29-July 9	+160	--	+160 <u>1/</u>	+40	+200

1/ Changes since June 25 are estimated.

2/ Changes in holdings of these banks, which are largely country banks, are estimated on the basis of very sketchy data.



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date July 16, 1947

To Chairman Eccles

Subject: A.B.A. Financing Recommendations

From Richard A. Misgrave RAm

I attended today's Treasury meeting with the A.B.A. Committee on Government Borrowing. The Committee's recommendations on Treasury financing were presented.

The Committee stated that its recommendations are made against the background of a still continued boom economy. While the inflation pressure is primarily not a credit problem, proper checks on the credit side are nevertheless important. Referring more specifically to the Government security market, the background is one of continued downward pressure on yields, notwithstanding heavy sales on Government account during recent months.

Regarding quarterly versus monthly certificate financing, the Committee felt that on the whole quarterly financing should be favored. The main advantage is greater flexibility for rate adjustments; while quarterly financing will result in larger issues, this can be handled. However, the Committee also pointed out that some investors like the monthly issues and in any case felt that no undue haste in the matter was necessary. There was no reference to using the spacing process as a device for raising the certificate rate.

With respect to the refunding of notes and bonds maturing in September and October, the Committee recommended that two-thirds be refunded into a 1-year certificate at the rate of 1 per cent and one-third into a 2-5 year issue at a correspondingly higher rate.

With respect to the coming certificate maturities, the Committee recommended that the August 1 issue be rolled over into an 11-months certificate at  $7/8$  per cent; the September 1 issue into a 13-months note at 1 per cent and the October 1 issue into a 12-months certificate at 1 per cent.

The Committee also renewed its recommendation for a  $2\frac{1}{2}$  per cent bond issue, based on the principle that long-term debt should be placed outside the banks in order to retire short-term bankheld debt. The report pointed out that a marketable issue would be preferable but that a G bond type issue should be brought out if the marketable issue was unacceptable. In the discussion it was stated that the G type issue might bring about 1 billion dollars, although perhaps not immediately. The Committee also recommended that the new G type issue be sold in limited amounts to commercial banks with savings deposits.