

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date December 17, 1947

To Chairman Eccles

Subject: _____

From Thomas Lee Smith

I talked with Mr. Willis of the New York Reserve Bank after the close yesterday about a tentative yield curve he has prepared for Mr. Rouse as the basis for discussion of the pattern of rates to be supported. Mr. Rouse had not seen the curve. The objective was to set up a curve that will be reasonably tenable in view of expected pressure on the money market in the first quarter of next year and a desire to avoid additional upward pressure on one-year rate. A net supply of bonds from all sources is expected in the first quarter.

Mr. Willis' curve does not allow for a full range of adjustment on outstanding issues. The curve is almost as flat as it can get and still allow some increase of yields, touching par for the restricted issues callable in 1959, 1.71 per cent (price 101.13) for the 2 per cent eligible bonds callable December 1952, 2.47 per cent (100.15) for the 2 1/2 per cent restricted bonds callable in December 1967, and 2.42 per cent (102.24) for the eligible bonds callable in September 1967.

The rise is kept gradual rather than steep so that no inducement to give up 1 1/8 per cent one-year certificates will result. Mr. Willis considers a yield of 1.71 per cent for a five-year maturity the maximum permissible if we are to avoid upward pressure on the 1 1/8 per cent rate.

So as to avoid the necessity for a second lowering of support prices, the curve I drew is at the lowest points in prices that we can permit consistent with par for all except restricted 2 1/4's. I do not think the market will support itself before reaching the suggested yields, but, if it should, so much the better.

Some upward pressure on the 1 1/8 per cent and 2 1/2 per cent anchor rates may develop because of shifting that probably will result if yields are allowed to increase to the curve I have indicated. Once the curve is established, however, there should be a smaller net supply of Government securities in the aggregate.

The latter curve shows a substantial rise in the yields of 1-5 year bonds and some increases in the yields of shorter restricted bonds, while holding the 1 1/8 per cent and 2 1/2 per cent anchors. Therefore, there should be fewer sellers of 1-5 year bonds and perhaps some increase in buyers, and fewer buyers of 1-year certificates and perhaps some increase in sellers. At the long end, because all 2 1/2 per cent restricted bonds are shown about at par and the 2 1/4 per cent

restricted at less than par in price, there would be additional sellers of the longest-term restricted issue sellers on shifts into the shorter restricted issues.

Some tendency to shift from the restricted 2 1/4 per cent bonds callable in 1959 to the bank eligible 2 1/4 per cent bonds callable in 1956 may result from the necessarily smaller spread between these issues as the yield curve is allowed to rise. It is assumed that we would maintain the bank eligible 2 1/4 per cent issue at par, and allow the market to determine the spread.

Although the 20-year 2 1/2 per cent bank eligible issue is shown with a premium of 1 1/2 points, the initial tendency would be for this issue to drop very close to par since temporarily the absence of any bank demand for this issue affords the investor no better market than for a comparable restricted issue. However, once institutional investors are convinced the restricted issue will be held at par, they may switch from the restricted to the bank eligible 2 1/2 per cent issue and reestablish a spread. They would do this because of the potentially better market for the bank eligible issue after, say, 6 months or a year. Consideration might be given to establishing our support rate at some point closer to par and below the price that might be established by arbitrage in the market.

Looking beyond the first quarter of next year, there would be no subsequent problem in adjusting the yield curve to a lower pattern of rates unless such lower pattern were not justified by market demand. Should there be a resurgence of demand, the pattern of rates will automatically adjust to a lower level.

In order to maintain either of the suggested yield patterns, it would appear necessary for the System and Treasury to support only a few issues; namely, the 1 1/8 per cent certificates, the 2 per cent December 1952-54 eligible bonds, the 2 1/4 per cent September 1956-59 eligible bonds, and the 2 1/2 per cent December 1967-72 restricted bonds. Everything else, including the partially tax-exempt bonds, short eligible bonds, other restricted bonds and the 20-year bank 2 1/2's, might be allowed to seek its own level.