CONFIDENTIAL

Dear John:

In my letter of September 13, 1948, I stated that sometime in the near future Mr. Sproul and I, in behalf of the Federal Open Market Committee, would like to discuss with you the two matters referred to in the letter and other matters relating to the credit and monetary situation. This letter has been prepared as a basis for a discussion of policies to be followed during the remainder of the current year.

It is believed that the period will be characterized by additional sales of bonds by nonbank holders which will have to be purchased by the Federal Reserve Banks in accordance with the present policy of supporting the 2½ per cent long-term rate. It is possible that such purchases by the System will be in substantial amounts. These transactions, together with a further gold inflow, will add to bank reserves at a time when there is a strong demand for bank loans. In order to curb the inflationary effects of this expansion, it is important that substantial pressure be kept on the reserve position of banks. To accomplish this the Federal Open Market Committee proposes that substantially the following program be undertaken promptly.

1. Short-term rates

a. Treasury bill policies. The rates on the System's weekly bids for exchanges of maturing bills will be adjusted so as to bring about reduction in the System's portfolio at the time of the exchange.

This will absorb bank reserves and put the banks under some restraint. The policy with respect to bills will be designed to achieve, as suggested in my letter of August 11, 1948, a greater degree of flexibility in the bill rate and will probably result in higher rates on Treasury bills in relation to the current rate on certificates.

b. Certificates. The Federal Open Market Committee will also allow the market yields on certificates to increase. This increase will encourage banks to purchase Government securities or to maintain their holdings and thereby discourage further loan expansion during the remainder of the period. Furthermore, it will permit the investment in short-term securities of corporate and other balances which would not be attracted by existing rates. This increased demand will enable the System to sell some of its holdings and thereby absorb bank reserves. Depending on market conditions, the rate might be permitted to go as high as $1\frac{1}{2}$ per cent.

c. Other short-term securities. The rates at which the System supports other short-term securities will be adjusted to conform to the higher certificate rate and the $2\frac{1}{2}$ per cent long-term rate.

2. Debt retirement and Treasury refunding

Because of its restrictive effect, it is desirable that the Treasury continue to draw upon its war loan balances to retire securities held by the Federal Reserve as rapidly as the Treasury's cash position permits. It appears at the present time that bills could be retired at the rate of $100 million a week for a number of weeks and at the same time available trust funds could be used to purchase marketable securities. Such purchases would reduce the amount the System would have to purchase in support of the long-term $2\frac{1}{2}$ per cent rate. If it should develop during the period that System support was not necessary for that purpose, the Treasury could purchase the issues needed for trust account investment directly from the System account.

As suggested in my letter of September 13, it is recommended that the $571 million dollar issue of bonds to be redeemed on December 15 be refunded. This issue is held entirely outside the Federal Reserve and retirement in cash would put funds into the market unnecessarily. The terms of the refunding as well as of the certificates maturing on January 1, 1948, would be considered later in the light of developments with respect to the short-term rate.

3. Treasury balances

Also as proposed in my letter of September 13, 1948, it would be desirable for the Treasury to time calls on war loan deposit accounts so as to exert some drain on bank reserves. In carrying out the transactions referred to above the Treasury could reduce its war loan balances as low as $500 million (they now amount to about $2.1 billion) and could also reduce its balances with the Federal Reserve below the present level of $1.7 billion. Large tax receipts in the first quarter of 1949 and current income in the second quarter will provide adequate means for meeting all needs during the remainder of the fiscal year.

4. Other System actions

It is believed that as soon as the market rate on certificates has risen above the 1-1/4 per cent rate, the discount rate of the Federal Reserve Banks be increased to 1-3/4 per cent. Such action would be an indication to the public of the System's views with respect to the need for restraint. Also the Board of Governors will continue to study the situation for the purpose of determining the action that should be taken during the period further to increase member bank reserve requirements.

Sincerely yours,

Thomas B. McCabe, Chairman
Federal Open Market Committee.