

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 4, 1941To Chairman EcclesSubject: Proposed Savings bondFrom L. M. PiserprogramSTRICTLY CONFIDENTIAL

After reviewing the Savings bond program submitted by the Treasury, most of the proposals appear to be entirely satisfactory. The only question concerning the plan as outlined is the rate of $2\frac{1}{4}$ per cent placed on an issue with a 10-year maturity. In view of the market action of the new taxable bonds it appears that yields on future issues are likely to be higher than had previously been expected. On this assumption a 10-year taxable $2\frac{1}{4}$ per cent bond might not command par in the market. In other words, if the Treasury should put out such an issue the yield that would be obtained from it might be slightly above the yield on the proposed Savings bond. It does not seem safe for the Treasury to go on any other assumption until the market has had an opportunity to value a new issue of taxable bonds of longer maturity and higher coupon.

Against this position two objections may be raised. The issue is in effect a demand obligation and is guaranteed against fluctuations in market prices. In addition, an individual who pays only the normal tax or a small surtax would be given a subsidy as compared with available market issues.

In view of the likelihood that interest rates may rise moderately over the next year and in view of the possibility that a $2\frac{1}{4}$ per cent 10-year bond would give the Treasury no margin, it would appear that the sale of such an issue might prove to be feasible for only a relatively short period of time. After perhaps a year the Treasury might find that it would have to place a higher rate on a 10-year Savings bond. This would be confusing to many investors and would subject the Treasury to severe criticism and to the ill-will of those investors who had purchased the $2\frac{1}{4}$ per cent bond.

In view of this situation the suggestion might be advanced that the Treasury should place a rate of $2\frac{1}{2}$ per cent on the new Savings bond and should lengthen the maturity accordingly. There may be some advantage from the point of view of the investor in having the coupon rate a multiple of $\frac{1}{2}$ of 1 per cent rather than $\frac{1}{4}$ of 1 per cent. In addition, and of more importance, in the event of a change in market rates, the Treasury would be subject



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to much less criticism if the higher rate were made effective on Savings bonds by shortening the maturity rather than by raising the rate.

Some objection, however, may be made to this position. Because the yield on outstanding issues increases rather sharply with each year of maturity, a $2\frac{1}{2}$ per cent issue would appear to command a maturity of only 12 years. A longer maturity would be subject to the same criticism of possibly inadequate return that has been made for the 10-year $2\frac{1}{4}$ per cent issue. Another criticism is that it is much more difficult to price a taxable bond of longer maturity and higher coupon. At some point in the maturity schedule it seems likely that the demand of savings banks and insurance companies will become effective. It apparently has not become effective on a 7-year 2 per cent issue but might become effective on a $2\frac{1}{4}$ and is much more likely to become effective on a $2\frac{1}{2}$ per cent issue. Consequently, a $2\frac{1}{2}$ per cent 12-year issue might, after the market has had a chance to judge market issues of taxable bonds, appear to give a large subsidy. Since, however, this question cannot be settled until such an issue is actually sold and since the Treasury is anxious to proceed with the announcement on Savings bonds, there will be no opportunity to judge the market on this maturity.