THE SECRETARY OF THE TREASURY

Washington 25

March 28, 1946

Dear Marriner:

I am writing you on the subject of the preferential discount rate on Government securities due or callable in one year or less. As you know, the Federal Reserve System and the Treasury have had several meetings and some correspondence on the question of whether the present preferential rate of 1/2% should be increased. You will remember that we had an extended discussion on this subject at a meeting in my office last January 30. At that time I promised to send you a letter incorporating my views although I stated verbally that I was opposed to increasing the rate. Subsequently, I had such a letter on my desk when you were here to talk about another subject. I understood from your remarks that the letter was hardly necessary and I believe I told you that accordingly I would hold it up, which I did.

Now I have your note of March 22, referring again to the question of increasing the preferential rate. I still feel that this action should not be taken at this time, primarily because it does not seem wise to rock the boat in the middle of our transition to what I hope will be a full production peacetime economy. Accordingly, I am writing at some length to give you the Treasury's position on this matter.

The elimination of the preferential discount rate at this time would be interpreted by the market as -- and would, in fact, be -- a first move in the direction of higher short-term interest rates. Higher short-term rates would raise the cost of carrying the public debt and would be of principal benefit to commercial banks, most of which are now enjoying very high earnings.

Whether an increase in short rates would spread to longer-term rates could be determined only by the event -- by which time it might be too late to avert serious unfortunate consequences, both to the cost of Government financing and to our hopes of achieving full production and full employment in the postwar period.

I should, therefore, like to renew my request, made to you on previous occasions, that the Federal Reserve System refrain from eliminating the preferential discount rate on short-term Government securities at this time. This request is, of course, without prejudice to the possible elimination of the preferential rate at some future date when such action would be part of a whole policy orientated in the direction of continuing low interest rates, rather than, as it would be now, part of a policy directed toward higher rates.

"The significance of the preferential discount rate at the present time is almost entirely psychological. Total borrowings under it are not high in relation to total Federal Reserve credit, member banks reserves, or any other relevant measure. The principal significance of the rate is, as Mr. Sproul so aptly put it in our meeting on January 30, that of a signal to the market of the continuance of the official policy of low interest rates. Mr. Sproul wants to haul this signal down, and you concur. I do not. The Administration policy on low interest rates and the reasons for it were ably restated in the President's Budget Message. If it takes the action you suggest, the Federal Reserve System would be flying one signal and the President another. We cannot afford thus to act at cross purposes during this most critical year in the reconversion of our domestic economy."

"I think that it is necessary at the outset to clear up one misapprehension. You and Mr. Sproul stated on several occasions in the course of our January 30 meeting that one of the objects of the proposed action of the Reserve authorities would be to help in combating inflation. As you know, I am as much interested in combating inflation as any man in the country; and I was personally responsible for the Government's anti-inflationary program during my tenure as Director of War Mobilization and Reconversion and, earlier, as Director of Economic Stabilization. I should like to state very clearly, therefore, that I see no way in which increasing short-term interest rates would help in combating inflation. In my opinion, you and Mr. Sproul failed to make any case that it would, beyond the mere saying so.

The letter [illegible] added

"I was greatly surprised by your statement at the meeting that the proposal to eliminate the preferential discount rate was not really part of a program to increase short-term interest rates." I was surprised, not merely because of my knowledge of the general background of Treasury-Federal Reserve discussions of interest rates; but also because previously your Director of Research and Statistics had transmitted to the Treasury three Federal Reserve memoranda, each of which definitely contemplated higher interest rates. One of the memoranda seriously considered the possibility of increasing the rate on certificates of indebtedness as high as 1-1/4 percent within the next year or so.

"During the course of the January 30 meeting, Mr. Sproul qualified your statement that there would not be any increase in short-term interest rates by the phrase "for the time being". He stated that such an increase might be necessary later "as the lesser of two evils". In that event, he said, the Federal Reserve would come back to me with further proposals. I was glad to accept the assurance of both Mr. Sproul and yourself given to me in this connection that the Federal Reserve would not in any event permit the certificate rate to rise, unless there was a mutual agreement between the Treasury and the Federal Reserve.

"In view of the qualification expressed by Mr. Sproul, I think that it would be well to review briefly the history of Treasury-Federal Reserve discussions on interest rates.

In going over the records, I find that the Federal Reserve System desired originally to establish a level of short-term rates higher than did the Treasury. You and Mr. Sproul each stated that you were accepting the rates originally set only under duress and because you recognized that the Treasury Department had, as Mr. Sproul put it in a meeting on March 20, 1942, ". . . the full and final responsibility for the financing of this war . . ."

This was the atmosphere in which the pattern of short-term interest rates was originally set. In looking over the subsequent records, I find numerous references in minutes of meetings to requests by Federal Reserve officials or staff members that the pattern of short-term interest rates be raised. In addition to these references in the minutes of oral discussions, the Treasury records contain numerous written memoranda submitted to the Treasury by Federal Reserve officials or staff members, suggesting in one form or another an increase in some type of short-term interest rates. Memoranda containing such suggestions, which have been excerpted for me, bear dates in June, July, and October 1942; February and November 1943; and March and April 1944.

During my first day in office, Acting Chairman Ransom asked, on behalf of the Board of Governors, that I agree to the elimination of the preferential discount rate. I wrote him on July 27, 1945, saying in part:

> "I recognize, of course, that the fixing of discount rates is a statutory prerogative of the Board of Governors and of the Federal Reserve Banks. We have both always recognized, however, that it is necessary, for the duration, to work as a single team in financing the war in the best possible manner. I am sure, therefore, that you will be willing to continue the present preferential discount rate and the present policy with respect to short-term rates as long as it is required in the interest of sound war finance."

The Board of Governors and the Federal Reserve Banks acceded to my request at that time; but on December 13, 1945, you wrote and said:

> "With the completion of the Victory Loan, and with Treasury needs for funds during the coming year or longer largely anticipated, it seems to me, and to the other members of the executive committee of the Federal Open Market Committee, that an especially favorable opportunity is provided to eliminate this preferential discount rate. . ."

I replied on December 29, saying in part:

> ". . . the war has ended, and the Victory Loan campaign

has been successfully concluded. It seems to me, however, that the continuation of the preferential rate is as important to the successful financing of the transition period, and to the maintenance of full production and full employment in the postwar period after the close of the transition as it was to the successful conclusion of war finance. I feel sure that upon considering the matter further you will agree with me."

In this letter I stated that I should be glad to discuss the matter with you, and we discussed it quite thoroughly at the meeting on January 30.

The war on the battle fronts is over, but the public debt problems which it has left behind will be with us for a long time to come. We owe it to the country that these problems continue to be solved in the public interest. I know, therefore, that I can count, as the President stated in his Budget Message, on the continued cooperation of the Federal Reserve System in this matter.

Sincerely yours,

(Signed) Fred M. Vinson

Honorable M. S. Eccles
Chairman, Board of Governors
of the Federal Reserve System
Washington 25, D. C.