BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 27, 1947

To Chairman Eccles

Subject: Higher short-term rates

From R. A. Musgrave R.A.M.

I have some doubts about the argument regarding possible need for higher short-term rates, as presented to Mr. Bartelt at today's luncheon. (This has nothing to do with the proposed changes in bills, while maintaining the 7/8 per cent rate.) I understood your argument to be as follows:

> "The next 6 or 12 months may bring strong downward pressure on long-term rates, mainly because there will be an increased tendency for banks to shift into long terms as bank holdings of short terms decline. Assuming that the long-term rate should be held at 2 1/2 per cent, this pressure can be checked in three ways: (1) through direct control of bank investments as proposed in the Board's plans; (2) through an increase in the short-term rate; and (3) through an increase in the supply of long terms. Assuming (1) to be out of the question, (2) is preferred to (3) because it will cost the Treasury less."

My concern is that I doubt very much whether either (2) or (3) will be of much help in a situation where the pressure on the long rate is due to bank shifting into long terms. How do we know that this shifting will not continue to be profitable even after the short rate has risen to 1 or 1 1/8 per cent? To put the point in extreme form: given a stabilized long rate, will not banks continue to shift until the bill rate is at 2 1/2 per cent? More moderately, will it not take a very drastic and continuous rise in the short rate to check debt monetization and the pressure on the long rate? How do we know that results will be sufficient to offset the increased cost and can we even be certain that raising the short rate will be cheaper than increasing the supply of long terms? If a deflationary situation develops at which time pressure on the long rate would probably be even greater, should this pressure be checked necessarily?

Perhaps raising the short rate is all that can be done, but its remedial effects with respect to debt monetization are so dubious that perhaps there is not much point to doing it. If one had to defend this on the Hill, it should be pointed out at least that an increase in short terms is a very poor if any substitute for the Board's proposal for direct control over bank investment.

I do think that the problem is a different one where pressure on the long rate is not due to debt monetization, but to pressure on the part of nonbank investors.