4/12/47
[illegible] - Treas. Meetings 4/18/47

# SUMMARY OF PROPOSED PROGRAM

The proposed program involves three steps which are recommended for immediate action and which are to follow each other in brief intervals:

(1) The Board of Governors will announce imposition of an interest charge on Federal Reserve notes under Section 16 of the Federal Reserve Act for the purpose of transferring excess earnings to the Treasury.

The issuing statement (Exhibit A) will point clearly to the purpose of this action which is to transfer earnings, so that there will be no possibility of misinterpretation. Procedures involved are discussed in Exhibit B. The amount of earnings that would be transferred at present levels of earnings is estimated at 50 million dollars a year.

(2) The Treasury will announce that for future bill issues payment for accepted tenders may be made in cash or by surrender of maturing bills.

The statement issued by the Treasury (Exhibit C) will describe the procedures used and will explain that this change is made to permit direct exchange of Federal Reserve held bills and thus to simplify present cumbersome procedure without involving direct purchase by the System from the Treasury. The statement will also point out that any additional Federal Reserve holdings of bills will be purchased in the open market. The details of the procedure are outlined in Exhibit D.

(3) The Federal Reserve will announce that the fixed buying rate and repurchase option at 3/8 per cent will be discontinued

with respect to bills issued after a certain date.

The issuing statement (Exhibit E) will point out that the present arrangement was introduced to serve wartime needs which no longer apply and that the new policy is adopted to again make the bill a market instrument. This statement may be made jointly with the Treasury or the Treasury may issue a brief concurring statement.

The mechanism by which the refunding of bills will be handled under the new procedure is outlined in Exhibit F.

The general reasoning supporting these recommendations is summarized in Exhibit G.

## EXHIBITS A AND B

(To be prepared by Mr. Thurston and Mr. Smead)

EXHIBIT C

Treasury Announcement on Acceptance of Maturing Bills in Payment for Accepted Tenders for New Bills

"Beginning with next week's bill issue the Treasury will accept maturing bills in payment for new bills. In accepting tenders, purchases paid for in maturing bills will be given no preference over those paid for in cash. Cash adjustments will be made for differences between the par value of matured bills offered in payment and the issuing price of new bills bought.

The new procedure is adopted to facilitate weekly refunding operations in bills. Federal Reserve bill holdings now amount to 15.5 billion out of a total of 17 billion outstanding. Under current procedure, the Federal Reserve replaces its weekly maturing bill issues by purchasing new issues from security dealers who tender for the necessary amounts. Dealers charge no commission for this service and obtain only a nominal profit from the transaction. Under the new procedure the Federal Reserve will be in a position to tender directly with the Treasury for new issues to replace maturing issues of bills through exchanging the maturing issues. This will simplify the refunding operations for the Federal Reserve and will relieve the dealers of the need for handling harge refunding operations at a nominal rate of return.

Any addition to Federal Reserve holding of bills would be purchased in the open market as at present."

EXHIBIT D

Procedure for Handling Direct Exchange of Bills

(1) Under this plan the Treasury would offer weekly a specified amount of a new issue of Treasury bills for which bills awarded on tenders could be paid for either by cash or surrender of a like face amount of the maturing issue of Treasury bills. In cases where the investor tendered the maturing issue for the new issue, the investor would receive payment from the Treasury (through the Federal Reserve Banks) for the difference between the redemption value of the maturing issue (par) and the purchase price of the new issue.

(2) The Treasury's announcement for the invitation of tenders would be amended correspondingly. Using press release A-291 of April 3, 1947, as a sample, the last sentence on page 1 would be amended to read as follows: "Payment of accepted tenders at the prices offered must be made or completed at the Federal Reserve bank in maturing bills, cash or other immediately available funds on April , 1947."

(3) New issues of Treasury bills would be sold on a discount basis under competitive bidding as in the past. No preferential allotment would be made on tenders for which an exchange is to be made by surrender of a maturing issue. Full allotments for small amounts on a fixed price basis could be continued, as long as the buying sale and option are continued.

(4) Tenders for a new issue of Treasury bills may be entered by the System to the extent of its holdings of the maturing issue. According to an opinion by General Counsel of the Federal Open Market Committee,

awards of an amount not in excess of maturing bills held by the Federal Reserve Banks may be acquired directly from the Treasury without coming under the five billion dollar statutory limitation on direct purchases from the Treasury, provided the new bills are issued against surrender of the maturing issue of Treasury bills.

(5) In order that the System may tender option account holdings of bills in exchange for new issues the Federal Reserve Open Market Committee should amend its direction to the Federal Reserve Banks with regard to the period in which the seller of bills under the option agreement may exercise his option to repurchase. This amendment should require that the option be exercised on or before the last business day preceding the closing day on which the Treasury will accept tenders for a new issue of Treasury bills for which allotments may be paid for by surrender of the maturing issue of Treasury bills.

(6) Pending further changes in bill policy, the Federal Reserve would continue to tender for an amount of new issues equal to the amount of maturing issues in the System and Option accounts. Also, the Federal Reserve would have an agreement with the dealers that it will purchase at the stated buying rate of 3/8 per cent such amounts of the remaining new issues as are not absorbed the the market. After the buying rate is discontinued, the procedure would be as shown in Exhibit F.

EXHIBIT E

Federal Reserve Announcement on Elimination of Posted Buying Rate and Repurchase Option

"The Open Market Committee of the Federal Reserve System herewith announces termination of its policy of offering a fixed buying rate of 3/8 per cent and repurchase option on Treasury bills. The new policy will apply to bills issued on or after April . The present policy will continue to apply with respect to bills issued prior to this date.

The posted rate was a wartime measure designed primarily to facilitate war financing by encouraging banks to make the fullest use of their excess reserves and to stabilize market rates for Government securities. Since this policy was adopted in 1942, underlying conditions have changed. As confidence developed in the course of war financing that maturities could be extended with comparative safety, certificates of indebtedness which bear a higher rate than bills replaced Treasury bills in the market, not only as a medium for the investment of short-term funds but also as a means for banks to adjust reserve positions. Increased amounts of Treasury bills were sold to the Federal Reserve System and bills gradually ceased to be a market instrument. Currently, less than two billion of the 17 billion total of Treasury bills outstanding is held outside the Federal Reserve Banks and of this amount approximately one half billion is held for foreign central banks. The Treasury bill rate is no longer a factor in short-term money market rates. Moreover, the need for large scale financing has come to an end and currently the public debt is being reduced. Consequently, there is no reason for continuing the present policy.

Under the new policy the bill rate will be permitted to find its level in the market in proper relation to the coupon rate of 7/8 per cent on 1-year certificates. The Federal Reserve will continue to purchase and hold Treasury bills as well as other Government securities in amounts deemed necessary to maintain an orderly market.

In view of recent action taken by the Board of Governors of the Federal Reserve System to pay into the Treasury the bulk of its net earnings after dividends, approximately 90 per cent of any increase in Reserve bank earnings resulting from a rise in the bill rate will be recovered by the Treasury. Since most of the Treasury bills are held by the Federal Reserve Banks, the bulk of the increase in interest charges will thus be returned to the Treasury".

EXHIBIT F

Procedure on Bills After Discontinuation of Buying Rate

(1) The Federal Open Market Committee will withdraw its direction to the Federal Reserve Banks issued on August 7, 1942, for the fixed buying rate and repurchase option on Treasury bills issued after a specific date.

(2) As bills held in the option accounts mature, they will be exchanged for new bills to be held in the System Account. The option accounts will be liquidated in the course of a 13 weeks cycle.

(3) The purpose of discontinuing the fixed buying rate is to permit the bill rate to find its market level vis-a-vis the certificate rate. After such a level has been established, Federal Reserve tenders of new bills would be at a rate close to the market rate for bills.

(4) In the transition to a new bill rate, Federal Reserve policy will be adjusted to "follow" the market and not accentuate any upward pressure on the bill rate that may develop in the market. In this connection, the Federal Reserve might continue in the first week to tender for the amount of its maturing bills at a rate only slightly above 3/8. If the discount paid in the market should increase, the Federal Reserve would then raise its bidding rate in succeeding weeks. At the same time, the Federal Reserve would arrange with dealers to tender for an additional amount of bills at a rate which would be above that at which the market is expected to replace its maturing bills. This would enable the market to obtain a maximum amount of bills at what might be considered reasonable

rates, yet at the same time would assure the Treasury that no part of the issue would have to be sold at a rate above that of the dealers' tender for the Federal Reserve.

During the early weeks, there would have to be consultation between the Treasury and Federal Reserve regarding terms and amounts of weekly Federal Reserve tenders. After a new bill rate has been established and the volume of market-held bills has come to be adjusted to the new rate, Federal Reserve purchases of new bills would be such as to maintain an orderly bill market. Under normal conditions, Federal Reserve bids would be at a price just slightly below that of the market, i.e. at a rate slightly above that of the market. Market dealings of the Federal Reserve in bills would ordinarily be restricted to purchases. Increased demands for bills by the market would be reflected in additional tenders for bills at rates below the Federal Reserve tenders.

EXHIBIT G

Statement of Objectives of Program

1. The program helps to clear up cumbersome procedure inherited from war finance. By letting the bill rate again become a market instrument the functioning of the money market and control thereover is improved.

2. The program will serve to introduce some uncertainty in the market regarding possible changes in other rates. This will be a wholesome factor in discouraging inflationary expansion of bank credit and preventing further decline in interest rates.

3. This action may be sufficient to accomplish these purposes without changes in other rates but conditions may develop where an upward adjustment in the certificate rate may become necessary. No change in the certificate rate would be permitted without prior discussion with the Treasury aimed at reaching an agreement on such action.

4. Some increase in certificate rates may turn out to be necessary for these reasons:

    1. Banks may resume the practice of purchasing longer term issues of Government securities in the market while selling shorter issues to the Federal Reserve. There will be increased pressure for such purchases by banks because of loss of bank earnings under the retirement program and increasing costs of operation. The process of expansion will result in further increase in the money supply and renew the decline in long-term interest rates.

    2. In order to increase or maintain earnings, banks may also shift from Government securities to make unsound or speculative loans. This will directly add to inflationary forces and create the danger of a subsequent deflation spiral later on.

These contengencies can not be met by offering additional issues of long-term securities because such offerings might increase the shifting of eligible securities into the banks and sale of short-term securities into the Federal Reserve. In the absence of increased Federal Reserve authority to control the available supply of bank reserves, an adjustment in short-term rates is the only restrictive action that may be taken.