C O P Y

FEDERAL RESERVE BANK

of New York

October 13, 1942.

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

Dear Mr. Chairman:

As you know, we have been giving consideration for some time to the question of discount rates, with particular reference to the rates on advances secured by Government obligations. Mr. Morrill has now advised me of the views expressed by the Board of Governors as a result of its informal consideration of this problem. Inasmuch as we shall probably take some action on Thursday next (October 15), I am writing to give you my own views which I intend to present to my directors.

We are talking in terms of discount rate reductions, and it seems necessary to define the purpose of such reductions before considering the details of their accomplishment. Among the principal purposes I should list the following:

1. Encourage wider participation in war financing by banks in proportion to their available funds, by providing still further assurance that they will be able to obtain additional reserves, when they are needed, at low cost.

2. More particularly, to encourage investment in short term Treasury obligations by banks that still have substantial amounts of surplus funds.

3. Weaken the resistance of banks to borrowing and thus minimize the disturbing effect on the Government security market of unnecessary selling, and lessen somewhat the need for Federal Reserve open market operations, either for the purpose of maintaining market stability, or for the purpose of adding to the volume of bank reserves.

4. Provide a means by which banks less fortunate than the average in the distribution of reserves, may readily adjust their reserve positions, at low cost, thus perhaps weakening the tendency of such banks to press for lower reserve requirements before the position of banks of their class generally warrants a reduction.

Having in mind these major objectives, it seems to me that an appropriate schedule of discount rates would be as follows:

Rediscounts for and Advances to Member Banks:
Under Sections 13 and 13(a) - 1/2 of 1% when secured by direct or guaranteed obligations of the United States maturing or callable within one year; regular discount rate to remain at 1%.
I think there is some advantage in calling the 1/2 of 1% rate, on borrowing secured by short term Government obligations, a differential rate rather than a preferential rate, to help eliminate the idea that some borrowers are being preferred rather than a type of collateral. The general arguments for a differential rate at this time, we have previously discussed.
The arguments for including callable and guaranteed securities are obvious. The present rate structure in the Government security market is based on the assumption that call dates on short term high coupon Governments are maturity dates and that the Treasury will refund these securities on or before their first call date. To deprive them of the differential rate would jeopardize the present rate structure and promote unnecessary selling of these securities.
Fully guaranteed Government securities are being largely retired at call dates or maturity and their inclusion will widen somewhat the effectiveness of the differential rate.

Rediscounts for and Advances to Member Banks under Section 10(b) - 1 1/2%.
This rate has little significance in this district now, but in a general revision of discount rates, and under present circumstances, when borrowing for war purposes may conceivably bring the rate into use, the establishment of the minimum margin of 1/2 of 1% over our regular discount rate of 1% seems justified.

Advances to Non-Member Banks (Section 13) secured by direct obligations of the United States - 1/2 of 1% when secured by direct obligations of the United States maturing or callable within one year; regular discount rate to remain at 1%.

Our rate on advances to non-member banks secured by direct obligations of the United States has been the same as the rate on advances to member banks since August 25, 1939. Previously, a differential of 2 1/2% had obtained. The change was made in view of the possible effects of a war in Europe on the Government security market, and so that non-member banks could have access to credit against Government securities on the same terms as member banks in a war situation when, otherwise, sales under adverse market conditions might be forced. Having in mind the purposes of current discount rate reductions, the same general considerations would seem to apply now. We are not changing our discount rate schedules to promote membership in the Federal Reserve System, but to facilitate and widen the distribution of Government securities under the best obtainable conditions from the standpoint of credit policy. We already have a differential rate in the case of Treasury bills which is extended to member and non-member banks alike. To create a punitive zone in the small area between the Treasury bill and obligations of more than one year maturity does not seem to fit war conditions nor the main purpose of our differential rate structure.

Advances to Individuals, Partnerships, and Corporations other than member and non-member banks (under Section 13) secured by direct obligations of the United States - 2 1/2%. This is another rate which does not seem to have much importance at the present time. Small holders of Government securities hold chiefly non-transferable obligations and small and large holders of market type obligations can obtain accommodation at low rates at commercial banks, where they should do this business rather than with us. I think that our rate should be reduced from 3 1/2% to 2 1/2% to confirm acceptance by the public of 2 1/2% as a maximum rate on Government securities at this time, but I see no advantage and some disadvantage in establishing a rate which would seem to be catering to this business. We are not trying to promote a borrow-and-buy campaign and such necessitous borrowing as there may be or such partial payment buying as may develop can better be left with the commercial banks. It would be undesirable, for instance, to create a situation in which, under the pressure of a campaign, individuals or corporations might make large subscriptions to a 2 1/2% obligation and then have what they would consider a right to borrow the money from us with which to make good on the subscription, at a lower rate than the coupon. It is true, we could refuse the loan or refuse to renew it, but I think unnecessary friction and misunderstanding would result.

Government Securities Purchased under Resale Agreement (other than Treasury bills) - establish same schedule of differential rates as in case of advances and rediscounts.
While such transactions are of no significance at the moment, it would seem that the principle of the differential rate should be applied to resale agreements in order to permit Government security dealers to carry short term Treasury securities with us pending distribution, in the event that accommodation cannot be obtained at commercial banks.

I have set forth my views at some length because, as I said earlier, I plan to recommend action to my board of directors at its next meeting, and because my views on at least two subsidiary questions do not seem to be in agreement with what I understand to be the informal views of the Board.

Yours faithfully,

(Signed) Allan Sproul

Allan Sproul,
President.