May 22, 1945

President C. S. Young
Federal Reserve Bank of Chicago
Chicago, Illinois

Dear Mr. Young:

This refers to your letter of November 25, 1944, addressed to Mr. Goldenweiser, in which you requested that the System Research Advisory Committee consider the subject of interest rates as it might be related to the investment problem of the Retirement System. The undersigned have been designated as a Committee for this purpose. We set forth below our views on the future problem of interest rates.

With reference to your request that a representative or two of the Committee meet with the Investment Committee of the Retirement System from time to time, we shall be glad to make the services of the Committee or its individual members available at your request.

The principal factors determining the prospect for interest rates may be summarized as follows:

1. The Treasury and the Federal Reserve System are committed to the maintenance for the duration of the war of rates on Government securities no higher than those which prevailed in the first year after this country entered the war.

2. The fiscal conditions which have contributed to the adoption of this policy are likely to continue for at least a year, and perhaps longer, after the cessation of hostilities, since a high level of Government expenditures for purposes connected with the war will necessarily continue after the close of hostilities. In World War I the Government deficit continued for nearly a year after the Armistice. In the present case, the volume of war contracts to be settled is much larger than in the previous war, as are also the number of men overseas to be maintained and brought home, and the number of prisoners. The minimum requirements for relief, rehabilitation, and political reorganization of devastated areas are much higher than in 1919, and so also are commitments involving expenditures in other areas which cannot be liquidated quickly.

3. Apart from Treasury pressure for low rates during the period of deficit financing, there exists a widespread belief in the desirability of low interest rates to prevent a rise in interest charges on the public debt, to prevent depreciation in the market value of Government securities sold during the war, and to facilitate business expansion.1/

1/ There is considerable possibility of a return flow of currency and a renewed inflow of gold after the war, which would reinforce the factors making for low rates. However, it is to be assumed that open market policy would be directed toward insulating the credit structure from the effects of such an inflow. The amount of Federal Reserve credit outstanding would presumably be kept smaller than otherwise because of the influx of reserves from abroad and from the currency.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

4. If inflationary tendencies should gain momentum in the early post-war period, it is to be expected that efforts will be continued to control such tendencies by selective credit controls and non-monetary measures (such as price control and rationing), avoiding measures which would cause a rise in interest rates. If such measures prove inadequate and it becomes necessary to supplement them with general credit controls and to abandon the financial practices which have brought about the current low level of rates, a relaxation of credit controls may be expected as soon as the inflationary tendencies disappear.

5. On the other hand, we do not anticipate that public policy will favor a further material decline in long-term rates, because of the dependence of insurance companies, savings banks, trust funds, and endowed educational and other institutions on income from long-term securities.

6. In the event that it becomes necessary to apply policies of credit restraint which cause a rise in interest rates, the greatest rise is likely to be in short-term rates and the least in long-term rates. The long-term bonds are, to a considerable extent, concentrated in strong hands (insurance companies, savings banks, trust funds, etc.), so that they are not likely to be dumped on the market in large amounts in the event that short-term rates should rise. Treasury and Reserve System policy would probably be directed toward protection of the present yield on long-term bonds because of the effect of a rise on the market values of assets of banks and other investors. The price of long-term bonds could be supported even in a period of credit restraint, since the Treasury could avoid further issues of long-term bonds while the rise in short-term rates was in progress; Government trust funds could be used to purchase long-term bonds in the market; and if necessary, System open market operations could be used to support the market for long-term securities, even though total open market holdings were being reduced through sales or run-offs of short-term securities.

7. In an inflationary situation such as would call for a System policy of restraint on the availability of credit, increased demands for business capital would probably so change demand-supply relationships in the market for corporation bonds as to widen the spread of rates between high-grade corporation bonds and Government bonds, which is now abnormally narrow.

Charles O. Hardy, Chairman
David M. Kennedy
John K. Langum
H. V. Roelse

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis