FEDERAL RESERVE BANK
OF NEW YORK

January 21, 1942.

Hon. Marriner S. Eccles, Chairman,
Federal Open Market Committee,
Board of Governors of the
Federal Reserve System,
Washington, D. C.

Dear Chairman Eccles:

Enclosed is a copy of a memorandum which sets forth our latest views (one or two differences of opinion remain to be composed) on those aspects of Treasury financing which have been the subject of our discussions with the Treasury over the past few months.

The interest rates used in setting up the two alternative short-term tap issues are suggestive rather than definitive. There is room for some flexibility here, but we have tried to take account of such factors as competition with tax anticipation notes, interference with the broadening of the Treasury bill market, and present rates for outstanding market obligations.

Yours faithfully,

Allan Sproul, Vice Chairman,
Federal Open Market Committee.

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TREASURY FINANCING

On September 28, 1941, the Federal Open Market Committee, the Conference of Presidents of the Federal Reserve Banks, and the Board of Governors of the Federal Reserve System agreed upon the following statement of views, a copy of which was given to the Secretary of the Treasury by Chairman Eccles:

> "In the present emergency
> (1) The Treasury should take further steps to obtain the maximum amount of its borrowed funds from lenders other than commercial banks;
> (2) The Treasury and the Federal Reserve authorities should expedite their efforts to decide what additional powers over bank credit should be recommended for the Federal Reserve System, and we express the view that additional powers are needed;
> (3) As a complement to these steps, a pattern of rates on United States Government securities should be determined jointly by the Treasury and the Federal Reserve authorities from time to time and should be supported by such measures as may be necessary, including open market operations by the Federal Reserve System."

The magnitude of our war program directs immediate attention to the 1st and 3rd sections of the above statement.

Obtaining Borrowed Funds from Lenders
Other than Commercial Banks

(1) The President's budget message submitted to the Congress on January 7, 1942, indicated that expenditures of the Federal Government during the fiscal year 1942-1943 (beginning July 1, 1942) would be approximately $60 billions.

(2) On the basis of the estimates given in the budget message, including the revenue from proposed new taxes, the Federal debt will increase from $70,600,000,000 on June 30, 1942, to $110,400,000,000 on June 30, 1943, an increase of $39,800,000,000

(3) The net public borrowing contemplated in the fiscal year 1942-1943 totals $33,615,000,000.

(4) Making allowance for possible sales of Defense Savings Bonds under the present selling program, and a net increase over the fiscal year in the amount of

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tax anticipation notes and depositary bonds outstanding, it appears likely that $20 to $25 billions will have to be obtained by the sale of Government securities to banks and to other lenders and investors.

(5) The grave necessity of the Treasury's taking further steps to obtain the maximum amount of these borrowed funds from lenders and investors other than commercial banks is apparent, if fiscal and monetary policy is to contribute its share to the anti-inflation program. It will require more than additional pressure for the sale of the present series of Defense Savings Bonds, important as that is.

(6) The two principal sources of funds, other than the banking system and the purchasers of the present series of Defense Savings Bonds, are:

(a) Insurance companies and other institutional investors of various kinds;

(b) Corporations and other business concerns which, in the aggregate, may accumulate large idle balances as the war program interferes with their ordinary business operations and with the maintenance of their plant and equipment.

These two sources of funds must be tapped by the Government, and preferably should be tapped with obligations which have a special appeal for the holders of such funds, but which cannot get into the commercial banking system.

(7) It is suggested that an attempt should be made to reach these funds with two kinds of tap issues, one of longer term for insurance companies and similar long-term investors, and one of shorter term for business concerns (and public bodies) with temporarily idle funds. The general features of such offerings might be:

(a) Long-term tap issue:
  Interest rate: 2 ½%,
  Maturity: 15 years or thereabouts,
  Redemption: At cost value with interest adjustment (as in the case of Series E, F and G Savings Bonds) on one year's notice after bond has been held for six months,
  Negotiability: Not negotiable in consideration of redemption feature.
  Callable: Not callable prior to maturity.
  Sales Restrictions: Available in unlimited amounts so long as tap is open.

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(b) Short-term tap issue:
Interest rate: 1% interest payable semi-annually,
Maturity: 4 years,
Redemption: Redeemable on any interest payment date prior to maturity on 30 days' notice at par and accrued interest adjusted to the following rates for the period held: 9

1/2%	if held 6 months
3/4%	if held 1 year
7/8%	if held 18 months.

Negotiability: Not negotiable, in consideration of redemption feature.
Callable: Not callable.
Sales Restriction: Available in unlimited amounts.

Or:
Interest rate: 1 1/4% payable semi-annually,
Maturity: 4 years,
Redemption: Redeemable on any interest payment date prior to maturity on 30 days' notice, at par and accrued interest adjusted to the following rates for the period held:

0%	if held 6 months
1/4%	if held 1 year
3/8%	if held 18 months
1/2%	if held 2 years
3/4%	if held 2 1/2 years
7/8%	if held 3 years
1%	if held 3 1/2 years.

Negotiability: Not negotiable.
Callable: Not callable.
Sales Restriction: Available in unlimited amounts.

(8) It is also suggested that there be an immediate increase in the supply of Treasury bills to at least $2,600,000,000 (not including tax period bills) which would contribute not only to the fluidity of the money market, but would also provide an alternative medium for the temporary investment of idle public and business balances.

Consideration should regularly be given to issuing additional blocks of Treasury bills to mature in the three or four days following the quarterly tax payment dates.

(9) In so far as it is necessary to use bank credit in financing the Treasury's needs, new money should be sought from banks with short-term issues, that is, with notes and bonds with maturities not exceeding ten years, ~~and preferably of shorter maturity.~~

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Pattern of Rates

(1) Our experience in the last war, the experience of other countries in this war, and our present capacity for the management of the monetary and credit resources of the country, all indicate that this program should not be cast in the old pattern of rising rates of interest as the war progresses. Some measure of price fixing is required in the field of credit, just as in other fields, when the Government is the principal borrower in the market and the cause of its borrowing is the defense of our national existence.

(2) It is, therefore, desirable, and the existing situation in the money market and the Government security market makes it practicable, to determine, establish, ~~and make known~~ a pattern of rates for United States Government securities which will fix, for the present, the general terms of Treasury financing.

(3) It is suggested that the ? range of rates established by such a pattern should be, for the present, from 3/8-1/2 to 2 1/2%, for obligations other than Series E Defense Savings Bonds. The lower limit of the range and the short-term rates in general could have some flexibility without disturbing the maximum or long-term rate. ~~The long-term rate might have to be revised upward later if an inadequate flow of investment funds were being obtained, thus intensifying the problem of increasing bank purchases of Government securities. Meanwhile,~~ the 2 ½% rate long term rate approximates closely enough the general pattern of rates which has already been established, and steers a middle course between the danger of a substantial decline in the prices of outstanding securities on the one hand, and the danger of starving investors and investing institutions on the other.

(4) The establishment and maintenance of such a pattern of rates does not require the excessive volume of excess reserves which has characterized recent years. It does contemplate that when excess reserves have shrunk to more manageable proportions they will be maintained in sufficient volume to enable banks to assist the Treasury's financing to whatever extent is necessary. The program, to be successful,

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(a) That there be a change in attitude on the part of banks as to the need for, and desirability of, excessive excess reserves which have really only been a part of the banking position for the past ten years. In the case of individual banks, this will require the restoration of a market, through a larger issue of Treasury bills, in which adjustments of position can be made quickly and without loss. Eventually it should extend to restoration of the respectability of borrowing from the Federal Reserve Banks; ?

(b) That the fluidity or use of all funds which are available in any part of the country be facilitated so that they may be brought to bear on the Government security market;

(c) That the determination of the monetary and credit authorities to see to it that an adequate supply of funds is always available to permit Treasury financing at satisfactory rates be unquestioned.

(5) The general outlines of the program must, therefore, be made clear to the public. Fortunately, the public in general, and the investing public in particular, is prepared for this transition to wartime financing. A statement by the Secretary of the Treasury correlating his tax program with such a financing program should be made as promptly as possible, and should be supported by a statement from the Federal Reserve System pledging a credit policy which will be consistent with the Treasury's program.

January 20, 1942.