August 8, 1942.

Governor Ransom

Chairman Eccles

Attached hereto is a copy of a letter received from Allan Sproul yesterday morning, together with a memorandum on "Posted Buying Rates and Preferential Discount Rates".

Allan presents some very effective arguments in his memorandum for confining the posted rate to bills and for a preferential discount rate covering all Government securities maturing in a year or less.

Attachment

MSE:VE:b

(Sent to each Board Member individually, and to Dr. Goldenweiser, Mr. Morrill and Mr. Piser.)

COPY

FEDERAL RESERVE BANK
OF NEW YORK

August 6, 1942.

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

Dear Marriner:

Enclosed is the memorandum on posted buying rates and preferential discount rates, which I told you this afternoon I was going to send to you. As I also told you, in order to poison your mind further against a posted buying rate for certificates of indebtedness, I now confirm that one or two government security dealers are strongly advocating the same thing.

Yours faithfully,

(Signed) Allan Sproul.

Enc.

August 6, 1942.

POSTED BUYING RATES AND PREFERENTIAL DISCOUNT RATES

There is no argument about the fact that the purpose of all borrowing from the Federal Reserve Banks is to obtain additional reserve funds and that, in so far as possible, the borrowing will be done at the cheapest window which is open, regardless of the purpose for which the borrowed funds are to be used. It might, therefore, be argued that preferential discount rates, at best, are a sign of central bank immaturity, and at worst, may lead to undesirable developments in the credit situation.

My first observation is that, if this is so, the multiplication of fixed buying rates for particular government securities is a manifestation of the same disease in aggravated form. The form seems to me to be aggravated because (a) combined with repurchase agreement it is merely a substitute for borrowing which takes away a certain amount of initiative and flexibility from the Reserve System and gives an unnecessary impetus to bank rather than nonbank buying, and (b) it promotes abuse of the pattern of rates, which we are hoping to avoid. (The realized yield on a one year 7/8% certificate of indebtedness, put to us at the posted buying rate, after it had been held for nine months, would be substantially above the coupon yield.) We accepted the idea of a posted buying rate for Treasury bills in order to popularize a Treasury obligation which was not familiar to most banks and other investors, and because it was part of a compromise agreement with the Treasury on a general program. No similar need exists in the case of certificates of indebtedness, and the argument that the privilege, now extended to banks which hold Treasury bills, should be extended to banks which hold certificates of indebtedness seems to me to be susceptible of indefinite and impractical extension.

To meet that need (a storm cellar for banks requiring additional reserve funds) by means of a preferential discount rate on all government securities maturing within one year, would be the better alternative. It is not an ideal alternative; the ideal alternative, I suppose, would be one rate for all "borrowing", but at present that would have to be 3/8 of 1% to meet the posted bill buying rate. I think that would be both undesirable and difficult of accomplishment without a great deal of friction within the System. The preferential discount rate, on the other hand, does have some practical advantages and a certain justification under present circumstances. It would be widely and easily understood. It would lead toward the use of the discount or borrowing window which I think we must come to if we are ever to get rid of the false idea that safety demands some amount of excess reserves to be maintained in New York or in Chicago, or in the country as a whole. It might prevent a considerable part of the present dumping of securities into the market, to make way for the purchase of new issues which now unsettles the market and increases the need of open market purchases when a new Treasury offering is made. It would be related, under present circumstances, to the use of the additional reserve funds created by the borrowing. The main reason for any large amount of borrowing by the banks during the foreseeable future will be the purchase of additional government securities. We do not want to make this operation unduly profitable and we cannot expect the banks to undertake it if it involves a loss. If it be conceived that the borrowing by banks is to enable them to buy new issues of government securities (as in the aggregate it will be), a preferential rate of ½ of 1% on securities maturing within one year will meet the situation. The regular discount rate of 1% will permit borrowing to purchase all other maturities of government securities and should be maintained. Banks as well as other businesses have something to fear from "profiteering" in wartime, and I do not think they could afford to appear as borrowers, nor could we afford to appear to encourage them to borrow, at rates of less than 1% to purchase securities bearing interest as high as 2% or $2\frac{1}{4}$%.

In our last formal presentation of a financing program to the Treasury (July 29, 1942) we stated as one of the actions the Federal Reserve System is prepared to take "3---establish a discount rate of $\frac{1}{2}$ of 1% on government securities maturing with one year." We are not bound, of course, by such a recommendation when it is not accepted, but I do not think we want to veer around too much looking for new gadgets. I would stick by that recommendation. The basic problem still is how to provide the necessary reserve funds for the banks, and that recommendation leads to providing some of these funds through borrowing, a channel which must be developed.