

**FEDERAL RESERVE BANK  
OF NEW YORK**

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NEW YORK ~~7~~, N.Y.  
October 24, 1947.

Honorable M. S. Eccles, Chairman,  
Board of Governors of the  
Federal Reserve System,  
Washington 25, D. C.

Dear Marriner:

I have been giving a little more thought to discount rate policy in the light of the Treasury's decision to adopt our views as to an appropriate and coordinated program of credit control and debt management during the next few months.

First, with respect to the timing of action on our discount rate. I had in mind that action on discount rates would follow the pattern set forth in the draft of letter to the Treasury which I prepared, prior to the last meeting of the executive committee of the Federal Open Market Committee. The paragraph on discount rates read as follows:

"The discount rate of the Federal Reserve Banks is now in approximate balance with other rates in the money market, including the rates on Treasury bills and certificates. As it becomes necessary, in order to maintain this relationship, the discount rate would be increased moderately in line with the increase in rates on bills and certificates."

In our discussion at the meeting there was some difference of opinion as to timing, and we finally agreed on a paragraph which left us free to take action at any time after a further increase in the rate on certificates had been indicated, but which did not commit us to immediate action and retained the idea that an increase in discount rates should be in line with market conditions. The pertinent paragraph in the letter we finally sent to the Secretary of the Treasury reads as follows:

"Increase the Federal Reserve Bank discount rates to 1-1/4 or 1-1/2 per cent in line with market conditions after a further increase in the rate on certificates is indicated."

For two reasons, and they are interrelated, I do not think we want to get out in front of rates on certificates of indebtedness too far nor too fast. We do not want our discount rate to carry much, if any, penalty on borrowings collateralized by certificates. Otherwise the attractiveness of certificates to the banks, as contrasted with longer term obligations, will be diminished, or all of the burden of adjusting reserve positions will be thrown on open market operations, or both. This would be contrary to our aim of making the market for short-term securities equally or more attractive than the market for longer maturities, and to our hope that borrowing from the reserve banks might again assume such

proportions that the discount rate would have some direct effect. Looking at it from the Treasury's side, I think we must have regard for the continued successful refunding of its large certificate maturities, at the rates it has agreed upon, and that tactically it would be undesirable for us to seem, or actually to be, forcing up rates through discount rate action when we are supposed to be getting them up by mutual agreement. On this occasion, I think, more than ever before, the Treasury placed itself in our hands, and we should avoid doing anything which is not required by the situation and which would disturb its trust in our judgment.


You might suggest that the answer is a restoration of a preferential discount rate on advances collateralized by short-term Government securities. The more I think about this, the more it seems to me that it would be a step backward; the restoration of a wartime device which has no place in our present program. I know that you are aware that there is no relation between the nature of the collateral for advances and the use to which the credit is put. In this instance, however, we should not overlook the fact that a dollar obtained from the Federal Reserve Banks can become the basis of a credit expansion several times as large and, what is more important in this context, the credit can flow out through the borrowing bank to the whole banking system. That is to say, the credit will largely find use among banks which have not borrowed and which were uninfluenced in their investment policy by the preferential rate. It is the difference between the impact of Federal Reserve operations on the banking system as a whole as contrasted with its impact on the individual banks.

The argument can be made, of course, that the influence of the discount rate is largely or wholly psychological under present conditions, but I do not think this is true when it comes to the question of the rate at which certificates of indebtedness can be successfully refunded by the Treasury, or when it comes to the maintenance of a satisfactory market in such securities. Right now, in this transition period from a 1 per cent rate to a 1-1/8 per cent rate, the market is an uncertain one, and if our discount rate were advanced prematurely, it could expose us to such selling of certificates as might weaken our whole program of keeping pressure on the banks. Nor do I think we want to exhaust our psychological ammunition at a time when we already have the market off balance. The market now knows it is on the way to a 1-1/8 per cent rate for one-year certificates of indebtedness (and maybe further), and it will feel the pressure of the retirement of our holdings of certificates and of bills, steadily, between now and the end of the year.

Rather than rush ahead of these developments with a discount rate change, I believe that it would be better to wait until conditions in the security markets and in the banking situation (including the volume of member bank borrowing from the Reserve Banks) suggest that action would be appropriate and effective. That time may come either after the first short-term (13-month) 1-1/8 per cent note is successfully issued as of December 1st, or after the 1-1/8 per cent one-year rate has been actually established by announcement of the January 1st refunding, and when we want to give an additional indication both of restraint on borrowing and of possible further narrowing of the spread between short-term and long-term rates. At that time an increase in the discount rates of the Federal Reserve Banks to 1-1/8 per cent would be in order, with a later increase to 1-1/4 per cent in prospect. As the market used to say about rates on Government securities, I don't

like the idea of dealing in "hat size" changes, but if this transition from one rate level to another is going to be a smooth one, that is the kind of change which is indicated. After all, we are not seeking a sledge hammer adjustment designed to end a boom by curtailing capital expenditures, production and employment, thus bringing downward pressure on prices. Ours is the more delicate task of restraining a further increase in bank credit, and in the velocity of use of existing purchasing power, while giving every encouragement to high, or higher, production. The major attack on inflation will have to be made by means other than drastic overall credit restrictions.

Yours faithfully,



Allan Sproul,  
President.