BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date October 14, 1943

To Chairman Eccles

From Mr. Carpenter

Subject:

Attached is a copy of the memorandum which Mr. Sproul read at the meeting yesterday afternoon.

Attachment

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10/13/43
3 ~~~~~~ Open market Ex

1. Our main purpose still is to supply bank reserves necessary to support credit structure, including maintenance of market for Government securities. It is not to thwart speculation (they may even be of some use) nor to provide earnings for banks.

2. Peak of use of bank credit in war financing probably passed. But banks still need additional reserve funds because of continued rise in currency circulation and in deposits.

3. During past year banks have used up some excess reserves and gotten additional reserve funds mainly through selling us Treasury bills or failing to replace maturing bills. We have sold bonds and notes, bought a few certificates and a large amount of bills.

4. The chances of our being able readily to continue putting reserve funds into the market in this way are not too bright because of the distribution of excess reserves and our related "pattern of rate" trouble. The banks in the principal money centers which are the chief bill buyers have no funds for this purpose and the banks with funds won't buy bills, at least at 3/8 per cent. The uneven distribution of reserve funds around the country has resulted, in large part, from the disinclination of banks outside the largest cities to accept the low rates of interest on very short securities and their consequent tendency to hold unnecessarily large amounts of cash. If short-term rates were closer to long-term rates the reluctance of such banks to invest might be overcome, the drain of funds from the money centers alleviated, and profits in riding the pattern of rates reduced.

5. But right now (aside from temporary situations) the short-term Government security market appears to be satiated. We are taking up substantial amounts of bills not sold weekly in the market, in addition to acquiring bills from the banks under repurchase option. The demand for certificates of indebtedness of the shorter maturities hasn't been sufficient to absorb offerings at yields corresponding to the pattern of rates. There has been a marked departure from the pattern of rates in this section of the market, which in turn further weakens the bill market.

6. It is time for the Treasury and the Open Market Committee to take another look at policy. Our three main weapons remain the same.

a. Reduction in reserve requirements. Excess reserves of banks outside central reserve cities almost as high as at beginning of year. Difficult to justify a general reduction in reserve requirements and results would be unfortunate in market; difficult to lower requirements only in central reserve cities when excess has disappeared and results at best would be temporary.

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b. Discounts. With larger banks reaching point where they can't use the bill window freely, because of lack of bills, there has been some increase in willingness to borrow. This borrowing by large city banks may help overcome reluctance of others to show borrowing in their statements. Can not be relied on in sufficient volume for next two or three months but every effort should be made to encourage it.

Open Market operations. We are left with security operations as our major reliance in supplying reserve funds in coming months.

7. The basic decision we must make with respect to security operations is whether we are going to make a strong effort to maintain the pattern of rates established a year and a half ago, or whether we are going to begin some modifications of the rate pattern at the short-maturity end of the curve.

8. The rate pattern we have been maintaining at the short end of the curve does not appear to be tenable under present conditions, and it can be held only with increasing difficulty. This pattern was appropriate for a period when there were large amounts of idle funds, a limited demand, and considerable uncertainty about the maintenance or stability of longer-term rates. It is not appropriate in a period when idle funds are limited, demands are large, and longer-term rates are pretty generally accepted as stable so that fears of capital losses on longer securities are disappearing.

9. Only by using strong-arm methods to increase the supply of funds available, and by at least a partial abandonment of the policy of keeping the use of bank credit at a minimum in financing the war, can we expect to continue to maintain the presently existing short-term rate structure. On the other hand, an abrupt and substantial rise in very short rates would also be dangerous in that it would create doubts as to the whole of the present rate structure and interfere with Treasury financing.

10. A middle course is indicated. We and the Treasury should change our open market and financing policies so as to bring about some strengthening of the interest curve at the lower end of the pattern. I would suggest that we discuss with, or recommend to, the Treasury

(a) Increase in our bill purchase and repurchase rate to 1/2 of 1 per cent.
(b) That we support the new pattern thus established more vigorously than we have been supporting the old pattern.

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A satisfactory bill market can not be maintained so long as certificates of indebtedness of comparable maturities offer much higher yield.

(c) That the Treasury, unless conditions change, shift next new financing out of certificates into notes--eliminate certificates from next drive.

11. This change of program suggests reconsideration of differential discount rate of 1/2 of 1 per cent on loans secured by governments maturing within year. Doubt if that rate need be changed, at least for present. The advantage of being able to obtain reserve funds by selling bills under repurchase option, without showing borrowing, should outweigh the advantages of borrowing against other short maturities in case of many banks.

12. One other change, I think, is now forced upon us. It is one I have resisted, and one which I think should be adopted now only because it can no longer be avoided with reason and safety. The declining market interest in Treasury bills, and the large maturities in System and Reserve Bank portfolios, are accentuating the difficulties of placing weekly issues. In the circumstances, I think we should bid at fixed rate for amounts of bills equal to our maturities, with full public disclosure of what we are doing. This would still permit the market to take all the bills it wants by shading the fixed rate even slightly, but it would relieve the market of the pressure of taking up large maturities, which it no longer will do, except indirectly for our account.

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