CREDIT POLICY AND TREASURY FINANCING

A reconsideration of certain major aspects of credit policy and Treasury financing is necessary after two years of participation in the war, and in the light of the changes which have taken place during those two years.

Such a reconsideration must keep in mind the main objectives of policy during this period and, assuming that these objectives still hold, our future policy must contribute to their further attainment. These objectives, as circumscribed by the overall and compelling need of financing the war in one way or another, we conceive to have been:

1. Keeping the expansion of bank credit to a minimum.

2. Maintenance of an interest rate structure which would both contribute to the successful financing of the war and be tenable in the immediate post-war period.

A considerable degree of success has been achieved in both of these areas. The adoption and gradual improvement of the drive method of Treasury financing, with increasing emphasis on sales of securities to non-bank investors, has produced beneficial results, and it now appears that the present fiscal year can be completed without further recourse to the banks for new money. At the same time, the pressure for continued bank purchases of government securities, which was inherent in the existence of a large volume of excess reserves, has been greatly reduced by permitting excess reserves to decline from $3.5 billion to $1 billion. This has been accomplished while maintaining, in general, the interest rate structure which existed at the time of our entrance into the war and which, in the light of circumstances at that time, had to be accepted as the rate structure to be maintained during the initial financing period.

If our objectives are now the same as they were two years ago, the problems involved in achieving them are different. We no longer have to rely on the banks for any substantial amount of new money, if at all, and we do not want to recreate conditions which will again put pressure on all banks to increase their holdings of government securities. It is claimed that a comfortable margin of excess reserves is necessary to provide the "feel" of easy money. This was the claim when excess reserves were $5 billion instead of $1 billion, but the policy of allowing excess reserves to diminish gradually has demonstrated its effectiveness. We no longer want to impress all banks with the "feel" of easy money, and non-bank investors get that "feel" from idle holdings of currency and deposits, not from excess bank reserves.

We do have to contemplate some readjustment of the short term interest rate structure if we are to avoid again putting the banks under pressure to buy government securities, and if we are going to develop, gradually, a rate structure which will accommodate itself to the needs of the post-war situation. This does not imply a change in the long term rate of interest either now or later; quite the opposite - the long term rate is the key rate which, so far as we can see, must be maintained. It is rather a recognition of the fact that present short term rates will only maintain themselves, now, if bank reserves are maintained at or increased to levels which encourage banks to continue to bid for government securities held by others, or if it is believed that a rise in long term rates is likely. There is no reason for accepting very low rates at short term, if the higher yields obtainable at long term can be had without serious risk of a decline in price (rise in yields) of the long term obligations. The task of financial statesmanship is to combat the belief in a higher long term rate, by demonstrating that a narrower spread between short and long term rates can be effected without changing the long term rate. In the future, this will protect investors in long term obligations, and protect the Treasury in its refunding operations in the post-war period and currently it will protect the smaller banks against an undue concentration of their holdings in the longest term securities available to them, and to some extent, it will protect the "pattern of rates" against abuse.

What are the immediate problems involved in developing such a program? For the Federal Reserve System, primarily, there is the problem of supplying the additional reserve funds which will still be needed to support a continued rise in currency circulation and an increase in the required reserves of member banks (as War Loan deposits are converted into private deposits). For the Treasury, primarily, there is the problem of how best to bring about an adjustment in the interest rate structure so that it will be suitable to the present situation, and so that it could contribute to the development of a tenable post-war situation. The two problems must be dealt with jointly.

METHODS OF SUPPLYING RESERVE FUNDS

The methods available to the Federal Reserve System in supplying reserve funds to member banks remain the same - reductions in reserve requirements, advances and rediscounts, and open market operations.

Changing Reserve Requirements:

Further action to reduce reserve requirements appears to be inadvisable, at least until banks throughout the country have more generally shown a disposition to use fully the funds they now have. Practically all of the existing excess reserves, amounting to about $1 billion, are held outside of the central reserve cities. If reserve requirements were reduced for all classes of banks, large amounts of reserves would be released at banks which would probably contribute little to the improvement of the market for short-term securities, and might accentuate the difficulty of maintaining an orderly market for the longer term bonds available to banks. If reserve requirements were reduced only in central reserve cities, it would be difficult to secure acceptance of a lower reserve requirement for the biggest banks of the country than for their smaller competitors in reserve cities, and only temporary relief would be obtained in any case. If, for example, reserve requirements of New York City member banks were reduced from 20% to 18%, there would be released only about $300 million of reserves. Most banks would probably use these funds to repurchase bills from the Federal Reserve Bank or to purchase other short term securities in the market. As funds flowed out of New York to the rest of the country (this continues to be the trend) the dose would have to be repeated. Such repeated action with respect to one class of banks would hardly be feasible, and such action applicable to all classes of banks, in the absence of a general need for additional reserve funds, would throw doubt on the sincerity of our desire to finance war expenditures, as largely as possible, outside the commercial banking system. The desire of the Treasury to finance its requirements as cheaply as possible could be held to have taken precedence over avoiding a potentially inflationary expansion of bank credit.

Advances and Rediscounts:

There has been some development of borrowing from the Federal Reserve Banks during recent months (by large city banks no longer in a position to use the bill window freely), but this method of making reserve funds available cannot be relied upon to supply the needed funds in sufficient volume during the immediate future. We should not be led away from the possible later use of this method, however, by faulty deductions drawn from the experience of the last decade when large excess reserves made each individual bank its own central bank. There is no tradition among bankers against borrowing either from correspondent banks or at the central bank; there has only been a lapse in the use of a normal mechanism during an abnormal period. In recent months many banks have been borrowing from the Federal Reserve Banks in substantial amounts by use of the Treasury bill purchase and repurchase arrangement. The large banks like this method of borrowing because it enables them to borrow without showing bills [redacted] payable, but this does not change the essential character of the transaction, nor is it desirable, from the standpoint of credit administration, to enlarge the field of this concealed borrowing If this means of borrowing were no longer open, or if particular banks lacked means of access to it, and if direct borrowing could be done at a profit (by reason of a differenc between the discount rate and the coupon rate on the securities used as collateral) there would likely be a resumption of direct and admitted borrowing. This is what has been happening in New York City and the example of the large city banks would, no doubt, help others to overcome their reluctance to resume the practice. It would be more of a break in tradition, in fact, if banks did not borrow funds from the central bank when they can do so at a profit and when the purpose would be to retain holdings of government securities in time of war. We need not be concerned about a withdrawal of banks from the market for new securities because we no longer need or want them there in any substantial way, and we do not have to be seriously concerned about their selling their existing portfolios in preference to borrowing. It should not be forgotten, also, that the most direct way for the Federal Reserve Banks to put funds into the banking system, where they are needed, when they are needed, and in the amounts needed, is through member bank borrowing. This is an important aspect of credit administration.

Open Market Operations:

Nevertheless, it appears that, for the immediate future, open market operations must be the main reliance of the Federal Reserve System in supplying reserve funds to the banks of the country, as they have been during past months. Banks have been obtaining additional reserve funds mainly through selling Treasury bills to the Reserve Banks or failing to replace maturing bills, and by selling some certificates of indebtedness (the Reserve Banks have sold Treasury bonds and notes in order to maintain the pattern of rates, and this selling, of course, took funds out of the market).

FEDERAL RESERVE HOLDINGS OF GOVERNMENT SECURITIES

	January 1, 1943	October 31, 1943	Change
Bonds	$2,777,059	$1,505,582	- $1,271,477
Notes	1,323,799	685,900	- 637,899
Certificates	1,041,000	1,565,350	+ 524,350
Bills	1,009,996	5,546,634	+ 4,536,638
Guaranteeds	36,782	50,481	+ 13,699
Total	$6,188,636	$9,353,947	+ $3,165,311

Entire System Account
(000 omitted)

Because of the mal-distribution of excess reserves and because present short term rates of interest are no longer appropriate, it appears that the Federal Reserve Banks will have difficulty in continuing for long to put reserve funds into the market in this way while maintaining the existing pattern of rates. Banks in the principal money centers, which heretofore have been the chief buyers of bills, now have no surplus funds, and banks with funds are generally not interested in bills at 3/8 of 1%. As a consequence, the very short term market for government securities appears to be satiated. From the end of May to the middle of September, the outstanding amount of Treasury bills increased by $2.2 billion and, during the same period, the Federal Reserve System's holdings increased by $3.3 billion. After a temporary halt in this movement, resulting from changes in reserve requirements associated with the Third War Loan drive, the System's holdings of bills are again increasing. There has also been a lack of demand for certificates of indebtedness of the shorter maturities at yields corresponding to the pattern of rates.

The basic decision which must be made with respect to open market operations is whether we are going to try to force the maintenance of the short term rate structure established nearly two years ago or whether we are going to permit a modification of that structure. The rate pattern we have been maintaining at the short end of the curve does not appear to be tenable under present conditions, It was adopted and was appropriate in a period when there were large amounts of idle funds, a relatively limited demand for credit, and considerable uncertainty about the maintenance or stability of longer term rates. It is not appropriate now, when idle funds are more limited, demands are large, and a degree of confidence in the stability of longer term rates has been achieved. Only by forcing additional funds into the market, and thus abandoning in an important degree the policy of keeping to a minimum the use of bank credit in war finance, can we contrive to maintain the existing short term rate structure.

The suggestion that, in these circumstances, the cure is to increase the weekly issue of Treasury bills, seems unrealistic. Combined with a prohibition against direct bidding for bills by the Reserve Banks, it is impossible.* It is argued that reserve bank purchases of government securities should be concentrated in bills; that bills are now importantly used by city banks as secondary reserves; that they have taken the place of excess reserves in providing a margin of safety for day-to-day operations; and that any substantial reduction in the amount of member bank holdings would be dangerous. This is to repeat the error which was implicit in an earlier insistence on a very large volume of excess reserves, namely, that each individual bank, and the whole commercial banking system, must protect its reserve position without regard to the existence of a central bank. The fact is that Treasury bills are not a secondary reserve in the usual market sense; they are a means of borrowing at the Federal Reserve Banks at a preferred rate. No special amount, and certainly not $7½ billion, of such obligations needs to be maintained in the portfolios of the banks, nor can be unless an excessive amount of bank reserves is deliberately created, or unless bills are made more attractive to banks outside the money markets.**

RECOMMENDATIONS OF FEDERAL OPEN MARKET COMMITTEE

The Federal Open Market Committee has considered this problem. It believes that the only desirable approach to a solution is to bring about a narrowing of the present spread between long term and short term rates, by increasing the rates at short term. Two alternative methods of accomplishing this purpose were considered.

Under one approach, the present three-month bills and one-year certificates would be replaced by nine month bills. These bills would be issued in a total amount of not exceeding a billion dollars a week, unless a demand developed for a larger amount. Tenders for $100,000 or less would be allotted in full at 3/4 of 1 per cent, and larger tenders would be allotted to the highest bidders. The Committee would establish a buying rate and repurchase option at 3/4 of 1 per cent on the new nine month bills. ?

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*As is developed in a separate memorandum on the question of direct bidding for Treasury bills by Federal Reserve Banks, the present System whereby bids are induced in the market to assure the sale of each week's offering of Treasury bills, is becoming more and more unwieldy. To change the inducement to a promise of an immediate small profit for bidding in behalf of the Reserve Banks, would not greatly improve the situation. We have shared the Treasury's concern about the dangers of creating the impression that the Treasury is resorting to direct borrowing at the central bank to finance the deficit. Our present situation, however, is one in which the method used to avoid creating this impression is becoming more likely than not to bring censure on the Treasury and the System, whereas a change in method can be clearly and adequately explained to the public.

**A reference to conditions prevailing in the London money market before the war, and having regard for the substantial differences betwen the London money market and our money market and between the British banking system and our banking system, is not deemed to be relevant.

Advocates of this proposal believe that commercial banks would be much more inclined to hold bills at 3/4 of 1 per cent than to hold bills at 3/8 of 1 per cent or certificates, which under existing practices command increasing premiums. The new bills would attain a much wider distribution among smaller banks than do the present three month bills at 3/8 of 1 per cent. The System would no longer be faced with the increasingly difficult problem of maintaining a variable pattern of rates on maturities of less than ~~two~~ nine months. Speculators could no longer make a profit by playing the pattern of rates on short term issues; most of the playing of the pattern has been in short term issues, and an extension on any large scale to longer term issues is unlikely because of the greater risk that it involves. Finally, the proposal would simplify the Treasury's financing program and eliminate a large refunding problem.

Under the other approach, the problem would be met by continuing to issue one year certificates at 7/8 of 1 per cent and at the same time diminishing the spread in yields by substituting for the present bills four month bills at 5/8 of 1 per cent. Advocates of this proposal point out that the existing pattern of financing and types of securities would be maintained; that it would not involve a drastic change in the one day interest rate; that it would permit of some adjustment in the amount of the weekly bill offerings without a change in the aggregate amount outstanding. They also suggest that it would help to widen the distribution of short term securities among smaller banks, which have excess reserves and whose deposits are increasing most rapidly; that it would make it more expensive for banks to sell bills to the Reserve Banks than to borrow at the differential rate of 1/2 of 1%; that it would not increase the amount of outstanding securities on which "borrowing", without showing bills payable, is possible; that it would reduce the incentive for banks to shift from short term to long term securities; and that it would also diminish the incentive for playing the pattern of rates.

The Committee believes that a narrowing of the spread between short and long term interest rates can be brought about without disturbing the entire interest rate structure. Specifically, it believes that the steep forepart of the present interest rate curve is no longer tenable, and that levelling this section of the curve will confirm, not weaken, the stability of longer term rates.

The Committee recommends to the Treasury that prompt consideration be given to the policy which it suggests, and that action be taken to implement the policy at the first appropriate opportunity.

A.S.
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