December 7, 1944

To: Chairman Eccles Subject: Letter from Mr. Sproul

From: L. M. Piser

The letter and memorandum by Mr. Rouse, which Mr. Sproul enclosed in his letter to you dated December 5, concerns the maintenance of the pattern of rates on certificates. Mr. Rouse mentions the increased rates that the Federal Intermediate Credit Banks and the Federal Home Loan Banks were forced to pay on their recent financing as compared with similar financing last June and states that the reason for the increased rates was the increased yields on Treasury certificates. He says that Mr. Bell told him that, based on the Treasury's understanding of the Federal Reserve commitment to maintain the pattern of rates, the Federal Reserve is not doing its job. Mr. Rouse suggests that, if the present policy is to be continued, the Treasury must be brought into agreement with the policy and that instructions to the New York Bank should be made clear on this point. He suggests that both the Federal Reserve and the Treasury would then have to recognize that except for Federal Reserve participation no new Treasury bills can be issued. Otherwise, it would be necessary to reduce yields on three-month certificates to approximately 1/2 per cent.

Regarding the policy related to yields on certificates, Mr. Rouse makes the following observations:

1. By purchasing certificates when they cannot be sold readily by banks needing reserve funds, the Federal Reserve has encouraged banks to use certificates rather than bills in making reserve adjustments.

2. No marked improvement in the Treasury bill situation can be expected unless bills are made more attractive or certificates less attractive, or both.

3. As long as certificates are quoted at a premium, there will be large sales prior to drives, and nonbank investors will continue to prefer certificates to bills as a short-term medium of investment. It is better, however, to have playing of the pattern of rates centered in certificates than in notes or bonds, where the cost to the Treasury is higher and profits to those playing the pattern probably would be larger.

4. As long as the Treasury uses certificates as a principal means of financing, a broad market above par must be maintained.

5. A lowering of yields on certificates would require purchases by the Federal Reserve when there is no need to put funds into the market.

6. The yield on any marketable issue of Government securities is related directly to the yield on every other issue, and the market as a whole rather than just a few key issues must be maintained if the pattern of rates is to be maintained.

7. The payment by the Federal Reserve of small premiums on certificates is unimportant in comparison with the objective of successfully financing the war at low rates of interest with a minimum of bank participation.

Mr. Rouse states that the dilemma has been and is to reconcile these conflicting forces and to maintain a pattern of rates while avoiding too strong an invitation to play the pattern. He suggests that the Executive Committee might wish to give consideration to a pattern of rates on certificates that would result in the same premium for the first nine months that each issue is outstanding. This program would result in the establishment of a premium of perhaps 3/32 on certificates immediately after issuance. The yield on certificates would decline, therefore, from 0.78 per cent at issuance to 0.50 per cent when certificates had three months to run to maturity. Mr. Rouse recognizes that the principal objection to this proposal is the relatively high premium that would be established immediately on new issues of certificates. If the premium were placed at 2/32, however, three-month certificates would yield 5/8 per cent, which would be 1/4 per cent above the bill rate. Mr. Rouse concludes that this whole problem has been recognized as a difficult one almost from the beginning of the pattern of rates program but that a point has been reached where a reconsideration of policy, precedent to a review of our understanding with the Treasury, is necessary.

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