STRICTLY CONFIDENTIAL (Draft of December 7, 1944)

TREASURY BILLS, CERTIFICATES, AND 2 PER CENT BONDS

After giving further consideration to the declining demand for Treasury bills, the continuing difficulties with maintaining a structure of yields on certificates, and the increase in earnings of commercial banks, the following proposals are made:

(1) That the maturity of Treasury bills be extended to five months and the rate increased to 1/2 per cent,

(2) That such part of Federal Reserve holdings of bills as will not be needed for future sale in the market be refunded by the Treasury into special issues yielding 1/4 per cent,

(3) That the coupon rate on future issues of certificates be 3/4 instead of 7/8 per cent, and

(4) That the Treasury issue no additional 2 per cent bonds available for purchase by commercial banks.

The increase in the rate on Treasury bills, combined with the decrease in the rate on certificates, would make bills more attractive to investors in relation to certificates than they are at present. Bills should regain their former position, therefore, as a medium for the adjustment of the reserve positions of individual banks. The slightly longer maturity should not detract from the bills, since the Federal Reserve would purchase all bills offered at 1/2 per cent.

Since Federal Reserve earnings are considerably in excess of expenses, there is no need for the Federal Reserve to benefit from an increase in the bill rate from 3/8 to 1/2 per cent. In fact, earnings could be maintained at an adequate level if the rate on a substantial part of Federal Reserve holdings of bills were reduced from 3/8 to 1/4 per cent. Under the proposal, the Federal Reserve each week would be permitted to exchange such part of its bill maturities as it considered advisable for a special issue with a rate of 1/4 per cent. There would be no point in extending this offer to holders other than the Federal Reserve, because no other holder would be willing to make such an exchange. To the extent that the Federal Reserve replaced its maturing bills by exchanging them for the new issue of 1/4 per cent securities, the Treasury could reduce the weekly bill offering to the market. It would no longer be necessary, therefore, for the Treasury through the New York Reserve Bank, as fiscal agent, to make arrangements with dealers to place bids for new issues.

Another solution to the problem of excessive Federal Reserve earnings would be the reinstitution of a franchise or similar tax. The advantage of this solution would be that it would eliminate the necessity of making a special arrangement with the Treasury for the exchange of Federal Reserve holdings of bills, which arrangement might be interpreted in some quarters as

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a direct purchase. On the other hand, a franchise tax as a method of absorbing excessive earnings could be better defended when Federal Reserve earnings were based largely on discounts and bankers' acceptances. Now that they are based largely on Government securities, however, the Congress might prefer that the Federal Reserve purchase these securities on a no-interest basis, in order to do directly what the franchise tax would be designed to do indirectly. The Congress also might prefer that Federal Reserve expenses be approved by the Budget Bureau and by the Congress.

In estimating the amount of bills that the Federal Reserve would exchange with the Treasury each week, consideration should be given to the amount of marketable bills that the Federal Reserve would need to sell during the subsequent war loan drive, since Federal Reserve holdings of marketable bills should not be permitted to decline below the level necessary to provide for subsequent sales. At least in the initial stages, the amount of the exchanges should be considerably below this level. A reduction of the spread between the rate on bills and certificates from 1/2 to 1/4 per cent might result in a large shift in demand from certificates to bills. Federal Reserve holdings of marketable bills should be maintained, therefore, at a relatively high level, until such time as a more precise estimate could be made of the amount of bills that the Federal Reserve would need to hold. Over a period of time, of course, the Treasury could adjust for this development by retiring certificates on maturity and increasing the weekly offering of bills, but it would not be able to provide entirely for a large and sudden shift in demand.

The reduction in the spread between the rates on bills and on certificates from the present 1/2 per cent to the proposed 1/4 per cent would solve the present difficulty of the Federal Reserve in maintaining proper yields on certificates. If the Federal Reserve again should maintain on certificates a yield structure between 1/2 and 7/8 per cent, it would increase the incentive to play the pattern of rates. If the Federal Reserve should continue to maintain a yield structure such as the present, it would continue to discourage investment in Treasury bills. Under the proposal, the Federal Reserve would support certificates at yields ranging between perhaps 5/8 per cent on five-month certificates and 3/4 per cent on one-year certificates. There probably would be little difficulty in maintaining such a structure. Speculators would be given little incentive to play the pattern of rates, and bills again would become attractive.

The decline in the coupon rate on new issues of certificates would not materially reduce purchases by corporations. Corporations purchase certificates because, despite the low yield, these securities have a ready marketability, which is provided by their short maturity and by Federal Reserve support. A reduction in the rate from 7/8 to 3/4 per cent, therefore, would not materially reduce purchases of certificates by corporations, and any reduction that would occur would likely be replaced by additional purchases of savings notes. There is no need for paying as high a rate as 7/8 per cent on certificates purchased by commercial banks, moreover, because of the high earnings that commercial banks are now making.

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The Treasury should discontinue the issuance of 2 per cent bonds that are available for purchase by commercial banks because of the high level of commercial bank earnings. Banks probably would attempt to improve their earnings, however, by purchasing outstanding 2 per cent bonds at increasing prices. Yields on these issues might well decline to 1 3/4 per cent. A decline below this level could be prevented if the Treasury issued to commercial banks 1 3/4 per cent bonds of similar maturity. This decline in yields would result in an increase in the price of the latest issue of 2 per cent bonds to 102. This might create a disorderly market if the increase in price should occur very suddenly. To some extent, the transition could be smoothed by sales by the System and by the Treasury from its various investment accounts.

Another consideration is that banks might acquire a large amount of the present 2 per cent bonds by purchasing from the present holdings of those securities by nonbank investors. Nonbank investors would be willing to sell their existing holdings if they were able to replenish them by subscribing for restricted issues of similar maturity with coupon rates of 2, 2 1/8, or 2 1/4 per cent. It might be necessary at first, therefore, for the Treasury to issue no medium-term bonds either to commercial banks or to nonbank investors. It is not likely that nonbank investors would sell any substantial amount of their present holdings if they could not replace them by subscribing for issues of similar maturity.

Since there is a considerable demand for bonds in the medium-term category from nonbank investors for permanent holding, it might be desirable to issue some securities, restricted as to ownership, of this type. If nonbank investors were given unlimited allotment, they would be likely to purchase very large amounts of these issues and to dispose of large amounts of their present holdings of 2 per cent bonds, since the profit that they could make on such sales would be substantial. Consideration might be given, therefore, to limiting the allotment of such securities to the amount that nonbank investors would be likely to want for permanent investment.

From the point of view of the Treasury, the interest cost on the debt would be reduced to the extent that banks shifted their holdings from certificates to bills, since the Treasury could issue additional bills and retire some of the outstanding certificates. Interest on the portion of the debt involved in these transactions would be reduced from 7/8 to 1/2 per cent. In addition, interest on a considerable part of Federal Reserve holdings of bills would be reduced from 3/8 to 1/4 per cent. Finally, any subsequent offering of medium-term bonds to banks would be at perhaps 1 3/4 rather than 2 per cent. This latter change, together with the shift from certificates to bills, correspondingly would serve the purpose of reducing commercial bank earnings to more reasonable levels.

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