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July 11, 1945

Board - Washington

Your wire July 7th. As you know, I favor increase special discount rate from 1/2 to 3/4 of 1 percent rather than its elimination. This view derives from combination of following:

1. Most significant result of change, in my opinion, will be to cast some doubt on permanence of pattern of rates so as to reduce assurance of riskless profits in medium-term securities, thus maintaining or reviving bank interest in certificates and eventually helping create conditions permitting flexibility in short rates.

2. Objective of maintaining or reviving bank interest in certificates will be furthered by retaining some indication of preference on our part for investment in certificates through continuing the special rate though at a higher level.

3. Secondary question of abuse of borrowing privilege and profit to banks will be better met by increase in special rate rather than elimination. Most of possibility of bank borrowing for profit will be removed, so far as certificates are concerned, with 3/4 percent special rate. If special rate is eliminated there is danger that bank borrowing for profit, insofar as it is a problem, will express itself in borrowing on longer term securities at regular discount rate, which is exact reverse of what we are trying to accomplish. Tendency in these circumstances will be for certificate to go the way of the Treasury bill unless counter action is taken in open market.

4. Think it still desirable to give evidence of approval of borrowing to effect temporary adjustment reserve positions which is still most flexible means of caring for individual bank needs. Elimination of special rate would throw all of this load, at least so far as certificates are concerned, on open market operations. As long as Government finds it necessary to borrow substantial amounts from banks fundamental problem is to keep excess reserves at minimum consistent with assurance banks will be able and willing to do their share of Treasury financing. From beginning of warthis has been System policy and it has also been System policy and practice to seek this end not only by open market operations but also by encouraging banks to borrow to adjust individual reserve positions. There has been no change in this situation which calls for change in policy.

5. Change in special rate must be combined with change in open market operations in certificates if results are to be obtained. Little purpose in removing possibility of borrowing at profit if possibility of selling at profit is to remain. If special rate is eliminated we run risk of interfering with refunding and new issue of certificates. On the other hand, if open market support is given to overcome this objection the effect of eliminating special rate may be largely nullified. At this Bank member bank borrowings declined from a peak of approximately $700 million on June 9th to $2-1/2 million on July 2nd, and are now only $29 million. It is highly doubtful that this much Federal Reserve

credit would have been retired had we bought the certificates instead of loaning on them; and there is every reason to believe we would have had to buy them if the special rate had not been available.

6. Combination of special rate increase which takes up most of slack between coupon and borrowing rate on certificates and abandonment of support of certificates of all maturities except at prices which provide par to sellers seems to accomplish all purposes, including creating some doubt as to permanence of whole pattern of rates, eliminating idea of pattern of rates between 3/8 and 7/8 0/0, continued encouragement of bank purchase and holding of shortest-term securities, elimination of most of profit incentive heretofore combined with this encouragement. Realize, of course, that other steps which we have suggested to Treasury will have to be taken if whole character of Treasury financing is to be improved.

7. Agree that we must tread softly at this stage but think idea that elimination of rate would be less noticeable and less severe than increase in rate would deceive no one but ourselves. The alternative, in fact, is increase in rate from 1/2 to 1 0/0 or from 1/2 to 3/4 of 1 0/0. I prefer latter and think it offers greatest opportunity of working out acceptable program with Treasury.

Will canvass question informally with executive committee of directors on Thursday and advise further views, if any.

Sproul.