STRICTLY CONFIDENTIAL

July 14, 1945

To: Governor Ransom

From: L. M. Piser

Subject: Replies from Reserve Banks regarding preferential rate

In accordance with your request, the arguments advanced by the Reserve Banks for an increase in the preferential rate from 1/2 to 3/4 per cent rather than its elimination are as follows:

1. By casting some doubt on the permanence of the pattern of rates and by indicating a preference on the part of the Federal Reserve for bank investment in short-term securities, it would maintain or revive bank interest in certificates.

2. It should lessen the present strong appetite for certificates without undermining the investment demand for them. It would be less abrupt and less likely to interfere with sales of new certificates.

3. It would remove most of the profit in borrowing to purchase certificates, whereas elimination of the preferential rate might induce banks to borrow at the regular discount rate in order to purchase longer-term securities, which would destroy the market for certificates. It might tend to depress further the yields on longer-term securities.

4. It would continue to encourage banks to effect temporary adjustments of reserve positions by borrowing, whereas elimination would encourage them to sell certificates. This would make changes in total Reserve Bank credit less flexible and would increase the difficulty of maintaining the pattern of rates.

5. It would be less noticeable than elimination of the rate and consequently would offer better opportunity for working out an acceptable program with the Treasury.

6. It would indicate some flexibility in System policy without upsetting the market.

7. It would leave member banks in a slightly favored position compared with nonmember banks.

8. It would tend to curb speculative activity.

9. It would leave the System in a flexible position, whereas elimination would make it difficult to reinstate the rate if that should prove later to be desirable.

10. It would give the System an opportunity to examine the consequences of a partial step in the desired direction, after which the situation could be re-examined to determine whether further action would be necessary and what the consequences might be.

11. In view of the appointment of a new Secretary of the Treasury, any change at this time might be misinterpreted, making it desirable to defer action until a later date.

As I understand them, the arguments for elimination rather than an increase are as follows:

1. The reason for establishing this rate no longer exists, because the problem now is to retard rather than to encourage bank investment in Government securities.

2. Its elimination would not interfere with the war financing program, because nonbank funds are flowing into Government securities in tremendous amount in the drives, because nonbank investors still have large uninvested funds, and because Treasury borrowing needs have declined sharply.

3. It would be more effective in retarding the growth of bank credit and particularly in retarding bank investment in longer-term securities, because it would cast more doubt on the permanence of the pattern of rates, because it would remove more of the profit in borrowing to purchase securities, and because it would have more effect on the rates charged by banks on loans to dealers and others.

4. It would be more effective in eliminating abuses, because it would remove more of the profit in borrowing.

I should like to make the following comments on the arguments advanced by the Reserve Banks:

1. The present indication of preference in the past of the Federal Reserve for bank investment in short-term securities has had little or no effect on bank investment policy.

2. Elimination of the rate probably would not undermine the investment demand for certificates, because the demand is based largely on the ability to sell to the Federal and to only a limited extent on the borrowing rate.

3. It is difficult to understand why banks would borrow more at 1 per cent than they would at 3/4 per cent in order to purchase longer-term securities.

4. The flexibility in total Reserve Bank credit can be maintained if System Account operations are flexible.

5. Mr. Bell indicated a preference for elimination.

6. Either change would indicate flexibility.

7. A slightly favored position for member banks over nonmember banks is not important.

8. Elimination would be more effective in curbing speculative activity.

9. Now that Treasury borrowing needs are declining rapidly, there is little likelihood that the System would want to reinstate the rate once it had been eliminated.

10. The arguement that an increase to 3/4 per cent would give the System an opportunity to examine the consequences of a partial step in the desired direction before determining upon elimination seems to me to be the strongest of the arguements advanced by the Reserve Banks. An increase to 3/4 per cent would do some good, and certainly could do no harm. After perhaps a few months' experience with the 3/4 per cent rate, the consequences of elimination would be much clearer than they are at the present time.

11. If the change is not made until the new Secretary takes office, it probably could not be made until after the next drive.

LMP:ij