FEDERAL RESERVE BANK
OF NEW YORK

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July 31, 1945.

Hon. M. S. Eccles, Chairman,
Executive Committee, Federal
Open Market Committee,
c/o Board of Governors of the
Federal Reserve System,
Washington 25, D. C.

Dear Chairman Eccles:

Enclosed is a copy of a letter which I have today sent to Secretary Vinson, answering his letter of July 27, 1945, addressed to Governor Ransom. Governor Ransom has also acknowledged Secretary Vinson's letter, and our two replies, couched in informal language, are intended to keep open for discussion the questions which we have had under consideration with the Treasury.

In consultation with Governor Ransom (and other members of the Board) at Washington yesterday, we came to the conclusion that this would be a better procedure than to attempt to have immediate meetings of the Board and of the Open Market Committee at which formal replies to the Secretary's letter might be prepared. Obviously the situation has changed since we presented our views to Secretary Morgenthau at a time when it was expected he would continue in office at least for several weeks. It is only natural that Secretary Vinson should wish to have time to familiarize himself with the problems of war financing and the related problems of banking and credit, and we thought we should not press him with formal communications now. Having in mind that we shall be establishing a pattern of relations with a new Secretary of the Treasury, it seemed much better to await an opportunity for further discussion with him when he has been a little longer in office.

Yours sincerely,

Allan Sproul, Vice Chairman,
Executive Committee,
Federal Open Market Committee.

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FEDERAL RESERVE BANK OF NEW YORK

July 31, 1945.

The Honorable Fred M. Vinson,
Secretary of the Treasury,
Washington 25, D. C.

Dear Mr. Secretary:

In the absence of Chairman Eccles I am answering your letter of July 27, addressed to Governor Ransom, in so far as it refers to the memorandum sent to your predecessor in office by the Executive Committee of the Federal Open Market Committee under date of July 9, 1945.

I realize, of course, that you will want to review the whole program of Government borrowing before making decisions with respect to future war loans. Our memorandum was prepared at a time when it appeared that Secretary Morgenthau would have to make some of these decisions respecting the Eighth War Loan, and the maintenance of the market prior to that loan. We shall now await your convenience, while looking forward to a discussion with you of the suggestions we have already made for Treasury consideration.

In our memorandum we also mentioned that the Board of Governors of the Federal Reserve System and the Federal Reserve Banks were considering the elimination of the special discount rate now fixed for advances collateraled by Government securities due or callable in one year or, alternatively, an increase from 1/2 to 3/4 of 1 per cent in that rate. As you know, this is a matter for final decision by the Board and the Federal Reserve Banks, but it is so intimately related to our open market operations in Government securities as to bring it within the realm of discussion by our Committee. Similarly, of course, it is a concern of the Treasury and therefore was brought to your attention.

Our Committee was impressed with the developing abuses which have fastened themselves to the drive method of Treasury financing, with the continued large growth in the use of bank credit in such financing, and with the responsibilities for support of the Government security market, extending into the indefinite future, which will be placed on the Federal Reserve System by these undesirable trends. The Government security market, in a sense, is becoming one of the great speculative markets of the country, with banks and corporations, as well as individuals, taking a fling in an atmosphere somewhat reminiscent of the late 1920's.

As one part of an integrated program to combat these tendencies the Executive Committee of the Federal Open Market Committee favored the proposal of the Board of Governors and the Federal Reserve Banks that the special discount rate on short-term Government securities be increased or eliminated. We did not consider this a proposal to increase short-term interest rates, except in that special area where they contribute to a growing speculation and a growing use of bank credit in the Government security market. The Treasury would continue to borrow on all kinds of securities of all maturities at not more than the rates it is now paying. If necessary to maintain this situation, particularly in so far as Treasury certificates are concerned, vigorous open market operations were contemplated.

Nor did we consider this a proposal to weaken the incentive of banks to hold short-term Government obligations - quite the reverse. The incentive of the banks to hold short-term securities is being undermined chiefly by a growing appreciation of the fact that the higher yields of longer-term securities can be obtained, without increase in risk, so long as the pattern of rates is maintained, and the feeling that the pattern must be maintained indefinitely, in peace as well as in war. It is partly to break out of this frozen position, which can only presage a continuance of general speculation in Government securities, and of lengthening maturities in bank portfolios, that the Federal Reserve System is considering a change in its special discount rate.

The subsidiary question of the "pattern of rates" between the 3/8 of 1 per cent Treasury bill and the 7/8 of 1 per cent certificate rate was perhaps given undue emphasis in our memorandum. It has seemed clear to us for some time that the 3/8 of 1 per cent bill rate has not been a market rate. Bills do not really circulate freely in the market; in so far as they are held outside the Federal Reserve System they are largely a means of borrowing at the Federal Reserve Banks, and the 3/8 of 1 per cent bill rate is itself a special discount rate. The maintenance of a pattern or curve of rates between 3/8 and 7/8 of 1 per cent has therefore become very largely an invitation to "roll over" subscriptions to or "roll over" operations in certificates. I think the Committee had in mind, therefore, that our present commitment should be to support all certificates, of all maturities, at all times, at not less than 7/8 of 1 per cent, but we also said that we would take whatever steps might be necessary to assure the Treasury of a ready market for any refunding or any offering of 7/8 of 1 per cent securities which it found necessary or desirable.

I recognize the special though erroneous interpretation which might be placed on any action, taken now, in this general area we have been discussing. Nevertheless, I do not believe that desirable action should be too long postponed for this reason. I am glad therefore that you intend to give further consideration to the Committee's suggestions with respect to future Treasury financing, and I hope that you will look at the proposals of the Board of Governors and the Federal Reserve Banks concerning an increase in or the elimination of the special discount rate on short-term Government securities with a new perspective.

We know of course that we must work as a single team, not only for the duration but "after the duration". It is in that spirit that we have approached this problem.

Yours faithfully,

(Signed) Allan Sproul

Allan Sproul,
Vice Chairman, Executive Committee,
Federal Open Market Committee.

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