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Form F. R. 511(a)

TO _____

FROM _____

REMARKS:

Mr. Carpenter brought this in and said it was a copy of a draft of a letter which Allan Sproul had prepared in accordance with Exec. Committee meeting of FOMC last week. A copy has been sent to each member of the Exec. Comm. and the staff is working on it now.

If you have any comments please advise Mr. Carpenter.

GOVERNOR ECCLES' OFFICE

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WOODLIEF THOMAS

BOARD

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

THERE FOLLOWS DRAFT OF PROPOSED LETTER TO SECRETARY WHICH I WOULD HAND TO HIM POSSIBLY ON FRIDAY AFTER CLEARANCE BY EXECUTIVE COMMITTEE INCLUDING WILLIAMS PHILADELPHIA. QUOTE ON JANUARY 4TH, AND AGAIN ON JANUARY 26TH, CHAIRMAN MCCABE AND I DISCUSSED WITH YOU THE PROBLEMS OF CREDIT POLICY AND DEBT MANAGEMENT WHICH PRESENTLY FACE US AND, AFTER EACH OF THESE DISCUSSIONS, THERE WAS A MEETING OF THE EXECUTIVE COMMITTEE OF THE FEDERAL OPEN MARKET COMMITTEE TO CONSIDER THE SAME PROBLEMS. AT ITS MEETING A MONTH AGO THE COMMITTEE WAS OF THE OPINION THAT THE NECESSARY PRESSURE WAS BEING EXERTED ON THE MARKET BY A WISE USE OF TREASURY CALLS ON WAR LOAN ACCOUNTS AND THAT, MEANWHILE, IT WOULD BE PREFERABLE TO AWAIT THE CLARIFICATION OF THE SITUATION, WHICH WOULD BE AFFORDED BY THE REPORT ON THE STATE OF THE UNION, THE BUDGET MESSAGE, AND THE ECONOMIC REPORT OF THE PRESIDENT, BEFORE CONTEMPLATING OTHER MEASURES.

IT IS THE VIEW OF THE COMMITTEE (A VIEW WHICH WE BELIEVE IS SHARED BY THE BANKING COMMUNITY) THAT THE TREASURY'S PROGRAM OF CALLS ON WAR LOAN ACCOUNTS, SO AS TO OFFSET THE EFFECT ON BANK RESERVES OF THE SEASONAL RETURN FLOW OF CURRENCY, GOLD IMPORTS, AND OTHER FACTORS, AND SO AS TO MAINTAIN SOME PRESSURE ON BANK RESERVES, HAS BEEN WORKING VERY SATISFACTORILY AND SHOULD BE CONTINUED. THIS WOULD PROBABLY MEAN CALLS AGGREGATING ABOUT \$1 BILLION DURING THE NEXT TWO MONTHS, CONCENTRATED IN THE FIRST HALF OF MARCH, WHEN OTHERWISE THERE WOULD BE A SUBSTANTIAL INCREASE IN THE RESERVES AVAILABLE TO BANKS. SUCH A PROGRAM OF CALLS, OF COURSE, TOGETHER WITH TAX COLLECTIONS DURING THE LAST HALF OF MARCH, WILL INCREASE THE

RESERVE BANKS. SINCE THESE BALANCES WILL BE IN EXCESS OF IMMEDIATE TREASURY NEEDS, AND SINCE THE TREASURY'S TOTAL BALANCES WILL BE IN EXCESS OF BOTH IMMEDIATE AND CURRENTLY PROSPECTIVE NEEDS, IT WOULD SEEM DESIRABLE TO USE SOME OF THE BALANCES ACCUMULATED IN THE FEDERAL RESERVE BANKS TO RETIRE GOVERNMENT SECURITIES HELD BY THE RESERVE BANKS. TO FACILITATE THIS PROGRAM WE INTEND TO REDEEM OUR HOLDINGS OF CERTIFICATES MATURING MARCH 1 AND APRIL 1, 1949, AND WE SUGGEST THAT TREASURY BILL OFFERINGS CAN BE REDUCED IN THE AMOUNT OF \$600 MILLION, WHICH MIGHT BEST BE ACCOMPLISHED DURING THE LATTER PART OF MARCH AND THE EARLY PART OF APRIL, SO AS TO BRING THE TOTAL OF EACH OF THE WEEKLY OFFERINGS OF BILLS DOWN TO NO MORE THAN \$900 MILLION.

SUCH A PROGRAM WOULD SEEM TO BE IN ACCORD WITH THE NEEDS OF THE PRESENT SITUATION, WHEN EXISTING AND PROSPECTIVE INFLATIONARY PRESSURES ARE STILL STRONG, EVEN THOUGH THERE ARE MANY SIGNS THAT DEFLATIONARY FORCES ARE ACCUMULATING. OUR HOPE MUST BE TO MAINTAIN THIS BALANCE WHILE NECESSARY READJUSTMENTS IN VARIOUS PARTS OF OUR ECONOMY ARE WORKING THEMSELVES OUT. SIMILARLY, THE COMMITTEE DEEMS IT MOST IMPORTANT, FROM THE STANDPOINT OF CREDIT ADMINISTRATION AND DEBT MANAGEMENT, TO REINTRODUCE AN ELEMENT OF FLEXIBILITY INTO THE SHORT TERM RATE STRUCTURE. AS YOU KNOW, WE HAVE BEEN EXPERIMENTING WITH THE RATES ON OUR BIDS FOR, AND OUR PURCHASES AND SALES OF , TREASURY BILLS, IN LINE WITH THIS GENERAL OBJECTIVE, AND THIS WE PROPOSE TO CONTINUE.

THERE IS AN OBVIOUS LIMIT TO THIS PROCEDURE, HOWEVER, IN LIGHT OF THE CEILING FIXED ON BILL RATES BY THE LEVEL OF SUPPORT OF CURRENT CERTIFICATE RATES. IT SEEMS CLEAR TO THE COMMITTEE THAT THIS SITUATION SHOULD NOW BE IMPROVED BY A FURTHER INCREASE IN THE RATE ON ONE YEAR CERTIFICATES OF INDEBTEDNESS, WITH APPROPRIATE MARKET ADJUSTMENTS IN SHORT AND INTERMEDIATE TAXABLE TREASURY OBLIGATIONS.

THE CONSIDERATIONS WHICH BRING THE COMMITTEE TO THIS CONCLUSION ARE MAINLY THE FOLLOWING.

(1) AN INCREASE IN SHORT TERM RATES WOULD BE EVIDENCE OF CONTINUED FLEXIBILITY IN THAT AREA OF THE MARKET, AND OF AN INTENTION TO AVOID THE RETURN TO A FIXED OR FROZEN PATTERN OF RATES WHICH WOULD ENCOURAGE BANKS AND OTHERS TO RESUME "PLAYING THE RAXX PATTERN OF RATES". THERE HAS ALREADY BEEN SOME RESUMPTION OF THIS UNDESIRABLE PRACTICE, AND THERE ARE INCREASING SIGNS THAT BANKS WILL BE REACHING OUT FOR THE HIGHER YIELDS OBTAINABLE ON LONG TERM GOVERNMENT SECURITIES IF THE SPREAD BETWEEN SHORT AND LONG TERM RATES IS NOT FURTHER NARROWED. IF THIS TENDENCY IS ALLOWED TO PROCEED UNCHECKED, IT WILL ALMOST INEVITABLY RESULT IN AN INCREASE IN THE MONEY SUPPLY (AS BANKS BID BONDS AWAY FROM NONBANK INVESTORS) , AND SO LONG AS THERE IS DOUBT AS TO WHETHER INFLATIONARY OR DEFLATIONARY PRESSURES WILL ASSUME THE ASCENDENCY, A FURTHER INCREASE IN THE MONEY SUPPLY IS NOT WARRANTED OR DESIRABLE.

(2) SO LONG AS SUPPORT OF THE GOVERNMENT SECURITY MARKET BY THE FEDERAL RESERVE SYSTEM IS OR MAY BE NECESSARY, THE NARROWER THE SPREAD BETWEEN SHORT RATES AND LONG RATES, THE MORE TENABLE THE RATE STRUCTURE WILL BE. IN A SUPPORTED MARKET IN WHICH ALL GOVERNMENT SECURITIES MAY BE REGARDED AS DEMAND OBLIGATIONS, A HORIZONTAL RATE STRUCTURE IS THE NEAREST THING TO A "NATURAL" RATE STRUCTURE, NO ONE WANTS OR CONTEMPLATES SUCH A REVISION OF RATES, WHETHER ACCOMPLISHED BY BRINGING LONG RATES DOWN OR SHORT RATES UP, OR BOTH, BUT THE EXISTING SPREAD IN RATES IS NOT CONSISTENT WITH CONTINUED SUPPORT OF THE MARKET AND IT UNNECESSARILY COMPLICATES THE PROBLEMS OF THAT SUPPORT.

(3) THE INCREASES IN THE SHORT TERM RATE WHICH HAVE BEEN PERMITTED DURING THE PAST YEAR HAVE BEEN A SUBSTANTIAL AND IMPORTANT FACTOR IN THE ABILITY OF THE TREASURY STEADILY TO INCREASE THE AMOUNT OF SHORT TERM SECURITIES OUTSTANDING, AND THUS TO DO ITS NECESSARY REFUNDING AT SHORT TERM RATES. INCREASED RATES HAVE STIMULATED THE INTEREST OF THE BANKS AND OTHER INVESTORS IN THE SHORT TERM MARKET. FREEZING SHORT TERM RATES AT PRESENT LEVELS AND THUS FREEZING THE WHOLE STRUCTURE OF INTEREST RATES, HOWEVER, AND THE CONCURRENT REEMERGENCE OF "PLAYING THE PATTERN OF RATES" CAN BE HARMFUL IN THIS SITUATION. NOT ONLY WOULD IT REMOVE INTEREST IN AND BUYING FROM THE SHORT TERM MARKET; IT WOULD ALSO MAKE IT IMPOSSIBLE TO APPRAISE THE REAL CONDITION OF THE LONG TERM MARKET, AND THUS WOULD DELAY THE REALIZATION OF THE HOPE THAT EVENTUALLY

THAT MARKET WILL NOT NEED TO BE SUPPORTED.

(4) FROM ANOTHER STANDPOINT THE REQUIREMENTS OF DEBT MANAGEMENT, IN THE NEAR FUTURE, STRONGLY RECOMMEND A FURTHER READJUSTMENT IN THE INTEREST RATE STRUCTURE AT THIS TIME. THE ACCUMULATION OF MATURITIES DURING THE NEXT THREE YEARS, AND THE LIKELIHOOD THAT IT MAY NOT BE FEASIBLE FOR SOME TIME TO ISSUE ANY ~~XXX~~ SUBSTANTIAL AMOUNTS OF LONG TERM SECURITIES, MAKES IT DESIRABLE, IF NOT NECESSARY, TO CONSIDER FILLING IN MATURITIES IN THOSE YEARS DURING THE DECADE OF THE FIFTIES WHICH NOW ARE BARE OF MATURING OBLIGATIONS. CONTINUED REFUNDING OF ALL MATURING OBLIGATIONS INTO ONE YEAR MATURITIES WOULD BUILD UP WHAT WOULD PROBABLY BE AN UNWIELDLY ~~EXCESSIVE~~ VOLUME OF SUCH DEBT. THE FLOTATION OF NEW INTERMEDIATE SECURITIES WITH IN THE RANGE NOW OPEN, HOWEVER, WOULD SERIOUSLY LIMIT THE FEDERAL RESERVE SYSTEM'S FLEXIBILITY OF ACTION, AND GREATLY INCREASE ITS SUPPORT PROBLEMS, UNLESS A MORE TENABLE LEVEL OF SHORT TERM RATES HAS BEEN ACHIEVED BEFORE THE SECURITIES ARE PLACED ON THE MARKET. OTHERWISE, WE SHALL BE FURTHER FROZEN INTO THE PRESENT PATTERN OF RATES OR, IF RATES ARE SUBSEQUENTLY INCREASED, WE WOULD HAVE SOME SICK TREASURY ISSUES ON OUR HANDS.

(5) WE DO NOT NEED TO FEAR THAT A FURTHER INCREASE IN THE SHORT TERM RATE MIGHT ACCENTUATE THE DEFLATIONARY FORCES NOW PRESENT IN THE ECONOMY AND PRECIPITATE A DEPRESSION. THERE ARE STILL STRONG INFLATIONARY PRESSURES, AND CREDIT ~~IS~~ IS AND WOULD STILL BE READILY AVAILABLE - PERHAPS TOO READILY - FOR ALL REASONABLE PURPOSES; AND ITS COST WOULD STILL BE LOW EVEN AFTER A FURTHER MODEST INCREASE

IN SHORT TERM

RATES . FURTHERMORE, IF AND WHEN A REVERSAL OF PRESENT POLICY BECOMES NECESSARY, AN INCREASE IN RATES NOW MIGHT MAKE POSSIBLE A SIGNIFICANT AND HELPFUL DECREASE LATER; AND A DECREASE, OR THE PREVENTION OF A FURTHER INCREASE, IN THE MONEY SUPPLY NOW, MIGHT REDUCE THE DANGERS OF AN INCREASE LATER WHEN AN INCREASE MIGHT OTHERWISE BE DESIRABLE.

(6) THE COST OF SERVICING THE PUBLIC DEBT CAN CONTINUE TO BE HELD IN CHECK, IF A STRONG SHORT AND INTERMEDIATE TERM MARKET IS MAINTAINED, AND IF MATURING LONGER TERM HIGHER COUPON OBLIGATIONS ARE REFUNDED IN THIS AREA.

PERHAPS THIS CAN ALL BE SUMMED UP BY SAYING THAT THE COMMITTEE BELIEVES STRONGLY THAT FLEXIBILITY IN SHORT TERM RATES IS ESSENTIAL AT THIS TIME IF MONETARY POLICY IS TO BE EFFECTIVE, AND THAT IT ALSO SEEMS TO BE ESSENTIAL TO A CONTINUING SOUND PROGRAM OF DEBT MANAGEMENT.

THE COMMITTEE THEREFORE RECOMMENDS THAT THE ISSUE OF TREASURY CERTIFICATES OF INDEBTEDNESS MATURING ON MARCH 1, 1949 BE REFUNDED INTO A 1 3/8 PER CENT ONE YEAR CERTIFICATE OR, ALTERNATIVELY, THAT IT BE REFUNDED INTO A 13 MONTHS 1 3/8 PER CENT NOTE. IF THE LATTER COURSE IS TAKEN, IT WOULD BE FOLLOWED BY THE ISSUANCE OF A ONE YEAR 1 3/8 PER CENT CERTIFICATE TO REFUND THE ISSUE OF CERTIFICATES MATURING ON APRIL 1ST, THUS REPLACING ONE LARGE AND ONE RELATIVELY SMALL CERTIFICATE ISSUE WITH A ~~SIX~~ SINGLE ~~LARGE~~ LARGE ISSUE.

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WHETHER THIS TRANSITION TO A HIGHER RATE SHOULD BE ACCOMPLISHED BY OUR OPERATIONS IN THE MARKET OR BY YOUR ANNOUNCEMENT OF FORTHCOMING FINANCING WOULD NOT SEEM TO BE IMPORTANT SO LONG AS WE ARE IN AGREEMENT. IN PRESENT CIRCUMSTANCES, HOWEVER, IT MIGHT BEST BE ACCOMPLISHED BY YOUR ANNOUNCEMENT OF THE MARCH 1ST FINANCING, WHICH WE UNDERSTAND SHOULD BE MADE ABOUT THE MIDDLE OF FEBRUARY.

WE HOPE THAT YOU WILL FIND YOURSELF IN AGREEMENT WITH THESE VIEWS OF THE EXECUTIVE COMMITTEE OF THE FEDERAL OPEN MARKET COMMITTEE. UNQUOTE

SPROUL.