

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Return to
MR. THOMAS

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December 22, 1941

Board of Governors

Conference at Treasury,

L. M. Piser

December 18, 1941

STRICTLY CONFIDENTIAL

A meeting of representatives of the Federal Reserve System and of the Treasury was held in Mr. Bell's office on Thursday, December 18, 1941, at 10:30 AM. Those present were Mr. Eccles, Mr. Sproul, Mr. Ransom, Mr. McKee, Mr. Leach, Mr. Williams, and Mr. Piser from the Federal Reserve, and Mr. Morris, Mr. Haas, and Mr. Murphy from the Treasury. Mr. Bell was unable to be present.

Chairman Eccles opened the meeting by reporting for the benefit of the Treasury representatives developments at the recent meeting of the Federal Open Market Committee, including the authorities granted at that meeting and the approval of the transactions in support of the market. He then outlined the two alternatives, discussed at the meeting, for supporting the 1967-72s either at par or at a discount of some points. He stated that it was important to plan a long range program at the present time and to make any adjustment in rates that should be decided upon at the beginning of the war effort rather than either just before the next financing operation or after additional market issues had been floated at present rates. There was general agreement on this position.

Mr. Sproul then mentioned earlier discussions with the Treasury concerning the establishment of a pattern of rates and stated that it was agreed at the Open Market meeting that it would be desirable to establish such a pattern of rates in consultation with the Treasury, that such rates should be maintained during the emergency, and that the Treasury should not gear its financing to the day to day fluctuations in the market. There was general agreement on this position. He said that it was important that the war should not be financed on a continually increasing level of rates. In determining a pattern of rates, he expressed the opinion that four considerations should be taken into account: (1) that the basic rates should be near present levels, (2) that they should be fair to the Treasury as regards the cost of borrowing, (3) that they should be fair to the market in the sense of providing a living return to investors, and (4) that they should also be deemed fair by the market. He stated that it was his idea and that of the Open Market Committee that a 2 1/2 per cent rate represented the maximum that

NOTE: This memorandum attempts to report accurately the various points of view expressed at the conference, as I understood them. Governors Ransom and McKee have made certain corrections, but Chairman Eccles has been unable as yet to read the memorandum.

should be paid by the Treasury. He also thought that a satisfactory bill rate would be between $1/2$ and $3/4$ of 1 per cent and that the Treasury should issue \$200 million of bills weekly.

He expressed the opinion that 26-31 years was too long for a $2\ 1/2$ per cent bond, since it represented the record low level for Treasury long-term financing. He thought that the 1967-72s should be allowed to decline to about 98, which would mean that 20-25 year $2\ 1/2$ per cent bonds would sell at par and that 15-20 year bonds would sell at a premium of about $1\ 1/2$ points, which would be sufficient to float such an issue in the market. He did not believe that a discount of as much as 2 points would have serious effects on holders of the new bonds, and he thought that the market would consider some increase in rates after the outbreak of war as more fair to investors than maintenance of the pre-war level.

Mr. McKee pointed out that rates have already changed since the 1967-72s were floated and that on the present market a long $2\ 1/2$ per cent bond would have a maturity of 20-25 years. In favor of maintaining the 1967-72s at par and basing the pattern of rates on such a level, he stressed the adverse psychological effect on the public of having a long bond selling below par, since he felt that the public would interpret any continuing discount as an impairment of the Government's credit. He also mentioned the increased difficulty to the Treasury in handling a large debt, if no additional issues should be floated beyond the 15-20 year period. Mr. Piser mentioned the fact that the difference between the two levels involved a relatively small change in rates, that the effect on the public might be to interpret a discount on a long bond as an impairment of the Government's credit, and that the fact that the Treasury and the Federal Reserve supported the issue at par at one time and shortly thereafter reduced their support to a lower figure might raise doubts in the minds of investors as to the point at which the market would be stabilized and if they expected that point to be continually lowered they would be disinclined to invest their funds at the present time.

Mr. Ransom felt that it is impossible to have a free market in Government securities during a war period and that the Treasury had ample powers to maintain a reasonable level. He thought the Treasury and not the market should determine at what rate the war will be financed. If a pattern of rates and a long range program were not determined upon, he felt that it would be necessary for the Government to exercise complete control over the market, such as prohibiting trading below par, and that although this may ultimately be necessary it was important to defer such control as long as possible. He recognized that any pattern of rates and long range program that might be established at this time was subject to change at a later time if changing conditions should warrant it. He thought that the level at which the 1967-72s would be maintained was a question for the Treasury to decide, although his own preference was to support at par, since he felt that allowing the issue to decline to a discount would impair future Treasury financing.

Mr. Williams raised the question as to the amount of support that would be necessary to maintain either level and stated that he thought the policy of the Government during the war period should be to maintain easy money but on a smaller volume of excess reserves. Mr. Morris suggested that in other fields, such as savings deposits, when the public knows it can get the funds there is generally little demand for them. Mr. Leach thought it was up to the Treasury to decide the maturity that they wished to place on 2 1/2 per cent bonds. He felt, however, that the fact that the 1967-72s had been supported during the period between the offering and the issue date was not conclusive proof that the issue should be supported at the same level for the entire period of the emergency. His own preference was to allow the issue to decline to a discount, so that 20-25 year 2 1/2 per cent bonds would sell at about par. He thought that the level at which the Treasury and the Federal Reserve would make their stand should be made clear to the public.

Chairman Eccles raised the point that the trend of yields, which has been declining for a period of years, is now being reversed and that, in the future, market factors will call for some increase in yields. Market financing, which has been relatively simple on a declining yield basis, will become much more difficult when yields are increasing. He also pointed out that the establishment of a pattern of rates on market issues amounts in effect to a guarantee of a 2 1/2 per cent return on a demand liability, and in addition, if the 1967-72s should be maintained at par, a premium of 1 1/2 points would be guaranteed subscribers to a 20-25 year issue. He stated that if market financing is to be followed in the emergency period the market should be allowed perhaps as much as 4 or 5 points in which to fluctuate, and he felt that this could best be done by supporting the 1967-72s at some point below par. Mr. Ransom said that if the Federal Reserve should underwrite new issues at par it would be possible for the Treasury to price such new issues at close to par rather than at substantial premiums. Mr. Sproul thought that a moderate premium was desirable, since banks are rendering the Government many free services and since they perform a useful function in the secondary distribution of new issues.

Mr. Haas felt that it would be better to support the 1967-72s at par, since he did not think that the small difference in rates that was being discussed was of sufficient importance to offset the adverse psychological effect of having long bonds selling at a discount. He expressed the opinion that action should involve either a drastic change in rates or no change at all. Mr. Morris thought that the actual level of interest rates was not of great importance in getting investors to subscribe to new issues.

Chairman Eccles stated that he would favor holding the 1967-72s at par if the Treasury would avoid long-term market financing for a period and at the same time would offer on tap a non-negotiable 2 1/2 per cent bond of 15 or 20 years, redeemable only after one year on six-months' notice, and limited to \$1 million for each investor, at least at the start. Mr. McKee raised the point that on a tap issue it might be desirable to have the securities assignable in case of emergency, in the event of death, or for use

as collateral for borrowing. Mr. Haas said that in view of the large amount of funds that would have to be raised the main sources of investment in Government securities were individuals and commercial banks, since other funds were relatively small and would not increase at anywhere near a sufficient rate to meet the Government's needs. Since it was desirable to sell a minimum of securities to commercial banks, he thought that the Treasury's financing should be directed at the type of securities that would be most attractive to individuals. Mr. Sproul suggested that the Treasury's program should involve much more vigorous efforts to sell the Series E savings bonds, that Series F and G bonds might be discontinued, and that a new Series H might be offered without any demand liability involved.

Mr. Ransom then suggested that the Federal Reserve should hold the 1967-72s at par until a decision was made on the following points: whether or not a pattern of rates should be established, what that pattern of rates if established should be, whether the Treasury was to float tap issues or to confine the financing to market issues, and whether or not trading should be prohibited below par. He stated that it was highly important that these decisions be reached before the next financing. There was general agreement on this last position. Mr. Sproul stated that if the 1967-72s are held at par for any length of time the decision as to the level of the pattern of rates will be automatically made. He did not think that a decision had been made already, since the issue was held at par only during the underwriting period, which investors recognized as a usual method of underwriting.

Chairman Eccles suggested that the Treasury representatives tell the Secretary and Mr. Bell of the two points of view that were discussed. He suggested that the relation between the Federal Reserve and the Treasury should be one of allowing the Federal Reserve to present their point of view on such questions to Treasury representatives, that the decision was up to the Treasury, and that the Federal Reserve would abide by the Treasury's decision. Mr. Morris closed the meeting by stating that he thought that before any final decisions were made there should be a further conference between Treasury and Federal Reserve representatives.