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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

December 13, 1945

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

Dear Mr. Secretary:

You will recall our exchange of correspondence last summer with respect to the increase or elimination of the preferential discount rate of 1/2 per cent on member bank borrowings at the Federal Reserve Banks collateralized by Government securities due or callable within one year. At that time, action, upon which all of the Federal Reserve Banks and the Board of Governors were agreed, was deferred in deference to your wishes in a period when we were still at war and a large program of war financing still loomed ahead.

With the completion of the Victory Loan, and with Treasury needs for funds during the coming year or longer largely anticipated, it seems to me, and to the other members of the executive committee of the Federal Open Market Committee, that an especially favorable opportunity is provided to eliminate this preferential discount rate. The preferential rate was established as a war measure at a time when an increase in bank holdings of Government securities was necessary and some encouragement of bank borrowing to obtain reserves or to adjust reserve positions was desired. The establishment of the rate was a temporary measure designed to meet a special situation, and it was felt at the time that the rate should be eliminated when need for it had passed. This feeling has been strengthened by the increasing tendency of banks to purchase larger amounts of Government securities than are required to assure the success of Treasury financing and by the tendency of some banks to maintain larger holdings of Government securities than they could hold with their own funds by borrowing from the Federal Reserve Banks at the preferential rate.

Now that war financing has been completed and the Treasury will not need to raise new funds for a considerable period of time, the conditions that prompted the establishment of the preferential rate no longer exist, and the continuance of the rate can no longer be of service to the Treasury's financing program nor to the maintenance of credit policy. "The elimination of the rate need have no influence on the aggregate cost of future Treasury refunding, however, because that will be determined by Federal Reserve support of the Government security market through open market operations.

✓ The preferential rate not only has passed its period of usefulness, but is an element of weakness in our battle against inflation, because it serves as a continuous invitation to banks to bid away from nonbank investors the bank-eligible Government securities previously acquired by nonbank investors or purchased by them in war loan drives. The preferential rate encourages and makes it profitable for banks to borrow in order to

purchase Government securities. As a result it encourages the expansion of bank credit, particularly through purchases from nonbank investors of the longer-term, higher-rate obligations. I think that we are all agreed that a further expansion of bank credit is to be avoided at this time, if at all possible. Now, a step can be taken in this direction by the elimination of the preferential rate with little or no disturbance to the banking system, because member bank borrowings are small and their excess reserves are large. The reasons for abandonment of the rate seem compelling, since it is no longer required in the interest of war financing.')

I am writing you about this matter, for your information, because I am sure that all of the Federal Reserve Banks will soon be reconsidering the elimination of the preferential discount rate and that the Board of Governors will wish to approve such action.

Very truly yours,

(Signed) M. S. Eccles

M. S. Eccles, Chairman,
Federal Open Market Committee.