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THE SECRETARY OF THE TREASURY

WASHINGTON

December 29, 1945

Dear Mr. Eccles:

I have read with interest your letter of December 13, 1945, in which you state that the Federal Reserve Banks are considering eliminating the preferential discount rate of 1/2 percent on Government securities maturing or callable in one year or less, and that the Board of Governors may wish to approve such action.

Last July, when the Reserve Banks and the Board of Governors were contemplating the elimination of the preferential discount rate, I wrote to Acting Chairman Ransom and said in part:

> rates is a statutory prerogative of the Board of Governors and of the Federal Reserve Banks. We have both always recognized, however, that it is necessary, for the duration, to work as a single team in financing the war in the best possible manner. I am sure, therefore, that you will be willing to continue the present preferential discount rate and the present policy with respect to short-term rates as long as it is required in the interest of sound war finance."

Since that time the war has ended, and the Victory Loan campaign has been successfully concluded. It seems to me, however, that the continuation of the preferential rate is as important to the successful financing of the transition period, and to the maintenance of full production and full employment in the postwar period after the close of the transition as it was to the successful conclusion of war finance. I feel sure that upon considering the matter further you will agree with me.

The primary effect of eliminating the preferential discount rate would be to increase short-term rates of interest. This is the principal purpose attributed to it in the financial press, and, as you know, the rumor last July that the rate was to be eliminated or increased was immediately followed by a decline in the prices of Government securities of all maturities.

"It seems to me that a rise in short-term interest rates at the present time would be unfortunate. It would increase the already large interest charge on the public debt, and most of this increase would go to increase the already high earnings of banks in the principal financial centers, where short-term securities are largely held."

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Moreover, it is by no means certain that an increase in short-term rates would not spread to long-term ones. As I have already mentioned, the rumor last July that the preferential rate was about to be eliminated, or increased, resulted in a decline in the prices of Government securities of <u>all</u> maturities. Also, you will recall that the restrictive actions taken by the Federal Reserve authorities in 1937, although designed to increase short-term interest rates only, actually increased all rates. An increase in long-term interest rates, while it would be of no assistance in combating inflation during the transition period, would make it much more difficult for the economy to attain full production and full employment in the later postwar period after the present backlog of consumer demand and urgent investment projects has been worked off.

The statistics indicate that member banks have not abused the preferential rate by borrowing in order to carry Government securities bearing a higher rate. At the present time total member bank borrowings from the Federal Reserve Banks are equal to only about 1/2 of one percent of member bank holdings of Government securities. At no time during the war have they risen as high as 1-1/2 percent of these holdings. This is not surprising, since, as we both know, commercial banks in the United States have a strong and healthy tradition against borrowing from the central bank for the purpose of obtaining an interest differential.

For the reasons which I have just given, it is my sincere hope that the Reserve Banks and the Board of Governors will not see fit to eliminate the preferential discount rate at this time. I shall be glad to discuss the matter with you.

Sincerely yours,

(Signed) Fred M. Vinson

Honorable M. S. Eccles
Chairman, Board of Governors
of the Federal Reserve System
Washington 25, D. C.