C O P Y

CONFIDENTIAL

April 19, 1946.

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

Dear Fred:

My associates and I were surprised by your letter of March 28, not because we were in doubt as to your attitude concerning the elimination of the preferential discount rate, but because of the fundamental misconception of our views which your letter contains. We do not advocate a higher level of interest rates than the Government is now paying, because higher rates would increase the cost of servicing the public debt and increase the earnings of commercial banks growing out of their holdings of Government securities. We do not favor either result.

While we are reluctant to burden the record with further discussion of this matter, we think it important to emphasize that there is nothing in the record to justify the statement in your letter that the proposal to eliminate the preferential discount rate is "really part of a program to increase short-term interest rates." That is not the purpose. The purpose is to avoid giving further impetus to the inflationary forces which now exist in our economy, among which must be included the supply of money in the hands of the public, particularly in its most active form -- currency and bank deposits. We must refuse, therefore, to be ranged on the side of the advocates of a higher interest rate policy. That is not the question here and should not be permitted to confuse the real issue.

The question is simply whether we propose to perpetuate a wartime measure which no longer serves the purpose for which it was designed but, quite the contrary, tends to aggravate the inflationary pressures which the Government is properly trying to combat. We are at present flying a signal -- to borrow your metaphor -- which is the direct opposite of the declared policy of the Government. We are, in effect, inviting member banks to come to the Reserve Banks and borrow at a preferential rate on Government securities due or callable in not more than one year, thus encouraging these banks to purchase Government securities as well as to make loans to others for the purpose of purchasing Government securities. This process has made for speculative profits, but it could not reduce the cost of Government financing unless the intention is to countenance and then take advantage of a further lowering of the entire interest rate structure of the country. That, as we understand it, would be contrary to your policy. It would certainly be contrary, in our judgment, to the best interests of the country.

When the preferential rate was adopted in 1942, the Board felt, and so stated, that in ordinary circumstances such preferential rates should not be established. It was recognized, however, that the war financing program would require substantial purchases of Government securities by the banks and it was the belief of the Board that, if there were a preferential rate for advances secured by Government obligations, that fact would encourage member banks, particularly outside the financial centers, to invest more of their then existing excess reserves in short-term Government securities, and that the preferential rate could be eliminated when the need had passed. Today it serves a wholly undesirable purpose, namely, that of facilitating further menetization of the public debt through the commercial banking system. We think you are flying the right signal of discouraging further creation of bank credit, but we find ourselves signalizing through this special rate exactly the opposite course.

You express the opinion that the elimination of this rate would be interpreted by the market as a first move in the direction of higher short-term interest rates. You will agree, we feel sure, that the adoption of what is the right policy should not be avoided for fear it would not be correctly understood. The boat can be rocked in this critical transition period by failing to do things which ought to be done as well as by doing things which ought not to be done. The important point, however, is that we have assured you that we would maintain the market for the 7/8 per cent certificates of indebtedness so that there would be no question about refunding or refinancing at this rate. Accordingly, if the elimination of the preferential discount rate were misinterpreted, official action through open market operations would promptly disabuse the market of its mistaken interpretation.

We do not agree that the significance of the preferential rate at this time is almost entirely psychological. The figures on the amount of borrowing under the preferential rate can easily be misleading because bank reserves thus created provide the basis for an expansion in credit of approximately six times the amounts borrowed. Thus, borrowings of 300 to 700 million dollars in recent weeks have provided support for about six times as much additional bank credit, which is by no means insignificant. Moreover, banks are thus encouraged to lend to their customers at excessively low rates which, in turn, makes for speculation in and holding of Government securities on bank credit. For example, current figures for reporting member banks show loans of 1.6 billion dollars to dealers and loans of 1.9 billions to others for the purpose of purchasing or carrying Government securities, or a total of some 3.5 billion dollars. Such bank loans represent exactly as much monetization of the public debt as if the banks themselves purchased the Government securities directly. While you are rightly, we believe, utilizing Treasury balances to pay off Government debt, largely that held by the banks, the Reserve System by its preferential rate is inviting the banks to nullify the effect of your action by borrowing from the Reserve Banks for the purpose of purchasing or holding Government securities. Furthermore, to the extent that the interest rate structure is thus being depressed below the levels on which the Treasury's financing has been based since the beginning of the war, the inflationary consequences are real and plainly evident, particularly in the entire field of capital assets, that is, in real estate, including homes, farms and business properties, as well as in the stock market.

We wish to emphasize with all the force we can command that our purpose and policy are based not on a desire for a higher level of interest rates and hence increased costs of carrying the public debt, but entirely on grounds of discouraging further needless monetization of the debt through a wartime mechanism. Elimination of the rate, far from indicating that the Treasury and Federal Reserve were flying opposite signals, as you put it, would signify that we were in accord instead of working at cross-purposes as we appear to be doing now.

We do not believe that, when the question is reviewed in this light, the Treasury would wish to ask us to continue following a policy which is unquestionably inflationary and wholly at variance with the President's stabilization program. The Treasury, of course, is properly concerned with any measure that might affect the cost of Government financing. However, we have given assurance that we will not permit elimination of the preferential discount rate to increase the present certificate rate or other rates now paid by the Treasury. Having thus been assured that its interest in the matter will be fully protected, the Treasury, it seems to us, would not wish to be put in the position of objecting to the System's discharge, in accordance with its best judgment, of a statutory responsibility placed upon it by Congress.

The incorrect premise upon which your letter is based is illustrated by your statement that we made no case as to how increasing short-term interest rates would help in combating inflation. We made no such case, of course, because our argument was not based on an increase in short-term rates. The case we sought to make and thought we had demonstrated clearly was based on our earnest desire to stop further creation of inflationary bank credit, both directly and indirectly.

It should be borne in mind that our increasing production will generate an increasing income that will currently provide means of purchasing what is produced. If this newly created income has to compete not only with the existing excessive supply of liquid funds, but also with further increases in the money supply resulting from bank credit expansion, we can have a destructive inflation no matter what our production may achieve.

Finally, we believe that an impartial review of the recommendations made by the Board and Open Market Committee to the Treasury from the inception of the defense and war financing programs will demonstrate beyond any possible question that we have consistently advocated policies and measures for financing the war at low and stable rates of interest. The pattern of rates on market issues agreed upon by the Treasury and the Reserve System ranged from the 7/8 per cent rate on certificates to the 2-1/2 per cent rate on the longest term Treasury bonds. There was also the 3/8 rate on 3-month Treasury bills. The only official recommendations the System has made at any time for any higher rate related exclusively to the bill rate. It became evident early in the war that the banks were less and less interested in buying bills and increasingly disposed to buy the longer-term, higher-yield issues, with the result that they sold the bills to the Reserve System and concentrated more and more in the longer term securities, thus increasing the overall cost of Treasury financing. Our recommendations were made with the expectation that a somewhat improved bill rate would result in the banks holding more of the bills and hence fewer of the longer-term, higher-yield issues, thus reducing the overall cost of Treasury financing. Time has served to confirm the view that the banks would be increasingly uninterested in bills at the 3/8 rate, for at present the Federal Reserve System holds nearly all of the bills outstanding. To construe our suggestions on the bill rate as signifying a purpose on the part of the Federal Reserve authorities to increase the rate structure and the costs of carrying the dent is to misread completely the plain purpose of the proposals.

As for memoranda exchanged between our staff members and yours, such memoranda were not submitted as official Federal Reserve proposals and are not properly so regarded. They canvassed a variety of ideas and alternatives for dealing with the situation but recommended no particular line of action. They have no place whatever in a discussion of the Board's own views in connection with the preferential discount rate and were given to members of your staff with that understanding. Continuous study and consultation between our staffs, analyzing and exploring all relevant ideas, seems to us to be highly desirable, but such consultations and staff memoranda connected therewith should not be confused with official policy.

We are embarked on a joint enterprise. We are all seeking to solve the difficult postwar problems of fiscal policy, monetary policy and debt management in the public interest, and in no other. We know the course that has been set by the Government. We want to discharge our responsibilities effectively as part of the general program of the Government. We believe that the elimination of the preferential discount rate would be in accord with the request of the President in his recent Executive Order, when he said:

> "For the duration of the existing emergency all departments and agencies of the government shall, in any matter affecting the stabilization of the economy, in which they have discretion in the use of their powers, exercise such discretion in such manner as will best promote the continued stabilization of the economy."

Sincerely yours,

M. S. Eccles,
Chairman, Board of Governors.