

FLEXIBLE LONG-TERM INTEREST RATES AND DEBT MANAGEMENT

Is there any possibility of a quick resolution of the present differences of opinion between the Treasury and the Federal Reserve System which would both enable the Federal Reserve System to utilize the open-market techniques they favor during the next few months and, at the same time, avoid the adverse fiscal consequences of such operations?

The objection of the Treasury to the Federal Reserve proposals as they stand is that whereas they are avowedly directed at a short-term bank loan expansion problem, they would result in a substantial increase in the public debt service charge for the indefinite future.

The objection of the Federal Reserve to the Treasury's adamant stand in favor of the peg on the long-term government rate is that it makes it impossible for the Reserve System to do anything, under its present authority, to check bank loan expansion other than through selective credit controls.

In my opinion, both the Federal Reserve and the Treasury are on sound ground. The conflict could, however, be resolved if a way were found to enable the Federal Reserve to permit interest rate flexibility via open-market operations but at the same time to offset the fiscal consequences of higher yields on certain categories of government securities.

There is one line of approach which would, in theory at least, reconcile the two positions:

The Treasury could, for its part, agree to let the Federal Reserve go ahead and introduce sufficient flexibility into the long-term government securities rate to achieve the restrictions on bank loan expansion that the System thinks practicable over the next six months. The Federal and the Treasury would jointly request Congress to authorize the Reserve System to require commercial banks to establish special reserves of up to 50 percent against demand deposit liabilities.

The special reserves would be held in the form of special Treasury reserve certificates bearing interest at 1 1/2% and would always be redeemable at par on demand. The banks would be authorized initially to exchange any of their existing holdings of government securities at par or market, whichever is higher, for the Treasury reserve certificates.

The commercial banks would, no doubt, object violently to my proposal for the introduction of special reserve requirements, especially of this magnitude. If, however, the Federal Reserve System were to let the yield on long-term governments rise to 2 3/4% or higher during the first couple of months of its flexible rate operations and the market reached the conclusion that the future long-term government rate would be nearer 3 than 2 1/2%, the commercial banks might be much more favorably disposed to an exchange of a portion of their existing long-term government securities for Treasury Reserve certificates. Since the present long-term government holdings of the banking system have been acquired at prices above par, they might even prefer to hold guaranteed 1 1/2% Treasury reserve certificates redeemable on demand to a mixed portfolio of government securities purchased at various prices, with the earlier purchases quoted at market prices involving a contingent liability against capital and surplus. But in any event, the Treasury and Federal Reserve System, standing together, might be able to persuade the Congress and the public that a guaranteed 1 1/2% rate was a reasonable return to the banks on an absolutely riskless Government security.

If this type of special reserve requirement were adopted, the Treasury would be able to count on having upwards of 40 billion dollars of the public debt carried permanently by the banking system at 1 1/2%. This would be an offset against the higher rate on long-terms brought about by the Federal Reserve operations and also represent a permanent change in the composition of the Federal debt.