

A PROPOSAL

With a view to reconciling the debt management problem of the Treasury with the problem of controlling credit by the Federal Reserve, the Secretary of the Treasury authorizes the fiscal and technical staffs of his department to negotiate with the Federal Reserve on the following basis:

The purpose of this negotiation is to reduce to a minimum the creation of bank reserves through monetization of the public debt without creating a market psychology which would entail a lack of confidence in the stability of the Government securities market. More specifically, the purpose of the proposal is to relieve the Federal Reserve to the fullest extent practicable of the support of long-term Governments without compelling the Treasury to refinance maturing obligations during this calendar year, or to finance new fund requirements, on the basis of indeterminable rising interest rates. This can be accomplished within the framework of the 2-1/2% long-term interest rate pattern announced by the Secretary of the Treasury in his address before the New York Board of Trade on January 18.

The proposal involves 3 elements, (1) a new nonmarketable security to be issued in exchange for outstanding long-term 2-1/2% bonds of June and December, 1967-72, (2) refunding the \$40 billion of maturing securities between June 15 and December 15 of this year, and (3) the raising of new funds to finance the present emergency.

These elements, while interrelated, will be dealt with separately.

EXCHANGE OFFERING OF NONMARKETABLE 2-3/4% BOND FOR OUTSTANDING RESTRICTED TREASURY BONDS OF 1967-72.

In consideration of an agreement on the part of the Federal Reserve to maintain a stable securities market, as more specifically outlined

below, the Secretary of the Treasury would agree to issue a long-term 29-year 2-3/4% nonmarketable security, which would not be redeemable by the Treasury prior to maturity, but which would be exchangeable prior to maturity for 1-1/2% 5-year Treasury notes. The purpose of this offering would be (a) to retire a large segment of the marketable debt, which is now causing difficulties for the Federal Reserve, and (b) provide a degree of flexibility for holders of the new nonmarketable security by making them exchangeable for a 1-1/2% 5-year note that could be sold on the market in case cash funds are needed. At the same time it avoids an increase in the demand obligations of the Treasury.

One of the merits of the proposal is that it avoids a prejudging of the securities market. It is believed that this exchange privilege would give bouyancy to the restricted Treasury bonds of 1967-72, since the "rights" or exchange privilege would be attractive to long-term investors who are more interested in interest return than they are in speculative possibilities. Thus, there would be created a buyers' market for the restricted Treasury bonds of 1967-72, and to this extent should relieve the Federal Reserve of a great deal of pressure. Conceivably, if market confidence would be restored through an unequivocal joint announcement by the Treasury and Federal Reserve that an agreement had been reached, the present market support problem of the Federal Reserve might disappear.

It is realized, of course, that consideration would have to be given by the technical staffs of the Treasury and the Federal Reserve as to the effect of this action on other outstanding marketable securities in the intermediate and long-term area.

In order to provide for this proposal a fair and reasonable testing period, it would be necessary for the Federal Reserve to agree to support the securities affected at present market levels. In a spirit of cooperation the Federal Reserve and the Treasury should become partners in the support program under which each agency would take a pro rata share of any purchases that may be required; that is, the Federal Reserve Open Market Account would take a percentage of the purchases and the Treasury would take the balance for Government investment account. It has been suggested, for instance, that the first \$200 million purchased under the agreement would be shared equally by the Treasury and the Federal Reserve; that the Treasury and Federal Reserve would finance 75% and 25%, respectively, of the succeeding \$400 million; and that the Treasury would carry the full amount in excess of \$600 million. This would seem to be a reasonable basis of purchase during a testing period, but there is an inherent danger in the event of a "leak" that the Reserve is committed to a stated amount. While it is realized that the Federal Reserve might not be willing to accept an "open end" agreement, it must be recognized that public knowledge of a limitation would not encourage market confidence.

REFUNDING OF THE \$40 BILLION OF MATURING SECURITIES
BETWEEN JUNE 15 and DECEMBER 15 OF THIS YEAR

During the 6 months period, June 15 - December 15, the Treasury will be required to refund almost \$40 billions of maturing obligations, exclusive of Treasury bills. Success of this refunding demands confidence in the stability of the Government securities market. Therefore, it is imperative that the Treasury and the Federal Reserve reach an agreement on a monetary-debt policy for the balance of the calendar year, at least. Obviously, this program should not be encumbered with uncertainty, misunderstanding, and the prospect of rising interest rates. In return for an understanding that the Federal Reserve would maintain a stable price level during this period of financing so that the Treasury would not be required to finance on a rising interest rate, the Treasury would agree to a policy under which the Federal Reserve would allow the short-term securities market to adjust itself before June 15 around the 1-3/4% discount rate now prevailing. From the Treasury point of view it would be desirable to extend this period of stability for the duration of the emergency, but it is doubtful whether the Federal Reserve would be willing to commit itself that far ahead. On the other hand, if a closer working relationship could be established between the technical staffs of the Federal Reserve and the Treasury, it may be possible to suggest a program of monetary-debt management which might be acceptable to the policy-making officials.

THE RAISING OF NEW FUNDS TO FINANCE THE PRESENT EMERGENCY

On the basis of the President's ~~budget~~ estimates, and without making allowance for an increase from new taxes, it is estimated that new borrowings from this time to June 30, 1952 will amount to approximately \$23 billion, distributed as follows: May 1951 \$3.6 billion; July \$6.5 billion; October \$7.5 billion; April 1952 \$5.4 billion. These figures make allowance for attrition on debt refunding operations of \$3.6 billion, in addition to the cash deficit. The figures might be reduced by a revitalized savings bonds program and a revision of the yields on Treasury savings notes.

Conferences with the Federal Reserve on the technical level might be helpful in laying out a program of debt composition in order that the Reserve may consider itself a full partner with the Treasury in maintaining a market for the securities after they have been issued.

It is generally recognized that there are no substantial amounts of non-bank funds seeking investment at the present time. Some people seem to think that there will be funds seeking investment sometime this Fall after other sources of investment have declined. It would seem that there would be no need at this time to attempt to prejudice the market so far ahead or to assume that the 2-1/2% long-term rate mentioned in the January 18 address will not be appropriate. Therefore, if a joint announcement of the Treasury and the Federal Reserve should be agreed upon, with a view to reestablishing market confidence, reference might be made to the fact that the Series G bond or the Investment Series Bond issued in 1947 might be made available for

purchase by non-bank investors from time to time, the purpose of this reference being to indicate that there has not been abandonment of the policy statement in the January 18 address.

While the following might appear unduly optimistic, and would, of course, depend a great deal upon the effectiveness of selective controls and other factors affecting the availability of investments, there is a possibility that this program may be of assistance to the Federal Reserve in de-monetizing some of the public debt which it now holds, and may enable the Treasury to acquire new money by selling in the market some of the restricted 2-1/2% bonds of 1967-72 previously acquired for Government investment account.