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THE UNDERSECRETARY OF THE TREASURY

WASHINGTON

August 3, 1923.

My dear Governor:

I take it that there is no immediate occasion at this time to consider possible advances in the discount rates of the Federal Reserve Banks, but it is conceivable that some such occasion may arise in the not distant future, and I am therefore writing to suggest a method of approach to the problem which it seems to me has not been sufficiently considered in the past. I refer particularly to the possibility of establishing a different rate for discounts at the Federal Reserve Banks representing the ordinary line of credit loans to commercial banks, as distinguished from paper of prime liquidity which has at the same time a recognized open market, as, for example, bankers acceptances and short-time Treasury certificates of indebtedness. The Federal Reserve Banks now are proceeding generally on the basis of a uniform discount rate for all classes of paper, with a special buying rate for bankers acceptances. I take it that there is nothing sacred, however, in a uniform rate, and it is manifest that any uniform rate necessarily fails to take into account the differences existing between different classes of paper. The most fundamental difference, which is much better recognized in England and is coming to be recognized in this country, is that between paper which has a recognized status in the open market, like bankers acceptances and Treasury certificates, and paper like customers' loans at a bank which has no market status and cannot be readily tested by the open market.

There is a growing realization in the Federal Reserve System of the importance of the open market powers of the Federal Reserve Banks, and with that, it seems to me, there must come a better recognition of the fact that the way for the Federal Reserve Banks to bring their operations into relation with the general credit situation is through an open market policy divorced entirely from any question of making enough earnings to meet expenses and dividends, and based instead on the market's need for credit. There has already been much progress along this line. For some years past the Treasury has been engaged in developing an open market for Treasury certificates of indebtedness, and there is now, and for some time back has been, an active open market, reflecting accurately the investment values of Treasury certificates as liquid short-time securities and at the same time enabling the Treasury to adjust the terms of its successive offerings to meet actual market conditions. The Federal Reserve Banks at the same time have been engaged in an effort to establish a market for bankers acceptances and have achieved some success, though frequently the buying rate at the Federal Reserve Banks has been so low as to undersell the open market, leaving the Federal Reserve Banks practically the only market for acceptances. More could be accomplished if the buying rate for acceptances were kept up to the market, and I understand the Central Committee of Governors on open market operations has been giving some study to this side of the problem. At any rate, both the Treasury and the Federal Reserve Banks have had sufficient experience with Treasury certificates and bankers acceptances to know that an open market can be successfully developed for both classes of securities, and that if free of artificial influences this market will constantly reflect the true position of the securities and afford free play, through purchases and sales of certificates and acceptances, to changes in the credit situation.

The further development of the open market for certificates and acceptances offers, it seems to me, the best opportunity in the world for placing the Federal Reserve Banks in something of the same relation to the market here that the Bank of England holds to the bill market over there, leaving the Federal Reserve Banks to deal, like the Bank of England, with only the marginal demand for credit. The open market, in other words, would act as a kind of balance-wheel between the banks and the Federal Reserve Banks. Banks in the financial centers would hold in their portfolios reasonable amounts of liquid short-time securities, like Treasury certificates and bankers acceptances, and when in need of funds would sell certificates or acceptances to the market before having recourse to the Federal Reserve Banks. The market would normally absorb the certificates or acceptances thus sold, probably through sale to an investor or to another bank having an excess supply of funds, but in the event of a real lack of credit the market itself could apply to the Federal Reserve Bank, through a sale of certificates or acceptances to the Federal Reserve Bank under its open market powers. To some extent this is already what happens in the principal financial centers under the present system, but it breaks down in a situation where member banks, without having recourse to the market, can get funds from the Federal Reserve Banks onthe same terms by discounting with the Federal

Reserve Banks customers' notes and line of credit loans which have no standing in the open market. Under this system discounts of customers' notes are almost always made at a rate lower than the going rate for such paper, while sales of certificates or bills to the Federal Reserve Banks, which must be regarded for practical purposes as only another form of discount, will probably be made at about the open market rate, unless the Federal Reserve Banks themselves cut in under the open market by establishing artificially low buying rates for bills. There is no real recognition given to paper enjoying an open market, and what has been done in the name of encouraging the market for acceptances has frequently tended to destroy it.

The remedy, it seems to me, would be to establish the rate of discount on customers' notes and line of credit loans at a sufficient figure, say, 1 per cent higher than the rate on Treasury certificates and bankers acceptances, to match the going rate on commercial paper and give a differential in favor of paper which has independent standing in the open market. This would encourage the development of the open market and bring the banks more and more to resort to the open market for certificates and acceptances as a means of securing necessary funds or of employing funds temporarily idle. At the same time it would tend to give an outside check on the credit policies of the Federal Reserve Banks and through the inevitable relations that would arise between the banks and the market would keep the Federal Reserve Banks more on their mettle in the development of these policies.

The suggestion offers particularly interesting possibilities in case there should be a situation calling for an increase in discount rates, for it would make it possible to recognize, as the official Federal Reserve rate, the rate on acceptances and certificates of indebtedness, with the proviso that the rate of discount on customers' notes and line of credit loans would be, say, 1 per cent higher than the established rate. This would recognize the essential differences between the two classes of paper, would be a perfectly safe distinction in view of the liquidity of the paper and the independent open market which it would enjoy, and would make the Federal Reserve rate more nearly comparable than it has ever been before to the discount rate of the Bank of England. Incidentally, it would have the psychological advantage of leaving one official rate at the relatively lower figure, with a higher rate applicable to discounts of line of credit loans, which are handled ordinarily by banks in practically all sections of the country at a rate considerably higher than the open market rate on certificates and acceptances. The differential would thus accord with the facts. Even now, for example, with a $4\frac{1}{2}$ per cent discount rate, it is the general practice of banks to charge around $5\frac{1}{2}$ per cent to their customers, and in many cases much more than this, whether in the form of direct interest charges or through incidental charges in the form of commissions, fixed deposits, and the like.

A recognition of the differences between paper enjoying an independent open market, like certificates and bankers acceptances, and customers' paper or line of credit loans by banks, on the other hand, would give the Federal Reserve Banks much more effective control over the general credit situation, would put their rates into better relation with the going rates on the different classes of paper, and would enable them to exercise such control as might be necessary through increasing their rates without at the same time prejudicing the open market which has been built up for both certificates and acceptances. To put it another way, it gives the Federal Reserve Banks the opportunity to establish their rate at or above the market without discriminating against certificates and acceptances. The facts are that there are different rates for different kinds of paper, lower rates for acceptances and certificates and higher rates for commercial paper, and unless the Federal Reserve Banks are willing to recognize these facts it will always be impossible for them to get on top of the market without operating unfairly against certificates and acceptances. At the present time the Federal Reserve rate on line of credit loans is undoubtedly below the market and just as clearly above the market on certificates and acceptances. An increase to 5½ per cent, for example, would unfairly penalize certificates and acceptances and still not much more than meet the market on customers' notes and line of credit loans. Any increase in rates large enough to put the Federal Reserve rate on top of the market rate on customers' notes and line of credit loans would thus operate most unfairly against certificates and acceptances and seriously upset the market for these securities without giving Federal Reserve Banks much better control over the general situation. If, on the other hand, the differential is reocgnized and different rates established for the different classes of paper, it would be possible, by putting a higher discount rate on customers' notes and line of credit loans, to put Federal Reserve rates all around into effective relation with outside rates and thus accomplish what the Federal Reserve Banks have been hoping to accomplish ever since their original organization.

The differential between the two classes of paper would also have a direct bearing on our position in world trade and commerce, for it recognizes the popular character of short-time paper like acceptances and would make it possible to finance such paper at an appropriate rate, unprejudiced by the higher rate that might be applicable to ordinary commercial paper. This would enable our bankers and business men to compete on more nearly an equality with the other money markets of the world, and facilitate the development of our own market for bills.

Another thing to be said for the suggested differential in rates is that it would keep the Federal Reserve Banks on their mettle, and require them in all their operations to keep in the closest touch with the market. Both the Federal Reserve System and the Treasury would have to exercise the utmost care to watch any artificial influences operating in the market for certificates or acceptances, and to avoid at all costs any action on their own part that would tend to put either certificates or acceptances on a false basis of value. The market itself will give a constant check on these things if not subjected to artificial influences, and would be the best test of whether the rates were being intelligently administered by the Federal Reserve Banks.

All of these suggestions are, of course, more or less tentative and would have to be further developed, but I am offering them now in the light of the Treasury's experience in these matters with the thought that there may soon be a real opportunity to consider their application to the development of Federal Reserve policy. I hope the Federal Reserve Board will receive them on that basis, and give some consideration to their possibilities in advance of the time when action will have to be taken. The term "Treasury certificates of indebtedness", I should add, ought to be regarded throughout this letter as meaning strictly what it says, and not as including other Government securities like Liberty bonds or short-time Treasury notes. Generally speaking, it seems to me that Liberty bonds and Treasury notes, not being at all in the class of short-time Treasury certificates or bankers acceptances, and not having the same kind of a market, would have to fall into the general classification and not enjoy any different rate of discount than customers' notes and line of credit loans.

Sincerely yours,

(Signed) S. P. GILBERT, Jr.,
Under Secretary.

Hon. D. R. Crissinger,
Governor, Federal Reserve Board,
Washington, D.C.