11/16/55
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See Thomas (next item)

Relation of Free Reserves and Treasury Bill Rates (Thomas Memo of 11/3/55)

1. Some of the conclusions are obvious, some appear to be true, and some are questionable.

2. That bill yields tend to vary with free reserves, and that this is particularly so at times of an actively easy credit policy seems to me to be in accord with facts and logic.

3. The conclusion that when credit policy is restrictive, the discount rate appears to fix a ceiling for the bill rate, seems to me to be questionable. At present, when the banks hold relatively few bills, and therefore are not relying so largely ~~on~~ bills as a principal instrument of reserve adjustment, and when certain nonbank investors have special needs and a special desire for bills, the ceiling relationship of the discount rate to the bill rate is not so clear as the chart might indicate, Also, as the chart shows, the bill rate was above the discount rate for some time in 1953.

4. There is quite a leap from the chart readings to the suggestion that at times (such as the present) the discount rate is probably the significant element of restraint. This conclusion follows, it seems to me, only if restraint is defined wholly in terms of the bill rate, and if you reject the idea that a high level of member bank borrowing and the reluctance of banks to stay in debt to the Federal Reserve Banks, or their inability to do so, are important elements of credit restraint. And even then, unless open market policy maintains the situation in which banks are forced to sell securities or borrow, or is expected to maintain it, the discount rate is not so likely to be the significant element of restraint.

it can be shown that in circumstances such as the present

5. In other words, I don't believe ~~that~~ a higher discount rate accompanied by higher bill yields is the most effective way of increasing restraint, without reference to open market operations. In the present situation, I think we can achieve some further restraint by increasing the discount rate, primarily because it will dispel whatever remains of the idea that we were about to relax all measures of credit restraint. If, later, we want to achieve further restraint, however, it may be more effective to push borrowing up by open market operations, leaving the discount rate alone for a time.

CONFIDENTIAL (FR)

November 3, 1955.

To: The Federal Open Market Committee

From: Woodlief Thomas

W.T.

Subject: Relation of Free Reserves and Treasury Bill Rates.

The attached chart shows fluctuations in weekly averages of net free reserves and of the margin between the discount rate and Treasury bill yields. It should be noted that, in order to show a positive relationship with the curve for free reserves, the curve showing the interest rate spread moves in opposite directions from the general trend of interest rates since it rises when Treasury bill yields decline relative to the discount rate and falls when Treasury bill yields rise relative to the discount rate.

The following relationships seem to be shown by the chart:

1. When free reserves are positive, the bill rate is generally below the discount rate, i.e., the spread curve is above zero, and when free reserves are negative the bill rate tends to be close to the discount rate.

2. Short-term variations in the two curves tend to move in the same direction.

3. When free reserves are positive, the broad movements in free reserves and bill yields tend to be fairly close.

4. When free reserves are negative, although there continues to be some similarity in short-term variations of the two curves, Treasury bill yields tend to remain fairly close to the discount rate, i.e., the spread curve does not decline below zero as net borrowed reserves increase.

From these relationships, it would appear that bill yields tend to vary with variations in free reserves, particularly when borrowings are less than excess reserves. When borrowings exceed excess reserves, however, the discount rate seems to set an upper limit on the rise in the bill rate regardless of the volume of net borrowed reserves. This indicates that when the bill rate is close to or above the discount rate, banks prefer to borrow rather than sell bills. It also means that in such a situation, the level of bill rates is influenced more by the level of the discount rate than by the level of the net borrowed reserves. Thus at such a time, of which the present situation is an example, the discount rate is probably the significant element of restraint.

profit?

MEMBER BANK FREE RESERVES AND DISCOUNT RATE LESS TREASURY BILL YIELDS