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To: The Federal Open Market Committee

Subject: Relation of  
Free Reserves and  
Treasury Bill Rates.

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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.

# MEMBER BANK FREE RESERVES AND DISCOUNT RATE LESS TREASURY BILL YIELDS

