

CONFIDENTIAL (F.R.)

February 5, 1960.

To: Federal Open Market Committee Subject: Revision in statement of
From: Messrs. Thomas, Rouse, and Young operating policies.

At the Federal Open Market Committee meeting on January 12, 1960 Chairman Martin noted that, at the organization meeting on March 1, the Committee will be reviewing its continuing operating policies. He also noted that the 2-1/2 per cent bonds of 1961, of which \$11 billion are outstanding, will pose a serious refunding problem at maturity for the then Secretary of the Treasury, and he mentioned the possibility that the System Account might be willing to undertake transactions in these securities in a manner that might help to alleviate the problem for the Treasury--if this is possible without compromising primary monetary objectives. Such action might also tend to blunt attacks on the alleged "inflexibility" of the Committee's operating policies. The Chairman then proposed that Messrs. Thomas, Young, and Rouse constitute a staff committee to review existing open market operating policies, and to prepare suggestions for discussion by the Open Market Committee in advance of the March 1 meeting.

In accordance with this frame of reference, the staff committee has developed for Committee consideration a revised version of the statement on open market operating policies, which is attached. As will be seen, the revision is generally consistent with the statement of operating policies, but endeavors to provide additional flexibility for meeting operating problems in the market.

The staff committee feels that a principal merit of the revised draft is that it reflects, and if unanimously adopted it would

emphasize, the large area of agreement that actually exists within the Open Market Committee with respect to operating procedures. The existing statement, by eliciting dissent, has the effect of emphasizing and riveting attention upon the limited area of disagreement that exists with respect to these procedures, with the consequence that this area of disagreement is magnified and otherwise distorted by critics of the Committee and its credit policies, without giving adequate recognition to the broad area of agreement. Adoption of a change which might find unanimous agreement would have great value from the standpoint of public understanding and acceptance of the Committee's position.

A further advantage of the revised version is implicit in the final clause appearing in the draft of paragraphs (b) and (c) of the operating policies, and in the corollary deletion of all reference to "disorderly conditions". Under the present statement of operating procedures, correction of disorderly markets is specifically set forth as an exception; the Manager must go to the Committee for specific authority to act for this purpose. There is a possibility, however, that under the present wording the Committee in authorizing action to correct a disorderly market will more or less automatically suspend all its rules even though this should later prove to have been unnecessary or undesirable. Under the proposed change, should disorderly conditions develop the Manager of the Account would seek authority from the Committee for an exception to one or more of the procedures enumerated under (b) and (c); and the Committee would consider which, if any, of its procedures it may be desirable to modify or suspend to deal with the particular situation.

The staff committee was specifically asked to consider the advisability of making Open Market Account purchases in the 2-1/2 per cent bond of 1961 as a means of helping the Treasury minimize its future refunding difficulties. The meaning of the revised statement and the manner in which it might be applied can be illustrated by this example.

When the 2-1/2 per cent bond of 1961 becomes a short-term security, it will at that point, under both existing and proposed policy procedures, be eligible for purchase and sale by the Open Market Account Manager in the normal exercise of open market operations. This action could be taken without any special authorization by the Open Market Committee, except perhaps a more precise definition of "short term". At some point in 1961, however, the November bond will become a "right" and at that time will no longer be eligible for purchase under the operating rules. Technically an issue becomes a "right" when the Treasury announces an exchange offering to holders of the issue, but the Committee might wish to designate an earlier cut-off point for operations in the issue.

During the remaining period before it became a "right", the November 1961 bond could be purchased or sold--like any other short-term security--at times when additional reserves are to be supplied or absorbed to achieve open market objectives and when transactions in that bond are appropriate to the portfolio needs of the Open Market Account. On such occasions the Manager would presumably call for offers or bids, as the case may be, from dealers over a wide range of the short-maturity list and would accept offers or bids on a best price basis. Since

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Treasury bills provide a vehicle for releasing or absorbing reserves with a minimum of market impact, however, most System transactions would continue to be carried out in bills. In fact, in order to keep the System portfolio sufficiently liquid to offset the large seasonal return flow of reserves in the early part of each year, it would be necessary to maintain a proper balance in the portfolio between bills and other short-term securities. For these reasons the volume of 2-1/2 per cent bonds that would be acquired on a normal operating basis in the period ahead is probably quite limited and might not be of measureable assistance to the Treasury.

To provide a more significant degree of assistance to the Treasury it would be necessary for the Account Manager to buy the 2-1/2s in quantities beyond those required for the release of reserves and to counterbalance these purchases at least in part by sales of other System holdings at the time of the purchase transaction, or shortly thereafter. Such transactions, which could be effectively undertaken only if the market would respond with acceptable bids and offers, would be an exception to the normal operating prohibition on swaps, and to engage in them would therefore require specific authorization from the Committee.

PROPOSED REVISED STATEMENT OF CONTINUING OPERATING POLICIES
OF THE FEDERAL OPEN MARKET COMMITTEE

a. It is not the policy of the Committee to support any pattern of prices and yields in the Government securities market, and operations in the Government securities market are primarily to effectuate the objectives of monetary and credit policy.

b. Open Market operations shall be conducted in short-term securities (principally but not exclusively Treasury bills), and during a period of Treasury financing there shall be no purchases, other than repurchase agreements, of (1) maturing issues for which an exchange is being offered, (2) when-issued securities, or (3) outstanding issues of comparable maturities to those being offered for exchange; exceptions to these general operating policies may be made at any time upon express authority of the Federal Open Market Committee.

c. Transactions for the System Account in the open market shall be entered into primarily for the purpose of providing or absorbing reserves, and shall not include offsetting purchases and sales of securities for the purpose of altering the maturity pattern of the System's portfolio; exceptions to these general operating policies may be made at any time upon express authority of the Federal Open Market Committee.

PRESENT STATEMENT OF CONTINUING OPERATING POLICIES
OF THE FEDERAL OPEN MARKET COMMITTEE

a. It is not now the policy of the Committee to support any pattern of prices and yields in the Government securities market, and intervention in the Government securities market is solely to effectuate the objectives of monetary and credit policy (including correction of disorderly markets).

b. Operations for the System Account in the open market, other than repurchase agreements, shall be confined to short-term securities (except in the correction of disorderly markets), and during a period of Treasury financing there shall be no purchases of (1) maturing issues for which an exchange is being offered, (2) when-issued securities, or (3) outstanding issues of comparable maturities to those being offered for exchange; these policies to be followed until such time as they may be superseded or modified by further action of the Federal Open Market Committee.

c. Transactions for the System Account in the open market shall be entered into solely for the purpose of providing or absorbing reserves (except in the correction of disorderly markets), and shall not include offsetting purchases and sales of securities for the purpose of altering the maturity pattern of the System's portfolio; such policy to be followed until such time as it may be superseded or modified by further action of the Federal Open Market Committee.