BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

March 18, 1960

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Young

There is enclosed a copy of a memorandum dated March 18, 1960 from Messrs. Rouse, Thomas, and Young with respect to System help in Treasury refinancings.

Ralph A. Young

Ralph A. Young, Secretary,
Federal Open Market Committee.

Enclosure

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TO: Federal Open Market Committee

FROM: Messrs. Rouse*, Thomas, and Young

SUBJECT: System help in Treasury refinancings

Suggestion has been advanced that the System Open Market Account function to help the Treasury minimize its refinancing difficulties when such transactions do not interfere with Federal Reserve credit and monetary policy objectives. Specifically, the suggestion is that the Federal Open Market Committee cooperate in smoothing the refinancing of one-year Treasury bills and November 1961 bonds by acquiring blocks of these issues prior to maturity and then rolling them over at the time of refinancing.

The one-year bill proposal has been advanced on two levels, one focuses on the immediate problem of acquiring maturing one-year bills for rollover in the April auction, the other would provide continuing assistance in succeeding auctions until the new one-year bill instrument can be accorded a full test of market receptivity. The proposal for buying November 1961 bonds envisages a straight rollover of such acquisitions at refunding similar to the exchange of System holdings in refundings of other maturing Treasury securities. Because of differences between these various proposals, it is useful to consider their specific features separately.

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* While Mr. Rouse participated in the initial discussions pertaining to the preparation of this memorandum, he was not available to review it in final draft. The memorandum was reviewed by Mr. Rouse's staff associates, however, and has had their concurrence.

Refinancing of One-year Bills

The general case for System aid. The one-year bill is a new instrument, designed to help restructure a cluttered market for short-term obligations and to extend the auction technique to a broader range of issues. When first offered, these longer bills were sold for cash with the benefit of tax and loan account underwriting. Subsequent roll-overs, however, must be accomplished--as was the case with January 1960 bills--without benefit of the tax and loan device.

In these subsequent auctions, it cannot be assumed that all holders of maturing one-year bills will automatically replace their holdings in kind; an uncertain number of them will have acquired the maturing issue as a liquidity instrument and will want cash. For some period, therefore, while the one-year bills are still a new type of security, there will be a risk that the Treasury will be obliged to pay a high stop-out rate in the auctions in order to obtain full market under-writing of issues as large as $2 billion. This risk of a long tail in the auction is enhanced by the fact that all of the one-year bill roll-overs in 1960 will be immediately preceded by a cash financing and followed shortly by large refundings. A high marginal rate in any of these bill auctions would be of particular concern to the Treasury since it could adversely affect the pricing of whatever one-year exchange offerings are made in the subsequent refundings. If the System Account, as well as Treasury investment accounts, held significant blocks of maturing one-year bills, roll over of their holdings at the time of refinancing would reduce the risk of a wide spread between the auction average and stop-out rates.

The April bill operation. In the short-term area of the Government securities market, the general strength that developed at the turn of the year has persisted into the March period--normally a period of seasonal weakness. Accordingly, the need for System aid in the April one-year bill rollover seems to have become less pressing. In these circumstances, question arises as to whether the Treasury is not already in a good position to conduct this operation successfully.

Currently the Open Market Account owns nearly $100 million April 1960 bills, and Treasury investment accounts hold just under $50 million. In recent weeks the Treasury has sought to add gradually to its investment account holdings, but has found it difficult to do so because of an active market interest in Treasury bills--especially interest in April maturities by investors preparing for the Cook County, Illinois, April 1 property tax date. Similarly, although the System Account in its own recent open market operations has been prepared to buy April bills along with other bills when offered at reasonable prices, offers have been small and infrequent. After April 1, this dearth of supply may, of course, be reversed.

Should the Treasury be successful in adding further to its investment account holdings of the one-year April bills, combined tenders by the New York Trading Desk for System and agency accounts in the roll-over auction could well total as much as $300 million even without any special program of System aid. These tenders would include the $100 million already held by the System account plus any foreign buy-orders then available, as well as the Treasury tenders, and could provide significant support to the auction by reducing the volume of the bill available to other investors.

Despite the present favorable outlook for the April bill auction, the experience of recent years suggests that it is too early to become complacent, for conditions in short-term securities markets are capable of sudden reversals. If, in view of this fact, it were decided that some further System acquisitions of one-year bills were desirable to provide a protective safeguard for the Treasury against a possible market reversal in April, there might well be a favorable opportunity to effect at least a modest volume of such buying after April 1. The present outlook for reserve needs between now and mid-April indicates that some net buying of securities for regular open market purposes will be needed in the second week of April to help supply reserves to meet the increase in required reserves associated with the Treasury cash financing.

Other alternatives open to the Treasury in April. If no special System aid were provided to the Treasury to meet the April bill problem, the Treasury possesses two techniques of its own which might be applied to limit the length of the tail in the auction. One option is to proceed as in the January rollover by anticipating an underbid in the auction and borrowing in advance an amount sufficient to retire the unwanted margin of the maturing issue. Since the Treasury is already planning a cash borrowing in early April, it has merely to raise somewhat the amount of this borrowing. The outlook at present is for a smaller cash need than was previously anticipated so that a borrowing consistent with earlier projections might be enough.

This first option may not be a desirable solution for the Treasury, since it involves a cutback in the size of the auction before the true state of the market is clear, and in the last analysis the receptivity of the market to a one-year bill as large as $2 billion can be tested only by attempting a full scale rollover. Given the recent favorable trend of bill rates, the April bill auction may be a propitious time to make such a test.

A second option is to attempt to roll over the full $2 billion of maturing April bills on the assumption that recent interest rate trends indicate a good market interest in bills of all kinds, but to allot a smaller amount should the stop-out rate prove to be excessive. The Treasury would, of course, move to cut off the auction tail in this way only if the stop-out rate proved to be wholly unreasonable, for such action could very well have undesirable repercussions on investor bidding in subsequent auctions. A modification of this approach which would avoid the undesirable influence on investor attitudes of a surprise, retroactive cutoff of the tail would be to announce in advance that no bids would be allotted above some maximum rate. Either of these techniques, particularly the latter, might require some supplementary cash borrowing via shorter term bills if the resulting dollar drain were large.

<u>Operations in one-year bills after April</u>. In its broader context the proposal for System assistance in quarterly bill rollovers contemplates continuing Federal Reserve underwriting aid for one-year bills until this instrument has been accorded a full test of market receptivity. Such a program would involve resale to the market of new bills obtained from the roll over of pre-auction purchases, accompanied by purchases of the next maturing one-year issue. These latter acquisitions in turn would be rolled over at auction and resold to the market, and so on for succeeding one-year bill issues.

Strict adherence to a program of this kind would probably involve swap transactions into and out of the one-year issues, since outright System open market operations to offset seasonal reserve movements would be unlikely to dovetail precisely with needs for buying and selling one-year bills, except in the case of the January maturity.

On the other hand, in the period ahead it is conceivable that the System Account management will find it desirable to hold a significant volume of one-year bills on a continuing basis as a regular part of the System bill portfolio. Holdings of such issues may be acquired from time to time in the course of normal open market operations. Since the Account management normally finds it most convenient for reserve absorption purposes to sell relatively short-term bills or to run off maturing issues in bill auctions, acquisitions of one-year bills are more likely to be held in the System Account over time than are those of shorter maturity. Thus, in any particular one-year bill auction the System would tend to hold some one-year bills which could be used to provide underwriting assistance to the Treasury.

The System tender in such auctions would depend upon reserve needs and market conditions at the time. If there were no desire to absorb reserves, the Account management would bid to roll over as it does in regular bill auctions. For auctions in which a run off of the one-year issue would fit reserve objectives, the management could effect such a run off in cases where market conditions raised no questions about the success of the auction. If market conditions indicated the possibility of a long tail in the auction, however, the System could place its tender on holdings of the maturing bill at a back-stop bid, moderately above the expected average rate (i.e., moderately below the expected average price) of the auction. Should interest in the auction prove in fact to be weak, this bid would be accepted and would provide underwriting support for the new issue. In these circumstances, the Account management, to fulfill its reserve objectives, would, of course, have to undertake sales of other bills. If, on the other hand, the Federal Reserve back-stop rate was not reached by the tail of accepted bids, System holdings would be automatically run off and reserve objectives would be realized. In this case, the market would in effect be underwriting the new issue on its own.

Refinancing of November 1961 Bonds

The 2-1/2 per cent bond of November 1961 is the largest of all marketable Treasury obligations outstanding and is almost entirely held by the public, particularly by commercial banks. In looking ahead, the refunding of this issue presents important problems by virtue of its sheer magnitude and the resulting distorting effect that its size has on the over-all debt structure.

Market disturbances that might arise from the unwieldy size of the November 1961 refunding are of concern not only to the Treasury, with its debt management responsibilities, but also to the Federal Reserve because of its continuing interest, for monetary purposes, in a smoothly functioning Government securities market. Federal Reserve acquisition and roll over of a block of November 1961 bonds would, therefore, provide a positive assist to monetary policy as well as to debt management by reducing, at least in a limited way, the excessive concentration of public holdings in a single debt maturity. The Treasury on its own may not be able in the period remaining to maturity to take action to improve the distribution of market holdings of this issue.

The November bond operation, as proposed, does not contemplate any definite program for subsequent System liquidation of the new issues obtained from exchanges in the refunding. New issues thus acquired would be treated the same as those obtained in other Treasury refundings under current System Account operating procedures. The securities obtained could be held in the Account and exchanged at maturity as in the past, or some could be sold if such sales became appropriate.

The only feasible debt management alternative available to the Treasury for cutting back the size of the November bond prior to maturity on its own is to attempt an advance refunding. If such an operation could be successfully accomplished, it would be far more effective in solving the Treasury's problem than the relatively modest amount of assistance that can be rendered by the System without interfering with monetary policy.

Unfortunately, despite the recent marked decline in yields on Treasury notes and bonds, new issue options that could be offered to holders of the November bond within the limits of the present statutory rate ceiling would probably not be sufficiently attractive to encourage a satisfactory exchange at this time. Opportunity for an advance refunding of the November 2-1/2's thus awaits either a further decline in market yields or a change in statutory rate restrictions.

A further difficulty which complicates the prospect of a successful advance refunding in November 2-1/2's is the fact that many current holders are interested in the issue as a liquidity instrument. More than 60 per cent of current holdings are in commercial banks, for example, and some of these have been used for reserve adjustment purposes. In concept, the idea of an advance refunding is to encourage bona fide long-term holders of an outstanding Treasury bond to refund into a new long-term issue (or issues) before the debt shortening effect of the passage of time leads them to transfer their holdings to others whose investment interest is essentially short term. Clearly, it is too late to effect an advance exchange of this type in the November 1961 2-1/2's. For this reason any attempt to advance refund the bond at this late date could probably be accomplished only after market churning similar to that which would be involved in any regular refunding of a maturing issue into a longer term bond. On the other hand, if at any time between now and the fall of 1961 banks are encouraged, by a further decline in interest rates and an easing of reserve pressures, to lengthen their investment portfolios, an advance refunding of the 2-1/2's into a medium-term bond might become relatively easy.

Technique for Providing System Aid

Outright versus swap transactions: System aid to Treasury refinancings could be provided either on regular operations, designed to provide reserves for credit and monetary objectives, or on swaps (concurrent purchases and sales) against other issues held in the System Account portfolio. Due to the practical requirements of portfolio management, however--particularly the need to maintain sufficient portfolio liquidity at all times to allow ready absorption of bank reserves--any significant aid program, especially in November bonds, would probably have to rely heavily on swaps. Too heavy a reliance on outright acquisitions in regular open market operations would reduce the amount of short-term bills that otherwise would be obtained, or necessitate offsetting sales and purchases to acquire such bills. Outright acquisitions would thus run the risk of unbalancing further the already unsatisfactory maturity composition of the portfolio as regards short-term bills.

Passive versus active System aid: If the Federal Open Market Committee were to undertake a program of aid to the Treasury in one-year bills and November bonds, the nature of the operating techniques employed by the Account management in its approach to the market would become of prime importance. As a general guide line, the Account Manager would be expected to take action only to the extent that it did not interfere with other monetary policy objectives. Where acquisitions or sales (of one-year bills in a post-auction period) were made on an outright basis as a part of regular open market operations, this general guide line could be adhered to relatively easily by treating one-year bills and November bonds the same as other issues. In other words, dealer bids or offers in these particular issues could be considered along with bids and offers in other short-term securities of adjacent maturity, and accepted or rejected on a best price basis as is now done in a regular Treasury bill go-around.

In the case of swaps, operations strictly consistent with monetary objectives could be assured by following a relatively passive approach to the market. Under this approach, the Account management might respond to dealer bids or offers in the issues to be aided only when quotations on such issues were out of line with adjacent maturities and corrective or counteracting bids and offers were lacking. Without risk of exerting an active influence on prices, the management could at times also take advantage of large offerings coming into the market at going prices. In effect, under the passive approach the Account's role would be largely that of remedying arbitrage deficiencies in the market when such remedy was consistent with the System's program. Adherence to such a procedure would mean that System acquisitions would be uncertain as to amount and timing, and could be accomplished only gradually. Similarly, no definite commitments to the Treasury on the quantity or timing of purchases would be possible, and the net rise of System holdings in the issues in question would be likely to remain fairly modest.

If the resulting size of System aid to the Treasury under a passive approach seemed too limited, the Open Market Committee might authorize the Account Manager to adopt a more active approach to swaps. At the extreme, the active approach could set a target goal of some amount of an issue to be purchased or sold over a period of time and then bid or offer actively in the market to reach this goal, forcing prices and yields to the levels needed to achieve the objective. Clearly, this extreme approach would inject the Account management into a much more active market role than it has played for a number of years, with consequent impact on the structure of market prices and yields. Between the fully passive and highly active approaches to System aid there is, of course, a range of other alternatives. Departure from the passive approach, adopted to enhance the weight of System assistance to the Treasury, would, however, tend to complicate the problem of setting guide lines for the Account Manager on swap transactions and might increase the risk of compromising other monetary and credit objectives.

Moreover, any movement toward concentration of System operations in particular issues--with offsetting operations in other issues--runs the risk of disturbing the free functioning of the market. As market participants become aware of the nature of such operations--and they no doubt would--they might become more hesitant to take positions.

Relation of an Aid Program to System Operating Procedures

Because any System program undertaken to aid Treasury financings would have to rely heavily on portfolio swaps if it were to provide any substantial assistance, such a program would immediately run afoul of clause (c) of the System's continuing operating procedures which prohibits swaps. Likewise, a program to acquire the November 1961 bond would fall outside clause (b), which restricts open market operations to short-term securities, unless the phrase "short-term" were defined to include maturities up to twenty months; and to avoid conflict with the prohibition against System operations in "rights," it might be necessary to designate some cut-off date in 1961 beyond which no further acquisitions of the bond could be made.

Both of these procedural conflicts could be resolved, however, without necessitating any redrafting of the operating procedures, and in a way that would still permit authorization of a program to aid Treasury financing. This could be done by authorizing whatever program or programs were decided upon as special exceptions to the operating procedures.

Operating directive. In authorizing a program to acquire either one-year bills or November 1961 bonds the Open Market Committee would clearly have to give the Account Manager discretion with regard to timing and pricing of the actual transactions effected. This discretion would have to be exercised within stated guide lines, of course--possibly a spelling out of the general criteria of a passive approach like the one described above. Also, full Committee oversight and control could be retained as the program progressed, if the Manager were directed to execute transactions--at his discretion--only up to some stated maximum over the three-week period between meetings. The size of this maximum could be varied from meeting to meeting, and the whole program could be revised or discarded at any time depending on the way in which it appeared to be working out in practice.

Committee Conclusions

In this memorandum the staff committee has attempted to summarize the principal aspect of the proposals for System aid in the refinancing of one-year Treasury bills and November 1961 bonds and to highlight the main technical and procedural issues that are involved in these proposals. The committee presents no detailed recommendations for System action on these proposals but suggests the following points for Open Market Committee consideration:

(1) The need for special System aid in the April 1960 bill rollover does not at this point appear to be pressing, particularly so because some underwriting help could be effected with present System and Treasury account holdings, as well as from anticipated foreign orders. Also, any further acquisition of appreciable amounts of the April bill in the short period ahead could result in undue distortion of the rate structure and be upsetting to the market. There is a chance, however, that market conditions will change with the approach of the early April Treasury cash financing and the reversal of the Cook County property tax situation. The Account Manager might, therefore, be directed to give special consideration to the acquisition of April bills on regular open market

operations between now and April 12 (the probable auction date), and if judged necessary, he might also be directed (under special exception to clause (c) of the operating procedures) to acquire additional April bills on swaps, so long as total acquisitions on both an outright and a swap basis between now and April 12 did not exceed some moderate amount, say $150 million.

(2) If a decision is made not to authorize System acquisitions of April bills except as they may be acquired in the course of normal operations--on the grounds that the need for further aid is not pressing--consideration should still be given at either this or the next Open Market Committee meeting to the longer range question of other one-year bill auctions. If there is a positive case for System action to assist the Treasury until the one-year bill innovation has been fully tested, the Account management might well be instructed to proceed gradually in regular open market operations to acquire holdings of the succeeding July bill, over the time remaining before its maturity.

(3) It is conceivable that the Treasury will find it impossible to effect an advance refunding of the November 1961 bond in the time remaining to maturity. If this should prove to be the case, System purchases of the bond may be the only way in which any cutback in the size of the issue can be effected. Under such circumstances and recognizing

that this is a unique situation that may justify special exception, System acquisitions of this bond might well be authorized. These acquisitions could be made to a limited extent by broadening the scope of regular System buying operations to include short-term securities other than bills, or they might be made on a swap basis under a strictly passive Account management approach, or both. It would be recognized at the outset that the magnitude of total System purchases in this issue would probably not be very significant and that no advance commitment on the size or timing of purchases could be made to the Treasury. The Treasury would be advised, however, that the System was doing what it could to help within the general constraint of not interfering with other monetary policy objectives. If the Treasury subsequently succeeded in effecting a successful advance refunding of the November 2-1/2's, the System aid program in the issue could then be stopped.