BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON 25, D. C.

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

July 15, 1960

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Young

For your information, there is enclosed a copy of a staff analysis, dated July 13, 1960, of the Federal Reserve Bank of New York's suggestion, made at the last meeting of the Committee, that the Open Market Account purchase short-term securities other than bills.

Ralph A. Young

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

Enclosure

CONFIDENTIAL (F.R.)

July 13, 1960.

COMMENTS ON SUGGESTION THAT SYSTEM PURCHASE SHORT-TERM SECURITIES OTHER THAN BILLS

The suggestion that the System supply some of the seasonal reserve needs during the remainder of this year by purchasing short-term securities other than bills should be carefully considered from a number of angles before deciding whether to make such purchases.

Reasons for. - Reasons advanced in favor of the proposal may be summarized as follows:

(1) On occasion the System has to make large, concentrated purchases of Treasury bills at times when the market supply of such issues has been scarce and demands from other investors have also been large. At these times Treasury bill rates have been forced to unusually low levels, and spreads with other short-term issues have widened. Although it is difficult to isolate the influence of Federal Reserve buying on bill rates in such situations, Federal Reserve demand has appeared to have an appreciable, though temporary, market impact. By operating in short-term securities other than bills in these situations, the market impact of such large System operations could be minimized.

(2) Purchases of bills in amounts needed at such times might push down the bill rate to lower levels than would be desirable for either domestic or international reasons.

(3) Because of large acquisitions of bills by nonbank holders and because of bank selling to obtain funds to make loans, bank holdings of bills are now close to a minimum, but banks continue to hold substantial amounts of other Government securities maturing within two years, some of which they might sell for seasonal reserve adjustments or to meet further loan demands.

(4) Bills are preferred to other short-term securities by nonbank investors and perhaps also by banks, and hence bill rates tend to be lower and more sensitive to variations in liquidity and reserve needs than rates on corresponding maturities of other issues.

(5) Purchases of such securities by the System would not be a violation of the established operating procedure rule as to transactions in short-term securities. Such purchases would give an indication that the operations under the rule need not be limited to "bills only", but may cover a broader scope.

Reasons against. - Reasons that might be advanced against adoption of such a proposal include the following:

(1) It is questionable whether, under similar conditions, System purchases of other short-term securities will have a significantly different effect on bill rates than would purchases of bills. The dominant impact of System operations arises from the secondary effects of the reserves supplied -- or absorbed -- not from the primary effect of the particular

System transactions. Moreover, changes in rates in one sector of the market are likely to be rather promptly reflected in other sectors, particularly if within the same maturity range; variations in yields on certificates do not depart much from those on bills, except perhaps for relatively short periods. Hence, the ultimate effect on the level and structure of rates of any addition to the supply of reserves is likely to be almost the same however the reserves are provided -- whether by the purchase of bills, certificates, or even long-term bonds or by release of vault cash or a reduction in reserve requirements.

(2) Question may be raised also as to whether there should be any particular concern over a decline in bill rates when policy is directed toward fostering credit and monetary growth and increased economic activity. In the absence of adequate credit demands a decline in rates would be unavoidable and probably desirable as a stimulus.

(3) System operations to meet seasonal reserve needs for any desired expansion in credit should not have the effect of depressing interest rates on bills. They would be conducted for the purpose of meeting demands for additional reserves. Increased demands for credit and money would be likely to induce liquidation of securities by banks to obtain additional reserves and also by nonbank holders

to raise funds. Because of the large nonbank holdings of bills and the varying liquidity needs of these holders, some of the liquidation is likely to be in that area. The fact that bill rates tend to rise in periods of greater liquidity demands provides evidence that bills become available when money is needed.

(4) The effect on the market of the special popularity of bills relative to other short-term securities cannot be greatly altered by Federal Reserve operations. The different market status of bills is indicated by the fact that the trading operations of dealers in bills are five or more times as large as those in other issues maturing within a year (eliminating awards of bills in the auction and operations in maturing and when-issued securities in periods of refunding operations). This is a fundamental structural characteristic that cannot be corrected through monetary policies or through changes in the structure of the System portfolio. Most System operations are largely temporary and have to be shortly reversed; they can make no substantial change in the structure of the debt held by the public in general. These preferences should be taken into consideration in debt management policies. It is the task of the Treasury, not the Federal Reserve, to determine the maturity composition of the debt held by the general public.

(5) The particular features of Treasury bills that make them more attractive to investors -- bank and nonbank -- relative to certificates and other short-term securities,

also make them most suitable for the Federal Reserve portfolio and for System operations. In the course of a year the System ordinarily sells almost as many securities as it buys and it should always be in position to sell more in order to offset the prolonged gold or currency flows or decreases in reserve requirements. Reductions in portfolio must be effected gradually and carefully to avoid upsetting the markets. Bills are eminently suited for this purpose, because they can be more easily sold or can be run off at maturity in small amounts.

(6) There never seems to be an opportunity to reduce System holdings of certificates, notes, or short-term bonds. They cannot be conveniently redeemed at maturity without interfering with Treasury refunding. Meeting seasonal reserve needs calls for large purchases of securities by the System followed by heavy sales or runoffs in January or February. In the latter period, there are usually Treasury financing operations which would be hampered by System sales of such issues. Fundamentally, the reason for not selling securities other than bills is the weak position of these securities, due in part to the unbalanced debt structure and in part to their less popular market position relative to bills.

(7) The net result of purchasing securities other than bills, therefore, would probably be a permanent increase in such holdings and a decrease in bill holdings. This would increase the imbalance that already exists in the System portfolio as a result of previous purchases of other securities at times of weakness. It would be difficult to maintain holdings of

bills adequate to cover customary seasonal operations, not to mention possible contingencies. Purchases of bills in the autumn are necessary in order to have bills to sell or run off in January.

(8) Purchases by the System of issues that appear to be selling "out of line" with other issues might interfere with the self-adjustment processes of the market. The differences in yields that appear in the market generally reflect market preferences or supply factors. Imbalances in supply are likely to be too great to be remedied by System operations; they should be corrected by the Treasury through debt management. To the extent that System operations diminish yield differentials that reflect market preferences, those preferences will be enhanced not reduced.

To be sure, it would be appropriate to conduct System operations so as to avoid adding to market distortions due to temporary influences. If operations in other securities than bills are conducted with this point in mind they need not be harmful and might be beneficial, but they would probably be relatively small and in any event should be reversed at times to avoid a gradual distortion of the portfolio.

(9) It is for the above reasons that, as long as the existing composition and maturity structure of the public debt exists, "bills usually" is the most appropriate operating rule. Theoretically the System should be able

to purchase securities other than bills and should as much as possible avoid causing undue price distortions. If, however, yield distortions are due to supply conditions or other characteristics that would not be effectively corrected by the System operations, then the conduct of System operations on the basis of yield differentials would not only create or intensify an unbalanced structure of the System portfolio but would also interfere with market processes.

Conclusions. - Under existing circumstances, System purchases of certificates or notes rather than bills to supply reserves for seasonal needs in any substantial amount would seem inadvisable. It is questionable whether such a shift in operations would do much to accomplish the stated purpose of keeping bill rates from declining to unduly low levels. To the extent that the purchases are to meet demands for reserves the effect on the level of rates should be relatively neutral. If the aim of policy is to stimulate credit expansion,then a decline in rates should not be prevented.

If the result of such operations were to narrow or eliminate the differential between rates on bills and on coupon issues of similar maturities, it would enhance the market preference for bills that is the cause of the differential. The rate structure would probably adjust to previous relationships.

Any such policy would be likely to have the effect of further distorting the already unduly distorted composition of the System portfolio. It would be difficult to dispose of holdings when necessary to absorb reserves. Partly because of their preferred status in the market and other characteristics, bills are eminently suited for System operations.

Purchases of securities other than bills to cover seasonal needs might be undertaken if purchases were made in relatively moderate amounts and only at times when bills were temporarily stronger than usual and in case similar securities would be sold to absorb releases of reserves in January and February or at other times. If purchases were large, it is questionable whether they could be disposed of later without creating market disturbances, particularly in view of the timing of Treasury financing.

From a longer-term viewpoint, System operations in a broader coverage of securities might be feasible and even advisable, if and after the Treasury carried out a debt management program that increased the supply of bills outstanding and reduced the amount of other short-term issues. This might have the effect of bringing about a distribution of the debt that conformed more closely to market preferences and also a basic adjustment in yield relationships. It would likewise make possible adjustments in the System portfolio to a distribution better suited for its needs both for current operations and to meet possible contingencies.