To Members of the Federal Open Market Committee and Federal Reserve Bank Presidents Not Presently Serving on the Committee

From Robert G. Rouse

Subject: Operations in Short-term Securities Other than Treasury Bills

At the July 6 meeting of the Open Market Committee there was considerable discussion of the possibility that open market operations might, under certain circumstances, be conducted in other short-term securities in addition to Treasury bills. It was the understanding of the Account Manager that the consensus of the Committee was that it was the Manager's responsibility to initiate operations in short-term securities other than bills if the general state of the market and the reserve situation suggest that such a course of action is desirable. If such an occasion should arise, the Account Management expects to state its intention at the time of the 11 o'clock call. This will allow members of the Committee an opportunity to register an objection, if they have one.

At the conclusion of the July 6 meeting a brief statement, supplementing Mr. Hayes' oral remarks concerning operations in short-term securities other than bills, was distributed to members of the Committee and to other Reserve Bank Presidents not currently serving on the Committee. Subsequently, a memorandum prepared by the Staff of the Board of Governors was distributed commenting on the suggestion that the System purchase short-term securities other than bills. The conclusion expressed on page 8 of this memorandum, namely that "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," appears to be consistent with the approach outlined above.

There seems to be no disagreement on this major issue. We are, however, attaching as a matter of interest a memorandum we have prepared commenting on some of the other points in the Board memorandum.

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FEDERAL RESERVE BANK OF NEW YORK

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The arguments of the Board's staff in response to the suggestion concerning operations in other short-term securities in addition to bills, made by the New York Bank and by others at the July 6 meeting of the Open Market Committee, are presented in a series of numbered paragraphs beginning on page 2 of the staff's memorandum dated July 13. The following pages quote those paragraphs, and present a commentary under each of the quotations.

(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.

It may be questioned whether, as a general proposition, the "dominant impact" of System operations arises from the secondary effects of the reserves supplied or absorbed, rather than from the direct effect of the particular System transaction. On the other hand, there can hardly be any question that the direct, primary impact of System purchases of Treasury bills is substantial in a market in which the supply of bills is scarce. Whether one would choose to call this direct impact "dominant", or would instead regard the secondary effects as "dominant", is an interesting subject, but it has no special relevance to the proposal submitted to the last meeting of the Committee. What is relevant to that proposal is that sizable purchases of bills when bills are scarce has a direct, observable, and significant impact on rates on these obligations, and it was to the problems raised by this fact that the suggestion was addressed.

(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.

It is surprising to find the staff memorandum questioning the concern over the level of bill rates in view of the fact that at recent Open Market Committee meetings, and particularly the last two meetings, many of those around the table expressed precisely this concern. It was in the context of those expressions of concern that the suggestion was made.

(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.

The task of conducting open market operations would be a good deal easier if, as suggested in paragraph (3) above, the market's need for funds was always signaled by the liquidation of Treasury bills by bank and nonbank holders and by an accompanying tendency for rates to rise, which would offset any opposite tendency for rates to decline as the result of System purchases to meet the indicated need for funds. There is little that can be said about this, except that the market does not operate with such precision and such simplicity. Sizable needs for funds can be generated without this need being quickly reflected in net liquidation of Treasury bills or in rising bill rates. Furthermore, the Open Market Account is not always able to operate in such a way as to await the development of clear and unequivocal signals of needs for funds. It frequently happens that the Account must anticipate such needs in order to prevent the development of a knot in the money market which could result in larger operations than would otherwise be necessary. Under present circumstances, with bank holdings of Treasury bills at a relatively low level, and with some of those bills retained for policy reasons, there is less reason to believe that a demand for funds will always bring out bills. Under current conditions there is a real likelihood that a good part of the securities liquidated by banks under the circumstances contemplated in the staff memorandum would be issues other than Treasury bills.

(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.

Paragraph (4) above deals with the structure of the national debt in relation to the preferences of the public with respect to the maturity of the debt which it holds. The point is made that these are fundamental matters that cannot be corrected through monetary policies, and the further point is made that System operations can effect no substantial change in the structure of the debt held by the public. Surely the modest operations suggested were not aimed at effecting any "substantial change in the structure of the debt held by the public", nor would such operations be of sufficient size to be of any great consequence in this regard. There seems little point in contending with the staff analysis over claims that were not made, except to note that the "special popularity of bills relative to other short-term securities" is in part due to the fact that a gain or loss on Treasury bill transactions is treated, for tax purposes, as ordinary income or loss and not as a capital gain or loss. This is an important characteristic to many investors. It may also be noted that the fact that the trading operations of dealers in bills are several times larger than those in other issues maturing within a year, reflects, in part, the absence from the market of the largest holder of such other issues.

(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.

Paragraph (5) states that Treasury bills are most suitable for the Federal Reserve portfolio and for System operations, and gives some of the reasons why this is so. One can agree completely that the Treasury bill is the instrument in which most System operations should be conducted. This does not, however, argue against the proposition that occasions may arise on which it would be wise to conduct operations in moderate amounts in other securities. No suggestion has been made that bills are unsuitable for System operations, or that open market operations as a general rule ought to be conducted in other securities. The proposal of the New York Bank was based on the proposition that moderate-sized operations in other securities might usefully be conducted under certain circumstances, and paragraph (5) makes no comment on this proposition one way or another.

(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.

Contrary to the first sentence of the above paragraph, there is no good reason why moderate amounts of certificates, notes, or bonds could not be run off at maturity in the same way as Treasury bills, particularly since the Treasury may conduct some--perhaps many--of its future refinancing operations on a cash basis. Except during the first weeks of the year, runoffs of bills seldom are very sizable, and if it suited reserve objectives to run off $100 million of a certificate, note, or bond, there would in most cases be no good reason why this could not be done. As to the selling of securities other than bills, referred to in the last sentence of paragraph (6) above, it is not contemplated that other securities would be sold in large amounts or in amounts that the market cannot readily absorb. It is evident that the market for Treasury bills is broader than the market for other short-term obligations, and it is also evident that the market's capacity to absorb a given amount of notes, for example, is less than its capacity to absorb the same amount of bills. Thus it is hardly likely that one would even contemplate, much less attempt, sales of other securities in the same volume that sales of bills would be undertaken.

(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.

Paragraph (7) above rests on an acceptance of the proposition advanced in paragraph (6) to the effect that "there never seems to be an opportunity to reduce System holdings of certificates, notes, or short-term bonds." Since that proposition is not valid, the proposition that a "net result of purchasing securities other than bills . . . would probably be a permanent increase in such holdings and a decrease in bill holdings" is not acceptable. It is true, however, that the System can have, within practicable limits, whatever kind of portfolio it wishes to have. It may be added that System Account holdings of bills presently amount to $2.4 billion. This amount alone would be more than adequate to cover seasonal sales or redemptions that occur in the early weeks of a calendar year. Furthermore, substantial additional amounts of Treasury bills will probably be acquired between now and the end of the year, for the New York Bank never considered or recommended that all subsequent reserve needs this year be supplied through purchases of securities other than bills.

(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.

There has been no suggestion that the System purchase issues that appear to be selling "out of line" with other issues. In this paragraph the staff analysis inverts what is implied in the New York Bank's suggestion, i.e., at times bill rates get "out of line". The current rate structure is witness to that as a fact, and some of the reasons for it are stated in the comment on paragraph (4) above. The staff analysis seems to assume that on these occasions bill rates are all right, and that it is rates on other issues that are "out of line"; and the implication is that these other issues would be purchased in order to redress this situation. The impression given by the staff analysis is that the suggestion of the New York Bank was aimed at redressing a yield structure which the Bank does not like. However, the aim of the suggestion was not to redress a yield structure, but rather to moderate any further declines in bill rates from levels which many members of the FOMC -- including the member from the New York Bank -- regarded as cause for concern under existing economic and financial circumstances, both domestic and foreign. It was out of this general background of concern over the level of bill rates, and its domestic and international implications, that the suggestion arose. It did not arise out of any preconceived notion as to what the yield curve ought to be.

(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.

Paragraph (9) states that the arguments propounded earlier point to "bills usually" as the "most appropriate operating rule". Most of these arguments, however, are on such a level of generality that if they were valid the Open Market Committee would perhaps never deal in any securities other than bills (except in the correction of disorderly markets). Thus if those arguments were to be accepted it might be suggested, with some justification, that the practice of the Open Market Committee in normally confining its operations to "short-term securities, preferably Treasury bills", a policy which has been dubbed "bills usually", or "bills preferably", is really a policy of "bills only".