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

December 9, 1960

From Robert G. Rouse

Subject: Governor Robertson's Views on Open Market Operations during the Period October 25-November 21, 1960.

At the meeting of the Federal Open Market Committee on November 22, 1960 Governor Robertson read a paper reviewing the operation of the System Open Market Account during the four-week period October 25-November 21. There were three major points made by Governor Robertson that may be summarized as follows:

(1) that the conduct of the System Open Market Account resulted in a "tightening operation", contrary to the wishes of the Committee.

(2) that an excessive amount of short-term securities other than Treasury bills were purchased, thereby reducing the liquidity of the System Open Market Account; and

(3) that excessive use was made of repurchase agreements, and at rates lower than the discount rate.

The attached memorandum deals with these three points.

I should also like to refer to my understanding of the function of the morning conference telephone call and the subsequent summarization of that call that is sent to members of the Federal Open Market Committee and to the Presidents of the Federal Reserve Banks not currently serving on the Committee. I have long been concerned about the problem of communication between the Account Management and the members of the Committee, and a great deal of my time, and that of the officers and staff of the Securities Department, is spent in an effort to communicate throughout the System as much as we can of the course and flavor of current market developments. The 11 o'clock call is an especially important part of this program of communication since, in addition to a review of early market developments, we attempt to spell out, to the extent possible, the course of open market operations that we expect to undertake during the day.

One of the principal functions of the 11 o'clock call, and the rapid dissemination of its substance, is to provide all members of the Committee with an opportunity to express their views concerning the proposed operations if they wish to do so. As I stated at the last meeting of the Committee, occasionally I have received a telephone call from a member of the Committee for the purpose of discussing developments and possible operations during the day; such calls have been rare. On these occasions I have had to make a judgment as to the Committee's wishes. If I felt that the views expressed by the individual member were not in accord with the consensus of the Committee, I felt compelled to follow what I considered the consensus to be, or to request a telephone meeting of the Committee to decide the appropriateness of the action contemplated. I think that the Manager of the Account has to make such judgments, and, as I stated at the last meeting, I am prepared to do so. If any member of the Committee considers that actions contemplated by the Account Management are not in accord with the wishes of the Committee, it would appear desirable for him to communicate his views as speedily as possible to the Manager or, if the member prefers, to the Chairman or Vice Chairman of the Committee. If it then appears that a telephone meeting of the Committee is desirable, one could be arranged promptly.

Attachment.

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COMMENTS ON GOVERNOR ROBERTSON'S VIEWS ON THE CONDUCT OF OPEN MARKET OPERATIONS DURING THE PERIOD OCTOBER 25 THROUGH NOVEMBER 21, 1960

At the meeting of the Federal Open Market Committee on November 22, 1960, Governor Robertson read a paper reviewing the operation of the System Open Market Account during the four-week period October 25-November 21. The three major points made by Governor Robertson are discussed in this memorandum.

1. The conduct of the System Open Market Account resulted in a "tightening operation", contrary to the wishes of the Committee.

The consensus of the Federal Open Market Committee at the October 25 meeting, as understood by the Manager and by the officers of the Securities Department of the New York Federal Reserve Bank, was that System open market operations should supply reserves readily, avoiding any seasonal strains on bank reserve positions. Doubts were to be resolved on the side of ease and the feel and tone of the market were to be emphasized more than statistical guidelines. In view of the Committee's concern over the balance of payments situation (reflected in a change in clause (b) of the directive) there was a strong hope that the System could avoid driving the Treasury bill rate lower and could maintain short-term rates at 2 per cent or above.

At the close of business on November 21, System open market operations had supplied approximately $1.1 billion net reserves since the October 25 meeting. The amount of net reserves supplied at times during the period was still higher, amounting to as much as approximately $1.5 billion on November 14. This exceptionally large supply of reserves through open market operations permitted member banks to meet heavy reserve drains from market factors and from a gold outflow of over $0.5 billion, and to support an increase of nearly $200 million in required reserves. During the period under review, total reserves were above the levels that might have been expected on seasonal grounds, despite a bigger drain on reserves from other factors than had been anticipated at the outset of the period. In our opinion the conduct of System open market operations did not result in any deficiency in bank reserves during the October 25-November 21 period.

At the close of business on November 21, the three-month Treasury bill rate was quoted at 2.35 per cent bid, compared with 2.14 per cent at the close on October 25. This development appears to have been fully in accord with the wishes of the Committee.

During the period under review, the effective rate on Federal funds fluctuated between 2 1/4 per cent and 3 per cent. The fact that the Federal funds rate was at 3 per cent on most days of the period may have been interpreted as a reflection of "tighter" conditions in the money market. However, as was pointed out in the regular written report of the Manager to the Open Market Committee prior to the November 22 meeting, the relative firmness of the Federal funds rate mainly reflected the heavy pressures on New York banks, resulting from sharp declines in demand deposits, and the continued concentration of reserves in country banks. At prevailing rate levels, there was no shortage of reserves available through the Federal funds market as might be expected in a "tight" money market. In fact, on the basis of the available statistics, the volume of trading in Federal funds appears to have been somewhat higher over the October 25-November 21 period than it was during the preceding interval between Committee meetings. During the period, the New York banks were able to sustain a daily average basic reserve deficit of about $400 million with average borrowings of about $30 million from the Federal Reserve Bank of New York. On some days gross purchases of Federal funds by the New York banks were close to the $1 billion level. In these circumstances, the relatively firm Federal funds rate reflected the uneven regional distribution of reserves--which was on the whole corrected through the Federal funds market--rather than general tightness in the money market. It should be recognized that tightness in the central money market banks frequently reflects a general tendency of these banks to keep fully invested and even overinvested.

2. An excessive amount of short-term securities other than Treasury bills were purchased, thereby reducing the liquidity of the System Open Market Account.

It was the understanding of the Account Manager and of the officers of the Securities Department that the Committee placed no limitation on the purchase of short-term securities other than Treasury bills, although there was a preference for limiting operations in such securities to a maximum maturity of 15 months. While Governor Robertson, at the October 25 meeting, stated his belief that the approach to such operations be experimental and in limited volume, this did not appear to be the consensus of the Committee. It was the Manager's understanding that references to experimenting with new techniques by other members of the Committee referred mainly to operations in longer-term securities, not to operations within the scope of current operating policies.

We believe there is no real problem in disposing of short-term securities other than Treasury bills whenever it becomes necessary to absorb reserves through open market operations. Both banks and corporations regularly adjust their liquidity positions both ways by operations in other short-term securities, and there is no reason to believe that the System cannot do so as well. The Trading Desk, within the past month or so, has executed sizable sell orders for such securities for Treasury and for international accounts, and in a go-around on December 2 the Account sold $30 million other short-term securities in addition to $46 million Treasury bills. Dealer bids for Treasury bills amounted to $228 million, and for other short-term securities to $142 million. We do not question the role of the Treasury bill as generally the most suitable instrument for day-by-day System operations under most circumstances. On the other hand, we see no reason to limit the purchase of other short-term securities because of inability to dispose of them at a later date in the market.

It may be true that the Account's purchases of other short-term securities, combined with other factors, tended to push Treasury bill rates higher rather than "...merely keeping the bill rate from going below 2 per cent...". This did not appear inconsistent with the Committee's wishes.

3. Excessive use was made of repurchase agreements, and at rates lower than the discount rate.

Repurchase agreements are made for the Account of the Federal Reserve Bank of New York on the initiative of the Account Manager for the sole purpose of providing reserves to the market on a temporary basis, not as a means of assuring dealers of adequate financing to carry their inventories. During periods of temporary reserve drains, reserves can be supplied through repurchase agreements with less of a direct impact on short-term interest rates than if the System purchased short-term securities outright, particularly when dealers have a negative "carry" on securities sold the System under repurchase agreement.

On October 26 the Board of Governors announced revisions of Regulation D releasing about $1 1/4 billion reserves on November 24 and December 1; thus part of the need for reserves prior to those dates was on a temporary basis. In view of the Committee's concern over the level of short-term rates and in view of the massive reserves that had to be supplied the market, partly on a temporary basis, during the period under review, the Account Management attempted to supply as many reserves as possible through use of repurchase agreements. Indeed, the knowledge of a prospective massive release of reserves a month ahead afforded a unique opportunity to furnish reserves on a temporary basis through the mechanism of repurchase agreements, pending the effective date of the action under Regulation D. In order to keep these temporarily needed reserves in the market for as long as possible, thereby reducing the necessity for outright purchases of short-term securities and the resulting impact on interest rates, the Account Management reduced the rate on repurchase agreements from 3 per cent to 2 3/4 per cent on October 31 to encourage dealers not to withdraw contracts prior to maturity.

The Federal Open Market Committee has authorized the New York Reserve Bank to enter into repurchase agreements with nonbank dealers "subject...to the understanding that the authority would be used sparingly in entering to repurchase agreements at rates below the discount rate...". "Sparingly" has always been interpreted by the Account Management in the time sense rather than in the volume sense. We have felt that the occasions for the use of repurchase agreements at rates below the discount rate should be infrequent but that if such use is appropriate at all it should be appropriate to make whatever amount seems called for by the circumstances. In keeping with this interpretation that such use should be infrequent, repurchase agreements had not been made below the discount rate since 1955. This seems to the Manager to constitute "sparing" use. To interpret "sparing" in the volume sense appears curious, since the object of lowering the rate is to encourage the dealers to make the contracts and leave them on the books during exceptional periods of temporary reserve drains. We believe that, for reasons enumerated earlier, the period under review was such an exceptional period.

The temporary existence of a repurchase agreement rate below the discount rate may give the appearance that nonbank dealers have been given a competitive advantage over bank dealers. It may be questioned, however, whether the Federal funds rate is not more relevant than the discount rate in this connection, particularly in view of the heavy use of the Federal funds market by the New York and Chicago dealer banks to adjust reserve positions, and their relatively small use of the discount window for this purpose. While the Federal funds rate was at the discount rate during most of the period in question, it was also below it--as low as 2 1/4 per cent--on several days. There would appear to be no need for System concern over possible charges of favoritism.

Dealers fully understand that repurchase agreements are made available solely on the initiative of the System at times when there is a need to supply reserves. When their financing costs are higher elsewhere, they would of course like to have repurchase facilities automatically available at the Federal Reserve, but there appears no possibility that, under present policies, they are in danger of becoming excessively reliant on the Federal Reserve. Therefore, we believe that the use of repurchase agreements is not "injurious to the independence and strength of the Government securities market".

Securities Department,
Federal Reserve Bank
of New York
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