BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

January 5, 1962.

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Young

Attached for your comment and suggestion is a draft of article prepared by the Secretariat for reporting in the Bulletin the Committee's action in terminating its continuing statements of operating policies and providing readers with some background and interpretative comment to aid in understanding this action.

If it meets with the approval of the Committee, this article could be published in the January issue of the Bulletin which becomes available from the printer about the 25th of the month. If this schedule is adhered to, it will be essential to receive comments and suggestions by letter or wire no later than late afternoon, January 10.

A more appropriate publication timing might be the February issue of the Bulletin. Publication of the Board's Annual Report, which includes the Committee's policy record, is scheduled for late February or early March. Thus, inclusion in the February Bulletin would put publication of the article and of the policy record in close timing relationship. If the February Bulletin would be preferable publication timing, suggestions and comments could be received through January 17. This would allow time for another revision and circulation to the Committee before preparing final Bulletin copy for printing.

It would be helpful if preferences as to publication dating could be expressed at the Committee's meeting on Tuesday, January 9.

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

Attachment

DRAFT
Jan. 5, 1962.

CONFIDENTIAL (FR)

Statements of Operating Policies
Federal Open Market Committee

(Prepared for Federal Reserve Bulletin)

The Federal Open Market Committee, at its meeting of December 19, 1961, voted to discontinue the three "statements of operating policies" relating to the conduct of open market operations that it had originally adopted in 1953 and reaffirmed in subsequent years. The discontinued statements, in the form last reaffirmed in March 1960, were as follows:

"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."

The language of these statements had contemplated that departures from various of the individual policies described would be required from time to time, and the Committee had in fact made such departures on several occasions. Although it had recognized that a need for departures would arise periodically, the Committee in earlier years had felt that the statements served several useful purposes. The December 19 decision to discontinue the policy statements reflected partly the belief that certain of the purposes for which they were originally intended were now of less importance, and partly the expectation that because of changes in the economic and financial environment more frequent adaptations in operating procedures might be required in the future than over most of the period since 1953. The decision, it should be noted, related to the desirability of continuing to have these statements of operating policies, and not to the actual course of monetary and credit policy to be pursued by the Committee. The action, therefore, did not reflect any change in the Committee's monetary and credit policy or in techniques for implementing such policy.

The December 19 decision provides an appropriate occasion for summarizing the events which originally led the Committee to adopt the statements, the circumstances which led the Committee at various times to depart from them in its operations, and the factors underlying the decision to discontinue the statements.

Origin of the policy statements

During the second World War the functioning of the Federal Reserve was bent to the overriding objective of facilitating the war effort. To assure ample funds for the financing needs of the Government, the System in effect maintained a standing offer in the market to buy outstanding Government securities in unlimited amounts at a relatively fixed schedule of prices and yields. It acquired large amounts of Government securities, and the reserves created in payment for them permitted the commercial banks to purchase new securities that the Treasury was issuing to obtain additional funds. The System's standing offer to buy at predetermined prices greatly reduced the risk of capital losses even on long-term Government securities, and consequently made them virtually as liquid as short-term securities.

This policy of pegging Government security prices served its wartime purpose. But it had two consequences, which together posed a major threat of inflation: money was created continually, on a massive scale; and the large volume of Government securities outstanding was converted into the equivalent of interest-bearing money.

The policy of pegging was continued for some time after the war, partly to permit a gradual transition to a free market for Government securities. A gradual transition was especially important because capital values generally had become moored to the artificial Government security prices. Under several actions in the years 1947 and 1948 yields on short-term securities were allowed to rise above their wartime levels, but the wartime ceiling was continued for bonds. By 1950 the inflationary dangers in continuing to peg bond yields and the need to bring this policy to an end had become clear to many observers. The inflationary crisis that accompanied the outbreak of hostilities in Korea carried the matter to a head.

After extended negotiation, the Treasury and the Federal Reserve System reached an Accord, jointly announced by them on March 4, 1951, which re-established the System's ability to regulate the availability and cost of money with a view to maintaining monetary conditions appropriate for the economy as a whole. Procedures were agreed upon for a gradual withdrawal of price and yield pegs, and in accordance with these procedures support buying of long-term bonds was continued over the next few months, but at declining prices. After mid-1951 the System ceased its support buying altogether, except for some minor purchases in the second half of that year.

As the years 1951 and 1952 progressed, however, market developments demonstrated a disturbing skepticism among investors that the Federal Reserve was in fact abstaining (or would continue to abstain) from attempting to maintain certain predetermined security prices and interest rates, regardless of the over-all state of the demand for and the supply of savings. This skepticism was fed by market observation that the System engaged in purchases of securities involved in Treasury financings around the periods of such financings. Uncertainties on the part of investors as to when and how the System might intervene in the market for longer term Government securities could, it was felt, have deleterious effects on the functioning of the market; and this in turn could reduce the efficacy of open market operations, the major tool of monetary policy.

It was in this period of transition from a "pegged" Government securities market to one in which prices were free to fluctuate in response to the forces of supply and demand, and against the background of confusion and uncertainty with respect to the specific role the System planned to play in the market, that the Federal Open Market Committee first adopted and published its statements of operating policies. The action was taken after intensive reexamination in 1952 of the techniques then employed in System open market operations with particular reference to the potential impact of such techniques on market behavior.

In part, the policy statements adopted in 1953 simply reaffirmed decisions the Committee had made earlier. This was the case with respect to the declaration (in the first statement) that the Committee would not support any pattern of prices and yields in the Government securities market, and (in the second statement) that it would refrain from operations in securities involved in Treasury financings. In part, however, the statements reflected new operating policy decisions. These included the decision reflected in the second statement to confine operations to short-term securities except in the correction of disorderly markets; previously the Committee had authorized operations in longer term securities to maintain orderly conditions--although, in fact, no such purchases were made after 1951. The decision reflected in the third statement, to avoid offsetting purchases and sales of securities (often called "swaps") for the purpose of altering the maturity pattern of the System's portfolio, also represented a new operating policy, and was originally adopted somewhat later than the others, in December 1953.

Both the adoption of the new operating policies reflected in the statements and the publication of the statements themselves were intended to foster the development of a self-reliant market for Government securities that would provide an effective medium for monetary policy actions. The Committee was in full accord on the declaration with respect to "pegging," but not on all of the other language of the statements. The differences in view were partly with respect to the nature of the operating policies the Committee should pursue and partly with respect to the desirability of adopting and publishing statements of the form then being considered. The policy differences were not large, and were mainly concerned with possible special circumstances which a minority of the Committee thought would warrant actions exceptional to the statements. The minority felt that while the language of the statements admitted departures from or exceptions to the described policies, their adoption and publication might nevertheless serve to restrict unduly the Committee's later decisions; in effect, the Committee might be in danger of sacrificing some useful degree of flexibility in its own later policy actions. Other members of the Committee recognized this argument as a possible disadvantage of the policy statements but gave greater weight to the advantages they saw in them, and a majority of the Committee approved the statements.

The main purpose served by the statements was to clarify the System's role to securities market participants and the public at large. While this purpose received greatest emphasis in the Committee's deliberations, other purposes contributed to the balance of advantages and disadvantages. The adoption of the statements, for example, provided a clear resolution of the Committee's discussions of optimal operating policies under then existing conditions, obviating some of the need for repeated debate and decision-taking in the affected areas. Again, at the time the statements were first adopted in 1953 and until mid-1955 the Federal Open Market Committee met relatively infrequently--a minimum of four times a year, with occasional additional meetings as required. In the relatively long intervals between meetings responsibility for effectuating policy lay with the executive committee, consisting of five members of the full Committee. The executive committee met frequently and transmitted detailed instructions (under the terms of the most recent directive issued by the full Committee) to the Account Management at the Federal Reserve Bank of New York, which was the Bank selected to execute transactions in the System Open Market Account. In these circumstances it was considered important for the full Committee to lay down broad guidelines for the executive committee and the Account Management, and the statements of operating policy, along with other types of instructions, served a useful function in this respect.

It is the practice for the Federal Open Market Committee in March of each year, following the election of and assumption of duties by new members from the Federal Reserve Banks, to review all continuing statements of policy and authorities for operations. In accordance with this practice the statements of operating policies have been regularly reviewed since 1953. Through the review of March 1960, the Committee on each occasion concluded that the balance of advantages and disadvantages favored reaffirmation of the policy statements in substantially unchanged form.

Departures from the policy statements

On various occasions since 1953 the Committee had authorized transactions which represented departures from the policy statements. The first such action was taken in November 1955, when the Committee authorized purchases, on a when-issued basis, of up to $400 million of Treasury certificates of indebtedness to be dated December 1, 1955, maturing December 1, 1956. Some $12 billion of such securities were being offered by the Treasury in a refunding operation, and evidence available at the time indicated that developments after opening of the books threatened an unusually large volume of cash redemptions of the maturing issue. The Committee had received a request from the Secretary of the Treasury for assistance directed toward preventing undue cash redemptions. In view of the possibility of psychological deterioration of the whole securities market if the offering came to be regarded as a failure, and of the fact that reserve projections indicated the Committee would probably find it necessary in any event to supply upwards of $400 million of reserves to meet seasonal and other demands, a majority of the Committee felt that an exception to its policy with respect to Treasury financings was warranted.

In July 1958 the Committee authorized purchases of Government securities in addition to short-term securities without limitation, after the Account Manager reported the existence of a disorderly situation in the market. The disorderly situation resulted from the combined impact of a large Treasury refunding and a sudden threat of war in the mid-East on a market characterized by heavy speculative positions and already weakened by an unexpectedly sharp reversal in the economic outlook from continuing recession to recovery. The authorization for corrective action was made on the afternoon of July 18, and was consistent with the language of the operating policies. Earlier on that day, however, when the Account Manager reported that the market was in a condition close to disorderly but had not actually reached that point, the Committee had authorized purchases of up to $50 million of securities for the purpose of steadying the market. The later advice that the market was disorderly came as the System Account was starting to put this authorization into effect.

On two occasions, in July 1958 and the Spring of 1960, the Committee departed from its policy on "swap" transactions. The first of these was connected with the action taken to correct the disorderly market situation. The Committee authorized a specific transaction for a foreign account in the amount of $30 million in a manner that would result in adding to the System Account holdings of Treasury bills that would mature on July 31, 1958. By letting these bills run off at maturity the Committee could absorb some of the large volume of reserves that would be released to the market on August 1 because of purchases for System Account on a when-issued basis of new Treasury certificates due to be issued on that date. This departure from the policy statement was believed warranted by the unusual circumstances of the period.

The second exception to the rule on "swaps" was made in April 1960, and was renewed at successive meetings in May and June. It consisted of an authorization to acquire up to a total of $150 million of 1-year Treasury bills maturing July 15, 1960, either by outright purchases or swap transactions against other bills. The purpose was to smooth the refinancing of an instrument which had not yet been afforded a full test of market receptivity. Thus the action also represented some departure from the policy that "intervention in the Government securities market is solely to effectuate the objectives of monetary and credit policy." A majority of the Committee believed that it would be appropriate to experiment with swap transactions to the extent authorized as a means of bringing some of the specified securities into the System's portfolio in order to help their refinancing. It was also felt that the acquisition of securities in this manner would help to increase the flexibility of the System's short-term portfolio.

The most recent and most important of the exceptions were the decisions taken in February 1961 and reaffirmed at each subsequent meeting until December 19, 1961 to authorize transactions in longer term Government securities and to suspend the prohibition against "swaps." 1/ This had been preceded by operations, beginning in October 1960, in short-term securities other than Treasury bills. In the Committee's judgment the February 1961 actions were warranted by an unusual conjuncture of circumstances: a domestic recession, which in itself called for a policy of monetary ease and lower interest rates, and a balance-of-payments problem, due in part to heavy short-term capital outflows, which would be

1/ Initially, transactions were authorized in securities having maturities up to ten years; after late March, in securities of any maturity.

aggravated by lower short-term interest rates. By supplying reserves insofar as possible through the purchase of longer term securities, rather than the short-term securities in which operations previously had been exclusively conducted, it was hoped that a contribution could be made to recovery in this country without unduly depressing short-term rates and thus worsening the balance-of-payments problem.

Decision to discontinue the policy statements

At the meeting of the Committee on March 7, 1961, at which the newly elected representatives from the Federal Reserve Banks assumed their duties as members of the Committee, the customary annual review of all continuing policy statements and operating authorities was included on the agenda. This meeting occurred shortly after the announcement on February 20 of the special authorization for transactions in longer term securities, and the Committee voted to renew that special authorization until its next meeting. At the same time the Committee decided to table consideration of changes that had been proposed in the three statements of operating policies, pending a more comprehensive review of the form that such statements might take in light of the new circumstances.

In the course of this review the Committee considered three alternatives: reaffirmation of the existing operating policy statements; adoption of revised statements; and discontinuance of the statements. The first alternative was rejected on the grounds that adaptations in operating policies might be frequent enough in the period ahead to render existing statements inappropriate. The second alternative required the development of language which, on the one hand, would be consistent with the kinds and degrees of flexibility the Committee thought might be required in future operations, and, on the other hand, would be sufficiently specific to serve usefully as statements of operating policies. The Committee chose the third alternative--to discontinue the statements--in part because of the difficulties encountered in attempting to frame language that would meet both of these conditions.

The decision to terminate the operating policy statements also reflected the feeling that some of the advantages of the statements seen earlier were now considerably reduced in importance. The transition from a pegged to a free market had been successfully accomplished and was now a matter of history; there was no longer the same need as earlier to convince market participants that the System would not intervene in the market for the purpose of fixing prices or supporting Treasury financings. Moreover, since 1955, when the executive committee was discontinued, the full Committee had been meeting regularly at short intervals--usually every three weeks--and was able to maintain close direction over the conduct of open market operations. Under procedures in effect for several years Committee representatives communicate daily with the Account Management by telephone for the purpose of reviewing how current or planned transactions accord with Committee intentions. For these reasons the importance of having statements of operating policies as guides for the actions taken on its behalf appeared to the Committee to be considerably reduced. In sum, it was the Committee's view that the balance of advantages and disadvantages had now shifted against having the statements, and they were therefore discontinued. With their discontinuance the special authorization permitting transactions in securities of longer maturity--adopted in February 1961 and renewed at each meeting since then--was no longer necessary, and this authorization was not renewed.

As noted above, the decision to discontinue the statements was not a decision to change the Committee's actual operating policies or procedures. Decisions with respect to operations in longer term securities will continue to be made at each meeting of the Committee in light of the circumstances prevailing. The bulk of open market operations will continue to be in short-term securities. This is, indeed, required by the nature of the Government securities market; it is only at the short end that there consistently is a volume of private transactions sufficient to absorb operations on the scale frequently undertaken for the purpose of affecting bank reserves, which is necessarily the main focus of System open market operations. Similarly, the Committee has no intention of pegging Government security prices or of creating artificial market conditions at times of new security offerings by the Treasury. Open market operations will continue to be directed toward helping to achieve and maintain a high level of economic activity and employment, sustainable growth, stability of the price level, and a sound international position of the dollar.