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To Federal Open Market Committee
and Presidents of the
Federal Reserve Banks

November 27, 1963

From Robert W. Stone and
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Subject: Procedures with respect
to allocations of the
System Open Market Account

The present procedures for reallocating the System Open Market Account contain three principal elements:

1. The Account is reallocated each statement date in order to bring the reserve ratios of the respective Reserve Banks into approximate equality and thus to minimize the possibility that any Bank will incur a deficiency on a statement date.
2. If, despite such reallocation, a Bank shows a deficiency on a statement date, a special "as of" adjustment to eliminate the deficiency is undertaken the following morning, before the books for the statement date have been closed. (There has been one such occasion since the present procedures were adopted last September.)
3. A special adjustment is made in the Account on any day other than a statement date if a Reserve Bank feels that it may incur a reserve deficiency on such other day.

The combination of (1) and (2) above has prevented any Reserve Bank from showing a deficiency on a statement date but, as indicated later, even statement date deficiencies may be difficult to avoid in the future.

The third principal element outlined above, however, does not insure avoidance of a deficiency by some Bank or Banks on other than a statement date (an "intra-weekly" deficiency). The reason for this is that special adjustments undertaken on any day other than a statement date are based on the reserve ratios of the preceding day. For example, a Bank may find on a given day that it is experiencing so heavy an outflow of funds that it feels its reserve ratio for that day may move below 25 per cent. On the basis of that feeling, which may or may not turn out to have been correct, the Bank concerned would ordinarily call the Manager and arrange for a special adjustment in which a part of its security

holdings would be reallocated to the Bank or Banks which, on the basis of the reserve position of the respective Banks on the preceding business day, seem to be in the best position to "take" additional securities. The difficulty here, however, is that the Bank whose reserve position was being reduced because it was relatively most favorable yesterday might itself be experiencing a substantial outflow of funds today. It is thus entirely possible that, in undertaking a special adjustment designed to prevent a deficiency in one Bank, we could put another Bank in the position of incurring a deficiency. Moreover, the procedure gives no protection in those cases where a reserve outflow exceeds expectations on a given day, so that a Bank might go below 25 per cent with or without having asked for a special adjustment. This general problem may well become more acute over the next few weeks. Not only will the reserve ratio for the Banks as a group decline as the seasonal peak in note and deposit liabilities approaches, but the size of inter-district money flows, and thus the size of daily swings in individual Bank ratios, will very likely increase.

The essential point of the above discussion was indicated at the outset: one or more Reserve Banks may incur intra-weekly deficiencies over the next few weeks under present procedures. It seems to us that the System, in considering this problem, has before it three principal alternatives:

- (a) Leave the present procedures unchanged. This would involve attempting to avoid an intra-weekly deficiency, but "taking it" if one should nevertheless occur.
- (b) Employ, on days other than statement dates, the "as of" adjustment procedures now employed for statement dates. This would be administratively feasible, although difficulties would be encountered (even on statement dates) if several Banks should be deficient at once, and particularly if a deficient Bank also found itself with most or all of its participation in the System Open Market Account pledged against its note issue; indeed, in the latter case it might be impossible to avoid a deficiency.

- (c) Choose to let intra-weekly deficiencies occur without attempting remedial adjustments.

If the System should adopt alternative (b) above, the present statement of procedures (attached) could be made to conform with such a decision by eliminating paragraph (3) of the procedures; by making certain changes in language in the first and last lines of paragraph (2); and by making a minor change in paragraph (4). If the System should choose to let intra-weekly deficiencies occur without attempting remedial adjustments, the present statement of procedures could be made to conform to such a decision by striking paragraph (3) of the procedures and by making a minor change in paragraph (4).

Attachment.