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STRICTLY CONFIDENTIAL (FR)

August 31, 1965.

TO: Federal Open Market Committee

FROM: The Staff

SUBJECT: Contingency Planning for the Government Securities Market.

This memorandum summarizes the consensus of recent discussions among Treasury and Federal Open Market Committee officials. Its purpose is to sketch the outline of an approach that might be taken by the Federal Reserve and the Treasury to insure an orderly adjustment of prices and yields in the Government securities market in the event of an abrupt psychological shock arising out of a possible sterling crisis or a serious deterioration in the situation in Vietnam.

In contingency planning to cover such hypothetical limited emergencies, a highly detailed blueprint of action is neither necessary or feasible. Such action can only be determined in the light of the needs of the situation emerging at that time, and taking account of market developments prior to the event. Nevertheless the general principles of such action can be outlined; prior agreement on these principles and on as much of the operational detail as can be spelled out can be helpful in meeting in an orderly fashion any emergency situation arising out of an international crisis.

General Principles

Among the general principles involved are the following:

1. Avoidance of disorderly conditions in the Government securities market--disorderly conditions being defined as a cumulative price decline that is "feeding on itself" with

successively lower prices evoking additional offerings rather than shrinking selling pressures and bringing buyers into the market--which could lead to a serious disruption of the whole domestic financial mechanism, of the balance of payments, and of the domestic economy itself.

2. Avoidance of pegging of any particular levels of prices and yields, while assisting the market to find a level at which it could generate its own support.

3. Coordination of Federal Reserve and Treasury policy and actions in assisting an orderly adjustment of the market through the purchase of intermediate- and long-term bonds.

4. Reduction of dealer inventories, at least of longer-term Government securities, in order to:

a. contribute to an orderly adjustment of prices and yields of Government securities;

b. avoid excessive dealer losses which could affect the solvency of nonbank dealers and undermine the viability of the market.

5. Temporary subordination of "normal" short-run Federal Reserve policy objectives (in terms of free or net borrowed reserves or money market conditions) to the avoidance of disorderly conditions in the Government securities market during the crisis period.

6. Minimizing any conflict between "normal" short-run Federal Reserve objectives and any required emergency action by offsetting sales of Treasury bills or by taking other action to the extent feasible.

7. Subordination of other Treasury debt management policies to the need for emergency action during the crisis period.

8. Suspension of the normal practice that prohibits the Trading Desk from having access to individual dealer figures. The possibility of suspension in an emergency situation is already covered by a letter from Mr. Hayes to the Government securities dealers dated May 17, 1960. (See attachment.)

Operational Aspects

1. Dealer inventories

The need to reduce dealer inventories of intermediate- and long-term bonds stems from the obstacle that the existence of such inventories poses to the eventual stabilization of the market, and the risk that the incurrence of large losses by nonbank dealers--following several years of relatively poor earnings--could seriously impair the viability of the market. (The problem is particularly evident at the moment because of the substantial size of such inventories.) The accordance of preferential treatment to dealers as compared to other investors in Government securities is justifiable because of the special responsibilities of the dealers in maintaining markets in Government securities and their crucial role in the re-establishment of orderly market conditions. A precedent for such action exists in the action taken at the time of the outbreak of war in Europe in 1939.

To be effective, any official intervention to relieve dealer positions should be undertaken promptly and at a level of prices only moderately below pre-crisis quotations (the level depending, perhaps, on how much price adjustment had already occurred at the time of the crisis) rather than on a sliding scale of prices over time.

Special procedures would have to be adopted to ensure that official purchases for this purpose by the Federal Reserve and appropriate Treasury accounts were in fact reflected in a reduction of dealer inventories and not in a channeling of customer orders by dealers into official hands. Normally, when either the Federal Reserve or the Treasury buys in the market, it is impossible to distinguish the ultimate source of the securities purchased.

Such special procedures might involve the following steps:

a. Determine the size of individual dealers' net position in various maturity classes. This data can be provided almost instantaneously by the Market Statistics Department of the Federal Reserve Bank of New York to the Trading Desk.

b. Prepare a schedule of amounts proposed to be purchased from each dealer. The amounts would be based roughly proportionately on the net long position of each dealer, with the precise portion of total dealer holdings to be acquired dependent on the circumstances prevailing at the time.

c. Prepare a list of proposed purchase prices, based on current market prices. Prices could be set quite close to the current market price if there had been a considerable prior decline; they could be set somewhat lower relative to market if there had been no, or only a slight, prior decline.

d. Call all dealers as nearly simultaneously as possible, and inform them that:

(1) The official accounts are prepared to buy a specified amount (roughly proportionate to their net positions) of various maturity classes of their current holdings of intermediate- and long-term bonds.

(2) Such sales by dealers are to come from their own positions, not from short sales or from the channeling of customer sales orders to the desk. (Deliveries could be delayed in cases where securities are tied up as collateral to repurchase agreements or dealer loans.)

(3) It would be made clear that there is no commitment to purchase additional securities at these price levels, but that the lightening of dealer inventories is expected to put them in a position to take care of their market responsibilities in a more orderly fashion.

(4) Further offerings would be dealt with as the occasion arises.

2. Subsequent market intervention

The course of any possible further official intervention in the market is much more difficult to spell out. The objective would be to assist the market to find a new sustainable level of prices and yields consistent with monetary policy objectives at which it would operate on its own. The extent of the adjustment would depend on the nature and duration of the international crisis;

on the impact of developments abroad on (a) the domestic economy--apart from psychological shock--and (b) the flow of funds both internally and externally; on the extent to which the crisis and its subsequent impact necessitated a change in U.S. monetary and debt management policy; and on the actions and reactions of other major countries in their monetary, fiscal and commercial policies.

For instance, if the developments abroad were such as to suggest that only minor U.S. corrective measures were required and if domestic conditions otherwise did not suggest a need for a significant firming of monetary policy, any subsequent intervention by the Federal Reserve and the Treasury might take place on the scale required at a price level only slightly below the level prevailing prior to the crisis.

On the other hand, if the developments abroad were such as to suggest a greater impact on the United States, including the necessity for some firming of monetary policy, then the bond market would have to go through a more substantial adjustment before reaching a sustainable trading level. Intervention would be called for during the course of the adjustment, to assure a functioning market during the adjustment process. The removal of some particularly panicky offerings from the market could be helpful in restoring orderly market processes, and probing and testing of the market would be required before an "appropriate" new level could be found. But no aggressive stand would be taken until it was felt that a viable trading level, consistent with the basic objectives of policy, could be established.

The advantages of permitting an adjustment in market prices and yields before undertaking an aggressive stand in the market include the desirability of "locking in" individual investors at the lower price levels and of encouraging private buying power to develop at the better yields. In this way, the market itself, once the initial shock had worn off, could generate its own support. Aggressive intervention at too high a price level (i.e., a level which would be likely to require considerable further downward adjustment) would not be likely to succeed since instead of generating private support it might intensify efforts of investors to dump their securities on the Federal Reserve and Treasury before prices fell further.

Furthermore, it would involve a waste of official "buying power" ammunition and diminish the credibility of later official efforts to establish a viable trading level.

Coordination

The general approach outlined here obviously requires the closest possible coordination between the Treasury and Federal Reserve in planning the objectives of operations. Fundamentally, both agencies would seem to be interested in the same final objective--the preservation of a viable capital market, which is free to respond to the interplay of market forces and the influence of broad monetary and fiscal policy actions.

Presumably, day-to-day coordination would be appropriate in the direction and execution of operations. Direction of the application of objectives to specific situations would necessarily involve daily exchanges between high level officials at the Treasury, Board of Governors, and

New York Bank. To facilitate this coordination, the Federal Open Market Committee might want to establish a Special Emergency Committee. The detailed execution of official plans would be most expeditiously worked out by those closest to the market--that is, by the officers associated with the Trading Desk at the New York Bank, in consultation with Treasury and Board officials. Regular communications between the Trading Desk, the Federal Open Market Committee and the Treasury would be supplemented as necessary in order to keep all responsible policymakers fully informed.

Attachment

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FEDERAL RESERVE BANK OF NEW YORK

New York 45, N.Y.

REctor 2-5700

May 17, 1960

An inquiry has recently been made concerning publication of dealer statistics and the possibility of access to individual dealer figures by officials of the Federal Reserve System or the Treasury outside of the Market Statistics Department of the Federal Reserve Bank of New York. We want to be sure that the conditions provided in the original authorization by the Federal Open Market Committee and the Treasury are fully understood by all respondents. We are, therefore, sending you the substance of the answer provided in response to the inquiry.

Concerning the first point, the major objective of the new Treasury-Federal Reserve program has been to develop data on the Government securities market appropriate for public information. We recognize, however, that prior to launching a continuing release of such statistics, some experience in the processing and interpretation of such data is necessary. We plan an experimental period of data collection of several months duration, during which no statistics will be made public. Following this period of familiarization, we plan to contact all the reporting dealer firms regarding problems of publication. At that time we will solicit suggestions from each dealer on the content and form of series to be released as well as your views on the time lag between collection and release date. We do not propose, however, to make our publication program in this area dependent on the individual approval of specific dealers as to the details of the information to be released.

Concerning the point relating to the conditions under which individual firm data will be available to persons outside the Market Statistics Department, the Treasury and the Federal Open Market Committee have adopted explicit procedures to limit access to individual firm data to specially authorized occasions and persons. With the exception of the few summary figures that may be requested by the Manager of the System Open Market Account for individual dealers seeking repurchase accommodation at this Bank, the release of individual firm data outside the Market Statistics Department under special conditions is expected to be rare.

To illustrate the conditions under which such exceptional release of data could occur, it would perhaps be most helpful to list the situations considered by the Federal Open Market Committee at the time it authorized the new market statistics program;

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1. The Manager of the Open Market Account may have full access to individual dealer reports in a market situation determined to be disorderly.

2. In other circumstances of an exceptional nature, the Market Statistics Department might be directed by the President of the Federal Reserve Bank of New York to make selected or full details of individual dealer reports available to qualified System officials designated to examine and study the situation.

3. In connection with any Treasury financing, the Treasury might, on occasion, request the President of the Federal Reserve Bank of New York to direct the special data be supplied as to dealer holdings of issues specifically involved in, or closely related to, the financing in question.

It is impossible for us to foresee at this time how many special occasions for access to individual dealer reports might arise. If any respondent in the program would wish to raise the question after several months of experience, we foresee no reason at this time why an answer might not then be supplied. All instances of access to individual dealer figures will be reported to the Federal Open Market Committee and to the Treasury so that an official record will be maintained.

I should like to assure you that the handling, the processing, and any exceptional official access to individual dealer figures will be protected at all times by the strictest standards of confidentiality. The program will receive careful staff review from time to time and substantive or procedural changes believed to be desirable may be recommended in the light of such reviews.

Sincerely yours,

ALFRED HAYES /s/

Alfred Hayes
President