BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

September 1, 1966.

STRICTLY CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Holland

As directed at the meeting of the Committee on August 23, 1966, the staff has prepared the attached memorandum concerning contingency planning for open market operations in the event of a sterling crisis. This represents an up-dated version of the staff memorandum of August 31, 1965, "Contingency Planning for the Government Securities Market" distributed and discussed at the Committee meeting on the same date.

It is planned that this memorandum will be placed on the agenda for discussion at the next meeting of the Federal Open Market Committee on September 13, 1966, and any comments or suggestions can be conveyed at that time. However, Committee members should be alert to the possibility of an earlier telegraphic request for reactions and guidance, should circumstances make that advisable. Because of the subject matter of this memorandum, its contents should be held in the closest confidence.

Robert C. Holland, Secretary,
Federal Open Market Committee.

Attachment

COPY NO.

STRICTLY CONFIDENTIAL (FR)

September 1, 1966.

TO: Federal Open Market Committee

FROM: The Staff

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SUBJECT: Contingency planning for the U.S. Government securities and other financial markets.

This memorandum--developed jointly by the Treasury and Federal Reserve--outlines possible official action in the event of a crisis in Sterling. It is highly likely that all financial markets in the U. S. would be affected by a U. K. devaluation, and the market reaction could prove particularly severe in the current environment of strong credit demands and vigorous monetary restraint. This memorandum considers courses of action to assure the continued functioning of the U. S. Government securities market, and also considers even stronger measures, such as operations outside the U. S. Government securities market or a possible temporary departure from the present thrust of monetary policy, that would have the objective of alleviating more general or more severe disruption of financial markets.

It is, of course, impossible to predict the exact impact of any potential crisis on U. S. financial markets and for this reason it is not feasible or desirable to spell out highly detailed courses of action. It seems preferable to reach agreement instead on over-all policies or objectives and to sketch some general approaches to possible solutions under likely market conditions. A good deal of flexibility and discretion would need to be left to those in charge of implementing the stabilizing operations.

Possible Impact of a Sterling Crisis on Domestic Financial Markets

The current very nervous state of the U. S. financial markets suggests the possibility of sharp adjustments and perhaps even of disorderly conditions in the event of an external shock such as a crisis in Sterling. Yields are already at their highest levels in over 40 years; banks are faced with real problems in rolling over maturing CD's; and credit demands show no signs of abating. A crisis in Sterling--one that forces a devaluation--superimposed upon this most fragile market situation could well trigger large-scale investor selling. Such selling could be very difficult to control because investors might anticipate further sharp interest rate adjustments on the grounds that the United States balance-of-payments position and international confidence in the dollar would be damaged. This tendency could be exacerbated by possible large attendant reserve drains because of speculative flights from the dollar. Upward interest rate adjustments could also be engendered by either the anticipation or the fact of an increase in the Federal Reserve discount rate as part of an international defense of the dollar.

If substantial investor selling did develop in these circumstances, possibly spearheaded by sales of U. S. securities by foreign holders, such selling would be accompanied by very substantial churning in the reserve positions of money market banks. The sheer magnitude of such churning would probably overtax the facilities of the Federal funds market for redistributing reserves, thereby forcing individual banks to borrow heavily from the System. It should be noted, however, that these developments would be likely to entrain some partially self-correcting mechanisms. For example, any large reserve drains stemming from a flight from the dollar would necessitate an offsetting provision of reserves which in turn would provide an opportunity for possibly extensive market support purchases of securities by the System (to be discussed more fully at a later point). In addition, the selling by foreign holders of U. S. assets would probably be concentrated in short-term Treasury securities and such securities would be likely to be in strong demand by domestic investors in a period of crisis.

In the pages which follow, attention will be directed initially to the types of assistance that might be rendered directly to the U. S. Government securities market in the event of a Sterling crisis. Consideration will then be given to broader based measures whose purpose would be to help stabilize a very disorderly or widespread financial market crisis. A final section of the memorandum will be devoted to possible means of supplementing the financial resources of dealers in order to encourage the continued performance by dealers of their market-making function. Before proceeding to these topics, however, some general principles or objectives will be outlined.

General Principles

A number of general principles to be observed in the event of a crisis in the U. S. Government securities market were suggested in a memorandum to the FOMC dated August 31, 1965. These are repeated here, but with modifications to take account of the possibly widespread market impact and adverse psychology that might be generated in all financial markets, if a crisis occurred under current market conditions. The guiding principles are as follows:

1. Avoidance of disorderly conditions in the U. S. Government securities market--disorderly conditions being defined as (a) a cumulative price decline that "feeds upon itself" with successively lower prices evoking additional offerings rather than reducing selling pressures and bringing buyers into the market or (b) a series of sharp price declines in a market vacuum, i.e. without significant retail buying or selling as a result of the shock effect of an international crisis (or for some other reason).

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. Such a level could be

hard to find while the System is actively pursuing a strongly restrictive policy.

3. Coordination of Federal Reserve and Treasury policy and operations in assisting an orderly adjustment of the market and assuring its continuing viability. Such coordination might include policies concerning market assistance operations, the types of securities to be purchased, the financing of U. S. Government securities dealers, the short-run implementation of monetary policy, and the marketing of new Treasury and Federal Agency issues.

4. Tailoring of official action such that it would involve the minimum response adequate to cope with a given situation. For example, every effort would be made to minimize the size of any required open market purchases, possibly by offsetting some of the purchases by sales in a maturity area where investor demand remained strong. Also, any discount rate action would be the smallest appropriate to the circumstances.

Official Intervention in the U. S. Government Securities Market

The U. S. Government securities market would constitute an area of immediate concern and responsibility for the Treasury and the Federal Reserve in the event of a crisis in Sterling. While it is impossible to predict just how this market might react to a crisis, particularly since shorter-term Treasury issues might become a temporary haven for nervous domestic capital, the possibility of disorderly conditions and the need for official intervention must be entertained. It may well be that a determined show of strength in the market by the Federal Reserve and the Treasury at some appropriate rate levels--possibly accompanied by an official announcement of objectives--would be the only effective means of curtailing any development of disorderly market conditions.

It should be noted that the current market exposure of dealers is relatively small. Over-all dealer positions in intermediate- and long-term Treasury securities are very light, although individual dealer firms have some net long exposure in such securities. But dealers do have fairly sizable (albeit about average) positions in Treasury bills and short-term coupon issues. And while the price exposure in such issues is relatively small, sizable losses can still be realized on large holdings and the dealers might decide to press offerings of such issues on the market at declining prices in order to cut their losses. On the other hand, if the potential loss is large the dealers could decide to hold such short issues to maturity. The dealers might also engage in aggressive efforts to make short sales of intermediate- and long-term securities, both to take advantage of declining prices and to hedge their remaining trading positions in shorter term issues.

A distinction has usually been drawn in the past between official purchases to relieve dealer inventories and purchases to accommodate other sellers of U. S. Government securities. In general, it has been deemed desirable to relieve dealers of unwanted positions in order to assure that the dealers could and would continue to perform their function.

There has usually been much more reluctance to buy securities from investors for purposes of market stabilization, presumably in part because the potential extent of such purchases needed to support the market at a given level can never be ascertained ahead of time and they might very easily balloon to extremely large size. But in present market circumstances, the very real possibility exists that a substantial amount of selling by foreign and perhaps by domestic investors could develop in the event of a crisis; indeed, investor selling might constitute the principal source of securities overhanging the market since dealer holdings are relatively small. On the other hand, a serious international crisis, which touched off sharp price declines, might not bring on an avalanche of investor selling. With the large adjustment in yields which has already taken place, many investors could feel frozen in and decide not to take losses. In such circumstances, a moderate amount of System buying could stabilize the Government securities market but might not help other financial markets. However, for purposes of this part of the discussion large investor selling is assumed.

As securities are offered into the market in a disorderly situation--no matter who the ultimate sellers--intervention in some size by the official accounts would be beneficial in giving the markets a sense of direction and restoring their functioning. Hopefully, a timely intervention would involve the least expenditure of official buying power "ammunition." There can never be any assurances that official purchases can be kept to relatively moderate amounts. It may be that the best approach would be a prompt entry into the market as conditions threaten to become disorderly and before markets are in full disarray. However, to be realistic, the appropriate point for System intervention would be hard to decide and there could be a lag due to the reluctance to get involved in this kind of operation. Hopefully, the nature and timing of any intervention would be such as to minimize the risk that investors will become convinced they are being offered a nonrecurring opportunity to dispose readily of large blocks of securities.

The question of a "peg" would present itself at this point. Ideally, it would be desirable to avoid pegging prices at a particular level, but at the same time the market would probably require some price leadership. On the assumption that a "peg" is to be avoided, the official accounts might abstain from further intervention once the initial round of purchases was completed (and the dealers and most nervous investors had been relieved of their holdings). Conceivably, this abstention might last only so long as any additional price erosion remained relatively small or, if large, was not accompanied by any evidence of sizable investor selling. If a second stand were necessary, it would naturally be at lower prices.

An alternative approach would be to make relatively small cushioning purchases after the initial stand, if and as prices tended to drift lower. It is possible that this approach would be more effective than sizable buying at one level in terms of buying power required to achieve a reasonable degree of market stabilization. On the other hand, small purchases at declining prices might only stimulate the market to search for the lower level at which large System purchases would be made, thus hastening the price decline. In any event the effectiveness of alternate approaches would depend on market circumstances, and since a matter of tactics would be involved, final decisions would undoubtedly be left to the managers of the operation.

Operations in a Widespread Financial Market Breakdown

A crisis in Sterling could have so sharp an impact on all U. S. financial markets that operations in U. S. Government securities alone would be not an effective remedy. Indeed, the current technical condition of the U. S. Government securities market is such that it might be affected relatively less than other U. S. financial markets. Moreover, the shorter term maturity area of the Treasury market might actually be the beneficiary of a desire for liquidity in a period of crisis.

The corporate, municipal, and Federal Agency securities markets appear to be particularly vulnerable to any shocks to confidence at the present time and it is conceivable that activity in these markets would be virtually paralyzed in the event of a Sterling crisis. Some smaller underwriting firms, particularly in the municipal market, might very well be carried to financial ruin in the process. The flotation of new issues through public offering would probably have to be suspended for a time in both the corporate and municipal bond markets and perhaps in the Federal Agency market as well. It seems likely that the functioning of markets for shorter term issues would be less affected by a crisis, although some sharp interest rate advances might occur and markets for less liquid instruments might bear the brunt of the adjustment.

Role of the Federal Reserve. The Federal Reserve could do little by way of direct intervention in most of these markets. The Federal Reserve would be able to purchase certain short-term municipal issues (with remaining maturities of 6 months or less) and could also participate to some minor extent in the Agency market under present law. However, such operations would involve many new problems which ideally should be worked out under other than crisis conditions. For example, consideration would need to be given to the minimum credit standing of municipal securities acceptable for System purchases. Decisions would also have to be made concerning standards for dealers eligible to transact business with the System or perhaps eligible for direct System loans under Section 13(13) of the Federal Reserve Act.

Probably the most important type of support that the System could give to financial markets in a period of crisis would be to make use of general monetary policy tools. It should be noted that the types of support envisioned for the U. S. Government securities market in earlier sections of this memorandum might in themselves require at least a temporary easing of monetary policy. This would be true because of the potentially large purchases that might be required.

What is contemplated at this point, however, is the possible use of open market operations to relieve bank reserve positions for the purpose of alleviating a general market crisis. Banks would be placed in a much better position to absorb some of the panic selling which might develop and, perhaps even more important, the banks themselves would become less inclined to sell securities from their own portfolios. In addition, the banks would be able to extend credit to dealers and underwriters, thereby providing an essential basis for the continued functioning of the financial markets.

The risks inherent in an easing of over-all Federal Reserve policy with its associated expansion in bank reserves would admittedly be great in terms of the current objectives of monetary policy. There is in fact no assurance that the banks might not take advantage of the opportunity to expand their loans. Perhaps some official underscoring that the monetary ease resulting from market smoothing actions was to be temporary would help to minimize expansion of bank credit in the loan area. On the other hand, such an understanding might tend to defeat the attempt to instill confidence in the market. In the end, the policy decision of whether or not the accept the risks of an easier monetary posture would have to depend upon the nature of the financial crisis and the ad hoc judgment as to the most practicable means of assuring the continued functioning of financial markets.

A supplementary, if not alternative, means of providing emergency assistance to financial markets would be the discount window. Banks might be allowed to borrow from the window without prejudice to their over-all borrowing records, if the purpose of such borrowings was to assist dealers and underwriters. Other types of loans useful in restoring the viability of financial markets might include temporary warehousing arrangements to finance takedowns of new issues by institutional investors, whose commitments were running ahead of available funds, and banks might also be allowed to make short-term loans to necessitous borrowers who had temporarily postponed flotations in the capital or money markets. It is again evident that the sort of "pass through" financial assistance envisaged here would run the risk of facilitating undesired bank credit expansion, but under crisis conditions such a risk would undoubtedly be worth accepting. It should be recognized that the System discount function would become involved in the process of direct credit control and allocation, thus requiring special guidelines for discount officers.

Role of the Treasury. The Treasury might also play an essential, if more particularized, role in a widespread financial crisis. The Treasury would presumably participate in any direct official intervention in the U. S. Government securities market, but in addition the Treasury might accept some responsibility for the Federal Agency securities market. In this respect, the Treasury would have a double role to perform. First, it would have some control over the amount and timing of new Agency issues, including in particular FNMA participation certificates. While some new Agency borrowing would be difficult or impossible to postpone, total needs might be cut back and some of the funds could be provided directly by Treasury loans or by sales of Agency securities to some of the Government investment accounts. The size of the Treasury cash balances would be a limiting factor here, and while relief from this constraint might be found through

Treasury borrowing from the Federal Reserve, the debt limit might also emerge as a constraint. Secondly, the Treasury might play some role in the secondary market for Agency issues. The objective, it must be stressed, would not be to "peg" prices in this market but rather to relax any market knots through timely purchases. This might be accomplished by helping to relieve dealers of unwanted inventories and perhaps by ad hoc purchases of individual blocks of securities that were causing trouble in the market. One drawback to this type of operation lies in the possibility of political pressure to purchase securities of a particular Agency, whereas the most urgent market need might be in issues of another Agency.

The ability of the Treasury to provide assistance in the U. S. Government and the Federal Agency securities markets would be governed by the Treasury's cash position except to the extent that position might be augmented by direct borrowing from the Federal Reserve. Market borrowing could also bolster the cash position, but it is assumed that the crisis conditions would render such additional market borrowing very difficult. Bill roll-overs would already constitute enough of a problem. Treasury balances are expected to be drawn down fairly sharply in early September prior to the mid-month tax date, and to levels that would leave the Treasury with relatively little leeway for market operations or loans to Federal Agencies. After mid-September the balance builds back up to substantial levels until late October.

The Problem of Dealer Financing

A contribution to the continued functioning of the U. S. Government securities market under very trying circumstances might be made by assuring the dealers of a source of financing at something less than penalty rates. Indeed, the very assurance of "last resort" financing at some rate would have a constructive influence on dealers' willingness to continue making markets. It is also not inconceivable that major sources of dealer financing might freeze up altogether in the event of a Sterling crisis, especially if the crisis entails or occurs along with a serious bind in CD markets and with losses of deposits by major banks through outflows of funds from the U. S. to abroad.

Under present circumstances, some type of official financing arrangement could prove to be the least costly means of official intervention. On the other hand, in a truly crisis atmosphere, dealer willingness to make markets could be influenced more by their anticipations, and thus financing would be a decidely secondary consideration. Of course, the provision of dealer financing would not preclude other avenues of market support and in fact would probably accompany some form of direct intervention in the market.

There are several ways in which the financing of dealers might be arranged and three possible approaches will be considered at this point.

1. System Repurchase Agreements. The RP instrument has much to recommend it for present purposes, if it is assumed that it will be used to finance dealer needs as they arise rather than solely to satisfy System reserve objectives. Among the advantages of System RP's are their longstanding familiarity and their flexibility. They may be employed in varying amounts on relatively short notice. However, they are to some extent self-policing in the sense that they would be repaid when the underlying collateral is sold or alternative and cheaper financing is found. It may well be that System RP's offer the best prospects of assisting dealers in a crisis situation via the financing route.

It bears reiterating, however, that to be truly effective for the above purpose, the RP's would have to be made more at the dealers' initiative than at present in order to provide for timely financing assistance. This departure from current practice would, of course, complicate System open market operations, but the System would presumably retain some over-all control by setting a maximum line of credit for each dealer firm which would be scaled proportionately to the total sum the System was willing to commit at each stage of market development. The question of rate is important as a penalty rate would not help the dealers and an unduly generous rate would be inappropriate; a rate near the rates on the underlying securities would seem to be in order.

The effectiveness of System RP financing might also be enhanced by removing restrictions with respect to the maturity of the underlying collateral. In addition, consideration might be given to extending the collateral eligible for System RP's to all the securities that legally may be purchased by the System, including Federal Intermediate Credit Bank debentures due within six months and short-term municipal securities. Another policy decision, which would also contemplate a departure from current practice, would be whether or not to include the bank dealers among the recipients of this form of financing assistance. It may be argued that the bank dealers should be included on the grounds that they would be more willing to carry inventory and make markets. Otherwise, the bank dealers might be under strong pressure from their bank managements to minimize holdings during a very tight money market period aggravated by a financial crisis. Of course, any System financing of bank dealer departments might also be arranged through the discount window.

Perhaps the most important policy decision would be with regard to the total amount of RP financing or total lines of credit to be made available by the System. As a matter of principle, the dealers as a group would have to be able to carry enough inventories to continue making effective markets. It is not possible to state with any degree of accuracy how large such inventories should be, but recent levels of some $1.5 to $2.5 billion may be considered close to minimal. Obviously, a significant proportion of such inventories would continue to be financed by banks, corporations, and other investors with large amounts of day-to-day funds available for investment. Moreover, the System would not be expected to help finance any speculative bulge in dealer positions. In sum, a total "line of credit" of around $1/2 billion should be more than adequate, although the System might in addition stand ready to act as a lender of last resort at a penalty rate.

2. Formation of Treasury-FR financing pool. This type of dealer financing arrangement would differ from the one sketched above in that an effort would be made to keep the pool at a nearly constant level to avoid complicating other open market operations. Considerable administrative effort would be required to achieve this result. Also, the Treasury would provide a portion of the funds for the pool. In addition, the form of the financing might be a collateralized loan rather than a repurchase agreement.

While the inclusion of the Treasury in any such financing scheme might have some political advantages that need not be stressed here, there would be some complications for the Treasury in meeting legal requirements and in the management of its cash balances. At some point the Treasury would have to raise the necessary funds in the market.

In view of these and other complications involved, it might be preferable if the Treasury did not join such a pool but instead conserved its cash balances for any direct intervention in the market, including that for Federal Agency securities.

3. System use of matched purchase-sale transactions. The use of matched purchase-sale transactions would be a means of relieving dealers of their inventory for a period of time, or in effect financing such inventory. Whether this form of contract would have any advantages over RP's would depend upon the terms of the purchase-sale contract.

One potential advantage might be that the matched purchase-sale transactions could be designed so as to provide dealers with what in effect would be "neutral" financing. That is, the buying and selling prices of coupon issues might be identical, but the System would collect the accrued coupon interest on notes and bonds. In the case of Treasury bills, the difference between buying and selling prices would reflect a return to the System (for the number of days of the contract) equal to the market rate on the bills at the time of the initial System purchase. Under the above scheme, therefore, the dealers would continue to assume a market risk, but they would not face the added obstacle of financing at a negative carry.

Even the market risk could be removed, of course, by granting dealers the option of not honoring their commitment to repurchase the securities. Such an option would not be attractive from the System's standpoint for a number of reasons, and it might be desirable therefore to make the matched purchase-sale transactions of relatively short duration in order to minimize the chances that adverse market movements would induce some dealers not to honor their obligations to buy back the securities. The same argument might be applied to regular RP's, of course. In the same connection, some "margin" should be required in these contracts, as is already the case for regular System RP's.

An advantage of matched purchase-sale contracts over regular RP's, then, is that the former might be more readily designed to provide the dealers with "neutral" financing. On the other hand, the newness of this instrument might give rise to unforeseen legal and other difficulties. Both matched purchase-sale contracts and RP's might also be open to the charge that they involve a subsidy to dealers, given the current structure of money market rates and dealer financing costs. The bank dealers might be particularly vocal, if they were not afforded an opportunity to participate in such financing.

To summarize, the provision of funds to finance dealer positions probably should not be regarded as a complete program to help stabilize the U. S. Government securities market in the event of a Sterling crisis. Rather, such financing is conceived as an adjunct to more direct intervention in the market. Once some measure of stability is achieved, the availability of dealer financing on terms such as those described above could make an important contribution to the renewed functioning of the market until a more normal market environment is restored.

Organizational matters

In the event of a Sterling or other market crisis, a good deal of operational flexibility would undoubtedly have to be left to those managing rescue operations, including the Manager of the Trading Desk, perhaps the discount officers at the Reserve Banks, and also the Special Manager for foreign exchange operations. Nevertheless, day-to-day or even hour-to-hour developments involving broad policy questions might be subject to review by a specially designated emergency committee composed of members of the FOMC and Treasury officials. Current market developments would have to be dealt with by the Manager who has to take primary responsibility in this area. The emergency committee could be the basis for achieving the necessary coordination at the policy level between the various officials and bodies with ultimate responsibility--Secretary of the Treasury, Board of Governors, and FOMC.