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STRICTLY CONFIDENTIAL (FR)

TO: FOMC

FROM: Staff

SUBJECT: Contingency planning for the U.S. Government securities market.

This memorandum is focused on possible official actions to forestall or correct disorderly domestic credit market conditions in the event of a devaluation of the pound sterling or of other potentially destabilizing developments. Emphasis is placed here on short-run official action rather than on the longer range policies which might be appropriate as markets resume normal functioning and in light of domestic economic developments.

In recent years various staff memoranda distributed to the Committee have attempted to outline general approaches which might be followed in the event of a crisis affecting the U.S. Government securities market.[1/] The notes which follow are partly based on the general principles contained in the earlier material.

Crisis in sterling

It is always difficult to predict how domestic financial markets will react to potentially unsettling developments. The impact of a crisis in sterling is particularly hard to evaluate because it involves both domestic and international ramifications,

1/ See staff memoranda on contingency planning dated August 31, 1965 and especially that dated September 1, 1966. See also memorandum from Robert L. Cooper to Mr. Holmes, dated August 20, 1965 entitled "System Support Operation in September 1939."

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including the possibility of flight from the dollar by U.S. as well as foreign holders. While, as a practical matter, any official action would need to be geared to the evolving situation and ad hoc judgments would have to be made as to the best manner to deal with the particular manifestations of the crisis, it appears desirable to outline possible approaches that may serve as guides to day-to-day decisions.

Use of official announcements. A sterling devaluation would seem to call for some sort of Presidential announcement indicating that the over-all economic and financial policies of the Government were continuing on a steady course and that the devaluation was welcomed as a useful means of correcting the British balance of payments situations without putting undue upward pressures on interest rates. Such an announcement might tend to limit or even forestall adverse domestic market reactions. The markets could be further assuaged as the Federal Reserve, through its official spokesmen, followed the Presidential lead with more specific assurances concerning financial markets, including the availability of Federal Reserve resources, as necessary, to maintain orderly market processes.

Whether such announcements would have to be followed by market action would of course depend on the magnitude and threatening cumulative movement of initial market reactions. In its announcement it would be desirable for the System to preserve its flexibility of action by not indicating the exact nature and extent of any market intervention it may have in mind.

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Open market operations. Even though specific courses of action should probably not be divulged or even settled upon internally without provision for optional responses in the sort of fluid market atmosphere that might develop, it would seem desirable as a matter of principle to be prepared to react as strongly as is necessary to dispel any crisis atmosphere in the market and to return the market as quickly as possible to a more nearly normal footing. Questions of how much, if any, adjustments should be permitted in market yields would seem to be subsidiary to prompt and vigorous action designed to get financial markets over any initial irrational responses to a crisis. If general confidence in the viability of domestic financial markets can be restored within a few days, the question of appropriate market interest rate levels can then be faced and evaluated in terms of the longer-run objectives of monetary policy and needs of the domestic economy.

The specific maturity areas in which open market purchases might be necessary so as to blunt any cumulative upward rate pressures cannot be readily foretold. The most sensitive holders of dollar securities, including particularly foreign holders, may wish to sell and move into gold or some other currency deemed less likely to be devalued. The early reaction of such holders could be sharp, and not entirely subject to logic, or, for that matter, to prediction. Presumably every effort will be made to persuade official foreign holders of securities to refrain from liquidating dollar assets. But some selling is to be expected, if not by official holders, at least by private foreign investors.

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Private U.S. investors may also add to such selling pressures. In part this may be in the expectation that monetary policy will tighten in an effort to protect the U.S. balance of payments. But it might also be in fear of a follow-up devaluation of the dollar and thus could be accompanied by outflows of dollar funds to abroad, with consequent pressures on the gold price and our gold stock. It would seem useful under the circumstances to make every effort to assure at least large institutional investors that the latter eventuality is simply not either a possible or desirable alternative.

While assurances that the dollar will not also be devalued may take some immediate pressure off domestic interest rates, some holders of dollar securities will still wish to sell, and others, as noted above, may think monetary policy has no choice but to tighten. To forestall a cumulative rise in interest rates from the interaction of the behavior of those who lose confidence in the dollar and those who wish to hedge against the course of monetary policy, it may become desirable for the Account Manager to prevent U.S. Government security dealer positions from building up over the short-run, even if reserve provision has to be expanded fairly sharply. To do so, purchases may have to be made all along the maturity spectrum, depending on the nature of offerings to dealers. It may even be necessary to offer some assurances to dealers that the Fed will stand as a residual buyer through a transition period--that is, will not be reluctant to buy securities from dealers, though perhaps at a declining scale of prices. In this way, the market may continue functioning and price declines kept from cumulating sharply downwards.

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An even more positive approach might have to be taken if interest rate pressures were most marked outside the U.S. Government securities market--say, in the Agency or corporate market. Direct purchases of Agency issues, including participation certificates, may need to be contemplated. Direct action in the corporate bond market, apart from the question of feasibility, may not be necessary if the System becomes a willing buyer of U.S. Government coupon issues that are currently in dealer position and/or that may be offered in swaps for increasingly attractive corporate issues.

Domestic market reactions to a sterling devaluation would be particularly acute if the market were in process of absorbing a Treasury financing. The mid-November refunding seems already to have been largely absorbed by the market. Some of the new issues could still come into the market, however, and they would likely have to be purchased by official accounts in the circumstances. The Treasury balance will be running so low over coming weeks that the purchases might have to be made by the Federal Reserve. In general, the Treasury's ability to undertake or participate in any market support operations will be limited for several months to come by its tight cash position.

In providing support against falling prices in debt markets, it would be desirable not to set a rigid peg on prices. Initially, purchases might be made at close to existing market rates, but if selling by dealers and their customers was not thereby discouraged, further purchases might be made at a slowly declining scale of prices in an effort to encourage the market to generate its own buying support and thereby economizing in the provision of total reserves.

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During the crisis period, demands for short-term bills may prove strong, at least from domestic investors who are not fleeing from the dollar. This may give some room for sales of short-term bills by the Desk to offset reserves supplied by other purchases. Nevertheless, one would have to expect an enlargement in the supply of reserve funds over the short-run, an especially if the sterling problem develops within a few weeks when the U.S. financial markets are having to absorb large corporate, municipal, and PC issues and when the banking system and the money markets are affected by the peak December seasonal churning of funds.

Discount rate and Regulation Q. The System may wish to consider in such a period action with respect to the discount rate and Regulation Q. A significant devaluation of sterling could trigger a reflow of funds back into the pound from the Euro-dollar market as some foreign holders in effect take the profit on which they had been betting. Such a reflow could limit availabilities to U.S. banks, cause a reduction in their borrowings through branches, and force them to seek additional funds in the CD market. But with Treasury bill rates close to Regulation Q ceiling rates, banks are likely to be quite uncertain about their ability to roll-over Euro-dollars in effect in the domestic CD market.

Under such circumstances, and with domestic interest rates already under upward pressure, it would be desirable to consider an upward adjustment in

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Regulation Q ceilings, particularly for large CD's, as a way of moderating over-all credit market pressures. This would be a means of maintaining the flow of funds necessary to continued domestic economic expansion, but probably at a rising interest rate level.

A rise in Regulation Q rates could moderate a domestic credit crisis by providing assurance to banks that funds will be available at a price. At the same time, consideration might also be given to a rise in the discount rate, say by half a percentage point. Such a rise could bring the rate more into line with developing domestic interest rates. The need for such a rate increase may be greatest if a sizable outflow of funds from the U.S. to foreign financial centers or into gold develops, either because of a loss of confidence in the dollar or because of higher interest rates abroad, with a further upward move in British bank rate not inconceivable. A rise in the U.S. discount rate would then help bolster international confidence in the dollar and hopefully help to restrain dollar outflows.

From the viewpoint of domestic markets, a discount rate increase might at least clear the air and, in conjunction with other measures noted, contribute to the establishment within a short time of a viable rate structure. Once such a structure is established and the domestic credit markets have been restored to normal functioning, monetary policy will be in a position to implement its longer-run objectives--whether for higher or lower interest rates, less or more credit expansion.

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The discount rate question is a highly delicate one, however, involving domestic as well as international considerations. It may be that such a move should await consideration in terms of the longer run trend of monetary policy, assuming that a flight from the dollar does not compel immediate action.

Market crisis generated by domestic pressures

The comments made in this section are directed to disorderly market conditions caused by strictly domestic pressures that might result from a continued erosion in bond prices and market confidence. At some point, loss of confidence could erupt into an accelerated pace of market decline, with the market becoming disorderly as falling prices failed to generate any cushioning market demand. Perhaps the key consideration here is not so much the extent of any previous bond market decline or current level of prices and yields, but the tendency for such bond price erosion to accelerate and dealers or investors to become less and less willing to take a stand at any level.

It should be pointed out at the outset that the System Account Manager already possesses the authority to take measures to counteract threats of disorderly market conditions. While timely marginal intervention in this regard could go a long way toward heading off actual market disarray, stronger medicine may at some point be required. At this stage a basic decision may need to be made about whether or not to "peg" the market and whether or not to accept the vast provision of reserves that pegging could require.

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The previous memoranda have taken the position that actual pegging should be avoided except as a last expedient.[2/] This still appears to be the appropriate posture in general. Some interest rate increase should be permitted so as to encourage the market to achieve its own equilibirum. However, if rates rise to the point where confidence about future credit flows on the part of savings institutions and borrowers begins to disintegrate, the System should probably hold an interest rate structure for a time regardless of the extent of reserve creation. But this is obviously an emergency posture, and if interest rates do not retreat or institutions make other adjustments, consideration may have to be given to longer run measures, such as Regulation Q adjustments or some sort of credit controls.

Less extreme measures than almost unlimited reserve provision (assuming the market has not already degenerated into actual disorder) might include some of the following: A first step might be an official re-affirmation of the position already taken before Congress by Chairman Martin who indicated that the Federal Reserve will not permit disorderly conditions to develop in debt markets. Second, the Desk might undertake to purchase troublesome blocs of securities (bonds or bills) which might otherwise be thrown onto the market at virtually any price. Third, the System might stand ready to purchase other

2/ See August 31, 1965 memorandum, pp. 2, 5-7, and September 1, 1966 memorandum pp. 4-5, 8-9.

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securities at a declining scale of prices to the extent necessary to prevent day-to-day price erosion from accelerating, but without actually "pegging" a level of prices. Fourth, Treasury and System officials might attempt to exercise some "moral suasion" on major investors and dealers. Fifth, to the extent possible, purchases of longer-term securities might be offset by sales of shorter term to minimize reserve effects. This last point assumes that investors will be tending to divert their funds to the shortest and most liquid market instruments, thereby making swaps possible.

The above considerations are addressed directly to the redress of the Treasury securities market. It may be that a wider approach may become necessary at some point, or may be pursued simultaneously. For example, some Federal Reserve support might have to be extended to the Agency market, additional financing made available to dealers, and efforts made by public officials to persuade large corporations and state and local governments to adjust their capital market borrowing schedules in the interest of orderly absorption of their credit demands by the market.