BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

May 1, 1969.

To: Federal Open Market Committee

From: Mr. Holland

Enclosed for your information is a copy of a memorandum from Mr. Axilrod to the Steering Committee of the U.S. Government Securities Market Study, dated April 30, 1969 and entitled "Governor Maisel's memorandum to FOMC on U.S. Government Securities Market Study." This memorandum has been prepared pursuant to the discussion at the Committee meeting on April 29, 1969.

Robert C. Holland, Secretary
Federal Open Market Committee.

Enclosure.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 30, 1969

To Steering Committee of U.S. Government Security Market Study

From S. H. Axilrod

Subject: Governor Maisel's memorandum to FOMC on U.S. Government Securities Market Study

Governor Maisel's memorandum suggests, among other things, the careful editing of the Government Securities Market Study, particularly with respect to Federal agency issues, before publication. The editing would attempt to make clear that the report is discussing mainly the performance of the Government securities market and not over-all monetary policy objectives of the Federal Reserve. There are ambiguities in the report in that respect, and some editing could reduce the potential for public misunderstanding.

With respect to the section on agency issues, this can be accomplished in the following way:

(1) Eliminate the last sentence of paragraph 1 on page 95.

(2) Eliminate paragraphs 2 and 3 on pages 95 and 96.

(3) Add the phrase ". . . from the point of view of market functioning." to the first sentence of paragraph 8, page 99.

(4) Eliminate the first sentence of paragraph 1 of the Conclusions on page 101. In the second sentence of that paragraph, change the phrase "the achievement of System reserve objectives." to "the ability of the System to alter the supply of reserves in the market."

(5) The second sentence of paragraph 5 of the Conclusions which reads "Thus, the Federal Reserve should undertake a periodic review of the desirability and feasibility of conducting outright operations in Federal Agency securities." might be changed to read "Moreover, the Federal Reserve should keep under review the desirability and feasibility of conducting outright operations in Federal Agency securities in light of the over-all objectives of System policy."

These suggested changes are noted in the attached excerpt from the Government Securities Market Study.

The paragraph on Agency issues on page 13 of the summary section of the report would also be edited to be consistent in language with the above suggestions. This would mean that the first and third sentences of that paragraph would incorporate the modifications noted in paragraphs (4) and (5) above.

Absent any further comments within the next week, I would assume we can proceed with publication on this basis.

Attachment

(3) Some suggestions cannot be considered feasible, such as "go-arounds" on all orders, placing orders with dealers on a rotating basis, and forfeiture of the right to operate at certain times, e.g., before Treasury bill auctions.

Federal Reserve outright transactions in Federal Agency issues

Considerations:

(1) The Federal Reserve now makes repurchase agreements against Federal Agency issues under authority of the amendment to the Federal Reserve Act that permits the System to buy and sell in the open market any obligation which is a direct obligation of, or fully guaranteed by, any Agency of the United States. This amendment was originally passed for a one year period in September 1966, and has subsequently been periodically renewed. [In view of the permissive legislation and the development of the Agency market, consideration needs to be given as to whether Federal Reserve outright transactions in Agency issues, including FNMA and Export-Import Bank participation certificates, would further System objectives, help to develop a broader Agency market, and enhance public policy objectives generally.]

[(2) Among the more important market reasons advanced for System outright operations in Agency issues (including PC's) are: (a) such issues are in effect debt of the U.S. Government, are in practice as risk-free as direct U.S. Government debt, and therefore should be treated on the same basis as direct Treasury debt by the Federal Reserve; (b) a willingness by the System to undertake outright transactions in all Agency issues, on a limited basis, would increase the marketability of the issues, would tend to place Agency issues on a more common footing with direct debt of the Government, insofar as investors are concerned, and would reduce somewhat the interest rate spread between Agencies and direct Federal debt; (c) Agency issues are sometimes in such large supply, relative to market demand, that they lead to over-all credit market pressures which might be most expeditiously moderated through Federal Reserve operations in the Agency market; (d) such operations may at times provide a degree of needed support to areas, such as housing, that might be under undue temporary pressure; and (e) Agency issues may be a useful supplement to open market operations in direct Treasury securities at times--when, for example, the floating supply of Treasury issues is temporarily thin.

(3) Among the more important problems likely to be encountered by System outright transactions in Agency issues are: (a) the small denominations and trading market for many individual Agency issues; (b) the risk of uneven and disproportionate price effects from System operations in particular Agency issues; (c) difficulties in choosing Agency issues to buy or sell, given the frequency of new offerings (averaging about 4 per month) and the desirability of not supporting the market for particular Agency issues; and (d) difficulties of rolling over holdings of Agency issues once these became sizable relative to the System portfolio and to the size of new Agency offerings.

(4) The capacity of the Agency market to absorb System operations, while not becoming dominated by such operations, depends broadly on

the over-all size of the market, the size and market availability of individual issues, and the nature of trading activity. Indicators of market performance that bear on those points show that the over-all market has expanded in breadth and depth in recent years, and in the short-term area as a whole (within one year) appears comparable to, or even more active than, the short-term Treasury coupon market. At the same time, however, the Agency market has many more individual issues, the issues are much smaller in size, and large market transactions in particular issues are thus often more difficult to execute than in the Treasury coupon area. A good deal of the trading activity in the Agency market is accounted for by the frequency of financings, but activity in short-term issues outside of financing periods holds up fairly well and has grown in recent years.

(5) Dealer positions in Agency issues (including PC's) have increased markedly since the early 1960's, with the increase reflected both in issues maturing within and beyond a year. Net dealer positions averaged about $114 million in 1961 and $365 million in 1967. About one-third of net positions in 1967 was in securities maturing in over one year. The average level of positions in Agency issues fluctuates widely, and shows characteristics not very different from positions in Treasury coupon issues.

(6) The rise in dealer positions and transactions in Federal Agency issues largely reflects the increase in the supply of Agency debt,

with outstanding Agency issues (including marketable PC's) held by the public rising from around $8-1/2 billion in mid-1960 to around $23 billion at the end of 1967. As of the latter date, issues maturing in a year or less amounted to about $11 billion, and in over a year to $12.0 billion; nearly half of the latter were marketable PC's. (By way of comparison, outstanding Treasury coupon issues maturing in a year or less held by the public at the end of 1967 totaled $17.9 billion, and those maturing in over a year totaled $91.5 billion; bankers' acceptances outstanding amounted to $4.3 billion).

(7) A critical question is whether the data on the Agency market are indicative of the size and activity of a single basically homogenous market or whether there are really several smaller markets for various types of Agency issues. (As with other markets there are differences by maturity of issue, with the longer end, as earlier noted, less active than the shorter end and attractive to different investor groups). The evidence gathered appears to indicate that the Agency market is fairly homogenous. There are rather small yield differences as between issues of similar maturity of the various Agencies; that is to say, a rather smooth yield curve can be traced utilizing various Agency issues, just as a relatively smooth yield curve can be derived from Treasury coupon issues. With respect to how investors may view Agency issues, the ownership data (using data for the nonguaranteed issues of the five major Agencies) indicate that investor groups do not appear to show any very significant preferences for one Agency as against another (with the exception of the relatively greater

preference of nonbank financial institutions for Federal Home Loan Bank issues, presumably due to the holdings by savings and loan associations of such issues)--although, of course, some investor groups have a larger proportion of Agency issues taken together than do others.

(8) Dealers were divided in their views as to the desirability of Federal Reserve outright transactions in Agency issues from the point of view of market functioning. A major argument of those who advised against such transactions was the probability that strong political pressures might develop for the support of particular issues or financings. Some dealers, in fact, attached great weight to this consideration, both in its implications for the System's continued ability to conduct open market policy in an environment relatively free from day-to-day political pressures and in its implications for the viability of the Federal Agency market itself. Some dealers also stressed the possibly disturbing impact on the secondary market of relatively large and, by nature, discontinuous Federal Reserve operations.

On the other hand, a number of dealers felt that the short-term sector of the Agency market could accommodate, on both the buy and sell sides of the market, more than token Federal Reserve transactions, although not all of such dealers favored the transactions. Dealers who did recommend such operations thought they would enhance the prestige of the Federal Agency securities market, stimulate investor activity in such obligations, and tend to lower interest rates on Agency issues and bring them into closer alignment with yields on U.S. Government securities. Some small-scale outright transactions in the Agency market have been undertaken by the Desk acting for Treasury investment accounts, but thus far the great bulk of acquisitions of Agency issues and PC's by these accounts has been directly from the issuers.

(9) Under present circumstances, operational difficulties would be encountered by the Trading Desk in executing transactions for System Open Market Account. The size of individual Agency issues is generally quite small in comparison with Treasury coupon issues,[1/] and as a consequence the amounts of individual issues that can be readily bought or sold in the secondary market tend to be correspondingly limited. An attempt by the System to conduct transactions in the amounts that are customary in Treasury coupon issues--and meaningful from the standpoint of System objectives--could therefore have a disproportionate impact on prices and yields in the Agency market. The availability and size of Agency issues would make it most difficult for the System to undertake more than token operations if undue market dominance is to be eschewed. In addition, because of the frequency of new Agency offerings there are limitations on the timing of operations if the System is to avoid having an undue influence on the marketing process for individual Agency issues. Total new offerings of the five major Agencies (Federal Land Banks, Federal Intermediate Credit Banks, Banks for Cooperatives, Federal National Mortgage Association, and Federal Home Loan Banks) average about four each month and there are in addition periodic offerings by other Agencies, including FNMA and Export-Import Bank participation certificates.

1/ The average size of an Agency issue is about $300 million compared with $2-1/2 billion for the typical Treasury coupon issue.

Conclusions:

(1) System open market operations must, of course, be conducted with a view to the furtherance of the monetary and credit policies of the Federal Open Market Committee. At the present time and under current market circumstances, outright operations in Federal agency securities would not facilitate, in any material way, the ability of the System to alter the supply of reserves in the market. ~~the achievement of System reserve objectives.~~ Purely technical operational difficulties, noted above, would seriously limit the size, scope, and opportunities for such transactions. Moreover, the frequent marketing of new Federal agency issues would considerably reduce opportunities for meaningful operations without undue influence on the market's appraisal of and absorption of the new issues. The System would also encounter technical difficulties when its holdings of particular agency issues matured unless special arrangements were made with the agencies for their replacement. The problem has been overcome in the case of direct Treasury debt where facilities exist for the automatic roll-over of Treasury notes and bonds held by the System and where bidding is feasible for a desired amount of new Treasury bills to replace maturing issues.

(2) A broadening of market instruments for the conduct of open market operations is in itself a worthwhile objective for the longer run, provided that operational difficulties can be resolved. It is doubtful, however, that marginal outright transactions in Federal agency issues would make any real contribution at the present time to the effectiveness of open market operations in supplying or absorbing bank reserves, given the large current and prospective market availabilities of direct Treasury debt.

Continued growth of the Federal Agency securities market, both absolutely and relative to the Treasury market, would of course counsel a reexamination of this conclusion.

(3) It is not clear that occasional and marginal System operations in Agency securities would significantly improve the functioning of the Agency market. Sizable, frequent, and significant System operations in Agencies could under current circumstances tend to exert a dominating influence on the Federal Agency market, giving rise to uncertainties and perhaps to false hopes which would be hard to dispel. The result might be to inhibit the market's continued development by impairing its functioning as a free, self-reliant, and effective mechanism for executing transactions.

(4) System operations in Agency issues would be made more attractive and feasible if the variety of Agency issues were reduced and especially if individual Federal Agencies were to consolidate their new issues into fewer but larger offerings, possibly under the aegis of a single marketing agent that distributed the funds raised to the individual Agencies. Such a development would tend to make Agency issues available in larger and more tradeable blocs and thereby facilitate more sizable transactions without marked effects on market quotations. Moreover, the frequency of Agency financings could be reduced as could the potential periods of System inactivity in this market. In general, the problems raised by the multiplicity of Agency securities and the allocation of System transactions among them would be eliminated.

(5) It is recognized that market conditions could develop--for example, as a result of further growth in the Agency market, the development of less frequent and larger Agency issues, or the availability of a large floating supply of Agency securities--which might make outright operations in Agency issues in the market by the Federal Reserve appear more desirable. Moreover, ~~Thus,~~ the Federal Reserve should keep under ~~undertake a periodic~~ review ~~of~~ the desirability and feasibility of conducting outright operations in Federal Agency securities in light of the over-all objectives of System policy. Meanwhile, the System should continue to make repurchase agreements against Federal Agency securities. Such Rp's, which were first undertaken in late 1966, have proved to be a useful supplement to regular Rp's against direct Treasury obligations, given the sometimes limited collateral immediately available to nonbank dealers and the System's need for large transactions. Moreover, repurchase transactions are not subject to the operational problems involved in outright purchases or sales outlined above.