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

January 7, 1972

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Broida

Enclosed is a copy of a memorandum from the System Account Manager dated today and entitled "Rate on System Repurchase Agreements." It is contemplated that this memorandum will be discussed at the meeting of the Committee on January 11, 1972.

Arthur L. Broida

Arthur L. Broida,
Deputy Secretary,
Federal Open Market Committee.

Enclosure

CONFIDENTIAL (FR) January 7, 1972

To: Federal Open Market Committee Subject: Rate on System Repurchase Agreements.

From: Alan R. Holmes

On December 23, 1971, the Federal Open Market Committee voted to suspend, until close of business on the day of the next meeting of the Committee, the lower limit on the repurchase agreement rate employed by the Federal Reserve Bank of New York as specified in paragraph 1(c) of the continuing authority directive. As you know, that lower limit is (1) the discount rate of the Federal Reserve Bank of New York at the time the repurchase agreement is entered into, or (2) the average issuing rate on the most recent issue of three-month Treasury bills, whichever is lower.

The purposes of this memorandum are (1) to review operating experience during the period in which the limit has been suspended, (2) to recommend continuation of the suspension for a further brief interval, and (3) to recommend that the staff be instructed to prepare a report directed to the question of whether an amendment of the provisions of the continuing authority directive with respect to rates on RP's might be desirable.

Operating experience under suspended limit

The reason for recommending a suspension in the long-standing rule in the Committee's continuing authority directive in late December was the unusual combination of prevailing market rates. Ordinarily, the three-month bill rate is sufficiently low in relation to prevailing rates on dealer financing so that a Desk repurchase rate as low as the last three-month bill rate could prove reasonably attractive to the market. In recent days, this has not been the case. Dealer financing rates have been particularly low because of a plethora of very short-term money available from various lenders, notably corporations, Federal agencies, and State and local governments.

Treasury bill rates, until very recently, had been low in relation to other short-term rates as a result of persistent foreign account buying. In the most recent period, however, Federal funds rates were encouraged by Desk action to move lower, in line with the Committee's wishes, and Treasury bill rates did not immediately follow a parallel downward course, perhaps because of market apprehension about a possible huge reflow of bills from abroad. Thus, three-month bill rates were, for a time, above the prevailing Federal funds rate and even further above the levels at which non-bank dealers have been able to accomplish much of their day-to-day financing.

A further background consideration was that short-term repurchase agreements appeared to be the most appropriate way to supply reserve needs while awaiting the widely expected sell-off of Treasury bills by foreign accounts in the wake of the re-aligned currency parities. For the Desk to have bought heavily in the market on outright basis, in order to supply a comparable amount of reserves, would have risked setting up the market for a major "whipsawing" once the heavy foreign selling developed. Thus, it was deemed far preferable to meet a substantial proportion of reserve needs on a temporary basis while keeping room in the System's portfolio for purchase of some of the bills from foreign accounts. Moreover, given the size of the reserve needs on certain days, repurchase agreements offered the only feasible means to accomplish the Committee's objectives.

On Wednesday, December 22, when the money market began to firm up shortly after noon, the Desk sought to make repurchase agreements at 4.05 per cent--which was about as low a rate as could be offered under the rule in the continuing authority directive. (The three-month Treasury bill rate had been established at 4.023 per cent in the preceding auction.) Dealers had already met most of their financing needs at rates around 3-3/8-3-3/4 per cent, and because of both the higher rate and the fairly late hour, the Desk could arrange only $15 million of repurchase agreements. Had the demand been there, the Account Management would have been willing to make $400 million or so of repurchase agreements.

On Thursday, December 23, with the lower rate limit temporarily suspended, the System offered repurchase agreements at 3-3/4 per cent. Dealers had been finding money at 3-1/2-3-3/4 per cent. With a more competitive rate and an early entry in the day, the Desk arranged $262 million of agreements--still somewhat short of the desired $400 million or so, but a much better outcome than on Wednesday. Again on Monday, December 27, dealers were finding money at 3-1/2-3-3/4 per cent and the Desk arranged $203 million of repurchase agreements at 3-3/4 per cent--which was short of the desired $400 million or so, but clearly better than could have been done without the newly provided rate flexibility.

On Tuesday, December 28, with reserve projections indicating some need for additional reserves, although Federal funds were trading comfortably at 3-3/4 per cent, the Desk offered repurchase agreements at 3-5/8 per cent. A total of $299 million was arranged, which was about in line with the Desk's objectives that day. The further reduction in the rate that day was deemed necessary in light of the fact that over-all dealer needs were fairly moderate and they were finding money readily at rates around 3-1/2-3-5/8 per cent.

The next day--Wednesday, December 29--the money market began to firm rapidly while revised reserve data indicated a very large reserve need. The dealer need was moderate and it appeared that some of it was starting to be met at rates around 3-1/2-3-5/8 per cent. In these circumstances the Desk entered the market early in order to arrange a large volume of repurchase agreements and the rate was kept at 3-5/8 per cent to insure its continued competitiveness. As the funds market continued to tighten, dealers were asked to round up customer collateral for repurchase agreements. A record total of $2,543 million of repurchase agreements was arranged that day. Member bank borrowing nevertheless bulged to $1,339 million on the day, and Federal funds traded at an effective rate of 5 per cent.

During the period from December 18 through December 29, the Desk had also bought about $418 million of bills from foreign accounts on an outright basis, although the bulk of the reserve provision was through repurchase agreements while awaiting the development of anticipated foreign selling.

On Thursday, December 30, facing a large projected reserve need, and a firm money market, the Desk bought $266 million Treasury bills outright, mainly in the market, and arranged $1,414 million of new repurchase agreements. This time the agreements were made at 3-3/4 per cent, up 1/8 per cent from the previous day, and incidentally a shade over the latest three-month bill-issuing rate (3.731 per cent). The dealers were finding some financing elsewhere at rates as low as 3-1/2-3-5/8 per cent, but in the firmer money market of the preceding and current day a 3-3/4 per cent System rate was deemed reasonably competitive.

No new repurchase agreements were made on December 31, but the System bought $156 million of bills outright from foreign accounts.

On Monday, January 3, money market conditions opened considerably firmer than desired and the Desk provided reserves through making $1,181 million of overnight repurchase agreements, again at 3-3/4 per cent.

Recommendation for Continuation of Temporary Suspension

It is anticipated that over the next several weeks, the same elements may be present in the market that made it desirable to suspend the lower rate limit on repurchase agreements in the recent period. Specifically, there may well be a need, in carrying out Committee decisions, to encourage easier money market conditions at the same time that Treasury bills might be under some upward rate pressure from either the threat or the actuality of foreign account selling. Accordingly, I recommend that the current suspension remain in effect through the close of business on February 15, the date tentatively set for the next meeting of the Committee.

Recommendation for Study of Repurchase Rate

Looking further ahead, it is suggested that further study be given to the question of the repurchase rate, perhaps through a staff committee. Such a committee could develop recommendations on whether to retain the long-standing rule in the continuing authority directive or to consider other options that might provide additional flexibility to the Account Manager on a more permanent basis, or that might provide for a competitive determination of repurchase rates which in effect lets the market decide the rate.

For example, among the options that might be studied would be:

(a) Permanent removal of the lower limit now contained in the continuing authority directive.

(b) Inclusion as an additional criterion of the lower limit the average effective Federal funds rate in a recent specified period.

(c) Inclusion as an additional criterion of the lower rate limit the prevailing Federal funds rate.

(d) Removal of the lower limit, along with specification that repurchase agreements be offered to dealers on a competitive basis.

There are, of course, variations of the foregoing that could also be considered. Option (a) above, permanent removal of the lower limit, would appear to offer maximum flexibility to the Account Manager to charge whatever rates appear desirable in light of the Committee's reserve or other objectives. The Committee might nevertheless wish to have an informal understanding" about the range of rates the Manager would plan to use, just as there has been an informal understanding in recent years that the Manager would not use a rate above the discount rate without prior communication with the Committee. The informal lower limit might, in addition to the discount rate or bill rate, be something akin to the current understanding that the Manager would not plan to use a rate below the bottom end of the Federal funds rate range specified at the last Committee meeting without prior notification to the Committee.

Options (b) and (c), inclusion as additional criteria of the lower limit the average effective Federal funds rate in a recent period, or the prevailing Federal funds rate,' would give some additional flexibility compared to the present continuing authority directive. However, these options would not have provided sufficient flexibility to have permitted the Manager to use the repurchase rates actually employed on some of the recent days described above.

Option (d), calling for competitive bidding for repurchase agreements, would represent more of a break with the past techniques. In letting the rate be set by market forces, it would remove or tone down "announcement effects" of particular repurchase rates. It would also remove or reduce the "subsidy factor" that emerges in periods of credit restraint when market rates of financing are well above the discount rate. On the other hand, the availability of some assistance to the dealer community through repurchase agreements at the discount rate has sometimes been helpful in keeping the securities markets functioning in periods of stress. Also, under a competitive procedure, the System would lose control of the repurchase rate which might interfere with other objectives of the Committee.