REPORT ON OPEN
MARKET OPERATIONS

Reporting on open market operations, Mr. Sternlight made the following statement:

Desk operations fostered a gradual firming of money market conditions during the period since the last meeting of the Committee, in response to growth in monetary aggregates that substantially exceeded Committee objectives. This excessive growth began to appear quite shortly after the July 19 meeting, but the Desk temporarily retained the previous 5 3/8 percent Federal funds rate objective while awaiting further clarification of data for the July 20 week, which might have been distorted in the aftermath of the power blackout in New York. By the final days of July it seemed clear that excessive monetary growth had indeed occurred and that little of it could be attributed to special factors. With the Treasury about to begin auctioning some $6 billion of intermediate- and longer term issues, it was important that the Desk indicate quickly and clearly the System's modified stance. Accordingly, the Desk aimed at firmer money market conditions on July 27 and 28--seeking a funds rate around 5 5/8 percent. Market participants, perceiving the strong growth in aggregates and noting the Desk's actions, pushed the funds rate even further than the Desk intended at that point, producing trading at 5 3/4 percent or a shade higher by Friday, July 29. Given the strength of the aggregates and with the Treasury auctions coming up on August 2 and 4, it could have been misleading to the market for the Desk to push the rate back down to 5 5/8 percent, so the Desk followed the market's lead and aimed at a 5 3/4 percent funds rate starting

August 1. This was the top of the funds range specified at the July meeting. The actual rate averaged 5.80 percent in the week of August 3. The Treasury nevertheless found excellent interest in bidding for its issues at rates only a little higher than had been anticipated before the funds rate moved up.

By August 4, further evidence suggested even greater strength in the aggregates. The Chairman recommended raising the upper bound on the funds rate to 6 percent, with the additional leeway to be used gradually and cautiously, bearing in mind the Treasury financing for which the auctions had just been completed, and also taking account of whether further incoming data continued to point to substantially excessive monetary growth. A majority of the Committee concurred in this recommendation. For a few more days the Desk continued to aim for a funds rate around 5 3/4 percent, while the market digested the Treasury offerings. Actual trading averaged 5.70 percent in the week ended August 10, pulled down by some unpredictably low rates on the final day of that week. By that same date--August 10--supported by confirming evidence of outsize monetary growth, the Desk began seeking a funds rate of 5 7/8 percent, and by August 12 a rate of 6 percent. With market factors tending to provide more reserves than projected, and banks making greater recourse than expected to the discount window, actual funds rates continued to lag slightly behind Desk intentions, although by yesterday market participants seemed to have a pretty good idea of the System's 6 percent objective.

The great bulk of Desk activity was in repurchase agreements and matched sale-purchase transactions during the period, mainly to supply reserves from late July up to August 2, and then to absorb reserves as Treasury balances fell off. Some $118 million of bills were bought outright in late July from foreign accounts, while $176 million was sold to those accounts in early August. In the last few days, the System has again purchased about $450 million bills from foreign accounts to meet reserve needs ahead. Given the timing of reserve needs, adjustments of rate objectives, and the ongoing Treasury financing, there was no suitable opportunity to purchase coupon issues during the period since the last meeting, although there may be such opportunities in the period ahead.

Money market rates adjusted higher during the past month as the funds rate rose, but the process went remarkably smoothly and with gradually diminishing effect on intermediate- and longer term maturities. Three- and six-month bills were auctioned yesterday at 5.67 and 5.98 percent, up from about 5.21 and 5.49 percent just before the last Committee meeting. Two-year Treasury issues rose about 35-40 basis points over the interval, while in the 5-7 year area the increase was about 25 basis points, and for long-term bonds it was about 7-10 basis points. Yields on long-term corporate and tax-exempt issues were up even less than that. There may have been more impact on stock market prices, however,--although other factors were also at work there--

with broad indexes off about 3 percent over the period, and the Dow Jones industrials off about 5 percent.

The modest size of adjustments in intermediate- and longer Treasury issues, in the face of higher money rates and increased Treasury supplies, reflected the low level (in fact a sizable net short position) in dealer holdings of coupon issues as the period began, and sustained investor demand as the period progressed. This permitted dealer takedowns in the auctions to be distributed quite handily. The short position at the start of the period was not surprising, given the upcoming financing and expectations of higher rates. Remarkably, the dealers continued to show a small net short position in coupon issues even just after taking their auction awards into position. Some of the demand in the market has come from foreign official accounts as their dollar holdings have continued to mount. By last Friday, dealers holdings of coupon issues over one year to maturity showed a net short of $1.1 billion, compared with $600 million just before the last meeting.

Finally, I should report that the Desk began trading with two additional dealers at the beginning of August--Lehman Government Securities and Paine Webber. This brought the number trading with the Desk to 33, while the number on the reporting list remained at 34.