REPORT ON OPEN
MARKET OPERATIONS

Mr. Sternlight made the following statement:

During the first three weeks of the period since the last meeting of the Committee, the Desk continued to seek reserve conditions consistent with the Federal funds rate remaining around the 6 percent level reached shortly before that meeting. Growth in the aggregates during those weeks was seen as being fairly high in the specified range for M_1 (though close to level that the staff had anticipated before the meeting), and around the middle of the range for M_2. By September 8, however, the Board staff's projections pushed above top of the range for M_1 and well into the upper part of the range for M_2. This strength was not yet evident in the New York staff projections. The Desk began to seek slightly firmer conditions, with a view to approaching a 6 1/8 percent funds rate by mid-September if additional data tended to confirm the Board staff view. The subsequent information did provide that confirmation, with an average of M_1 and M_2 estimates pointing to growth very close to the top of the combined range, though still within it, and in the last few days the Desk has sought to achieve a funds rate around 6 1/8 percent.

Market perceptions of this small change are not yet quite clear. The Desk acted overtly to drain some reserves from the market on September 9, when funds appeared to be comfortably available at 6 percent, and many market participants jumped to the conclusion that a new objective was probably being established around 6 1/4 percent. Funds trading quickly moved to the 6 3/16 -

6 1/4 level on September 12 and 13. The Desk promptly supplied reserves at those levels, and the funds rate backed down, leaving some observers with a view that no change had really been intended, others feeling that there had been a very temporary objective of 6 1/4 and then a retreat from it, and still others concluding that a modest move to 6 1/8 percent was sought. By yesterday it appeared that the latter group was becoming predominant, though some uncertainty remains.

Desk operations were somewhat different from usual in the past month because of the heavy build-up in member bank borrowings in the latter weeks of August. In effect, that source of reserves replaced the usual need for Desk outright purchases and repurchase agreement injections in the first half of the intermeeting period. The high level of borrowing, which emerged in the wake of a widened spread between the discount rate and the funds rate and imminent expectations of a rise in the discount rate, was a complicating factor in the day-to-day execution of policy as there was much uncertainty as to how high borrowing might go each day. Once the discount rate was raised, borrowing receded to more moderate and predictable levels. Repurchase agreements were not employed extensively until near the end of the period when they were used to help guide the funds rate to the desired range. Matched-sale purchase transactions were executed each day with foreign accounts, and on a number of occasions in the market, especially in early September when the usual drop in Treasury balances provided surplus reserves.

On an outright basis, System holdings of bills were up by a modest $124 million as purchases of around $725 million were largely offset by sales and redemptions. Near the end of the period the System bought $500 million of Treasury coupon issues--the first purchase of coupon or agency issues since June. This purchase gets a start on meeting the exceptionally large reserve need projected for the statement week beginning next Thursday--close to $7 billion. Some additional outright purchases will help to meet this need but the bulk of it will have to be done with repurchase agreements.

Market interest rates tended lower over the first few weeks of the period as participants took some comfort from the slower growth of monetary aggregates, the leveling out of the funds rate at 6 percent, encouragingly small price increases and the mixed bag of economic news that suggested a slowing in real growth. Against that background the rise in the discount rate announced on August 29 caused barely a ripple in the markets. About a week later, however, when publication of a large weekly increase in the money supply was followed by Desk action that appeared to be aimed at firmer money market conditions, securities prices declined for several days, though steadier footing was regained as the period came to a close. On balance, rates declined about 8 - 15 basis points on most issues due in over 2 years, were about unchanged for 1 - 2 year issues, and rose up to about 30 basis points on the shortest maturities.

Dealers moved from a deep net short position in over-1-year issues a month ago to a modest net long position in early

September, but then reverted to a net short position in the last few days as they appraised the possibilities for a firmer policy stance. Treasury sales of 2- and 4-year notes, raising $3 1/2 billion from the public, were readily distributed. A particular boost to note sales in the 2-year area has been provided by foreign purchases, especially by the Bank of England.

The rise in short rates near the close of the period partly reflected increased market supplies as the Treasury sold bills to cover the cash low point in early September; the rise also reflected reaction to the increased money supply growth and market perceptions or anticipations of a firmer System policy stance. Three- and six-month Treasury bills were auctioned yesterday at average rates of about 5.85 and 5.98 percent, respectively up 18 basis points and about unchanged from rates the day before the last meeting. Tomorrow, the Treasury will sell about $3 billion 2-year notes to refund a like maturing amount. Early rate talk is around 6.70 percent, little changed from the 6.68 percent yield on a similar maturity auctioned a month ago.

Like the longer Treasury issues, corporate and tax exempt bonds have also undergone some net yield decline since mid-August. The calendar of new offerings has picked up a bit seasonally, but appears to remain readily manageable while investors are reported to be maintaining a good appetite.