BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
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May 9, 1978

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida CHB

Attached is a copy of a memorandum from Messrs. Axilrod and Sternlight, dated May 8, 1978, and entitled "Proposed System Account Sales of Federal Agency Securities."

This memorandum will be considered at the FOMC meeting on May 16, under agenda item 6.

Attachment

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May 8, 1978

TO: Federal Open Market Committee

FROM: Stephen H. Axilrod and Peter D. Sternlight

SUBJECT: Proposed System Account Sales of Federal Agency Securities

In response to questions raised at the February 1978 meeting of the Federal Open Market Committee, this memorandum discusses the feasibility and desirability of having the Trading Desk sell Federal agency securities. The question of selling agency issues was raised in two connections--first, whether such sales could be helpful in avoiding problems of insufficient collateral behind Federal Reserve note liabilities; and second, whether such sales would be desirable in order to establish greater flexibility in Desk operations.

Our conclusion on the first point is that agency issues probably cannot in practice be sold in sufficient volume to be really helpful in meeting problems of note collateralization. The System could, however, help alleviate collateral problems in the future by holding back on purchases of agency securities, and buying Treasury securities instead. Still, a much better way to deal with the note collateralization problems caused by acquisitions of agency issues would be to seek legislation that would permit agency issues to be pledged against Federal Reserve note liabilities, a step already taken by the Board. In the meanwhile, it may be advisable to moderate the pace at which the System acquires agency issues. We would not advocate any very sharp curtailment of such purchases, however, especially in the period ahead when credit market pressures may begin to fall more heavily on the housing and related agency market.

As to the second point, we concluded that it is theoretically desirable to have flexibility to sell any holdings in the System's portfolio of securities, but our views were divided on the practical significance or actual desirability of sales of agency issues in the foreseeable future. In Mr. Axilrod's view, the Desk should seek opportunities to arrange occasional modest sales of at least short-maturity agency issues, to demonstrate that the System is prepared to undertake two-way transactions and that the System's holdings of all securities--not just Treasury bills--are liquid in at least some degree. In Mr. Sternlight's view, the admitted theoretical advantage of being able to undertake occasional sales is outweighed by the fact that sales could be readily misunderstood by the market. Careful preparation of the market through disclosure beforehand of the limited objectives of the sales would reduce the potential for misunderstanding, but would also tend to limit or remove the advantage of flexibility in operations that the sale was intended to demonstrate. In his view, an occasional sale of agency issues, carefully engineered under narrowly prescribed conditions so as to avoid undesired market consequences, would not be a useful addition to the System's capability for flexible open market operations.

1. <u>Sell agency issues to relieve note collateral problems?</u>

Under current law, System holdings of Federal agency issues may not be pledged against Federal Reserve note liabilities, while assets in the form of Treasury issues, gold certificates, SDRs, bankers' acceptances, or loans to member banks at the basic discount rate may be pledged for this purpose. Thus to the extent that the System Account buys agency issues rather than Treasury securities, there is greater potential for running into a problem of insufficient collateral behind Federal Reserve notes.

In recent experience, the narrowest margin of excess collateral prevailed on November 16, 1977, when the leeway was about $5.7 billion. A change in procedure was instituted at the start of 1978, under which inventories of Federal Reserve notes held at Reserve Banks are collateralized--as well as the notes actually put into circulation. If that procedure had been in effect last November, there would have been insufficient eligible collateral. (In the event that collateralizing inventories of Federal Reserve notes at the Reserve Banks causes a deficiency of eligible collateral, there is an emergency procedure for Federal Reserve agents at the Banks to retire such currency temporarily.) The chief reason for the particularly tight position last November was that the System Account had arranged a large volume of matched sale-purchase transactions to absorb reserves on a temporary basis. Since the start of 1978, under the new procedure, the lowest leeway occurred on February 10--a margin of $6.1 billion.

In addition to a large build-up in System holdings of agency issues, the problem of maintaining sufficient collateral against Federal Reserve notes could also be aggravated by a reduction in reserve requirements, as such a reduction would cause the System to reduce its portfolio of securities in order to absorb redundant reserves. Another factor that could worsen the collateral problem would be a large rise in Federal Reserve float--though there is no reason to anticipate such a development unless there were major changes in rules for granting credit in the check-clearing process. On the other side, one can also conceive of developments that would relieve the note collateral problem such as a large rise in Treasury or foreign account deposits at the Reserve Banks. These events do not seem likely to occur, however; in fact, the average Treasury balance at the Federal Reserve is likely to decline shortly when the Treasury puts in place its new tax and loan account procedure.

Just as a swift build-up in System holdings of agency issues can aggravate the note collateral problem, a moderation of growth--or a decline--in those holdings could be helpful in relieving the problem. Indeed, absent Congressional action to make System agency holdings eligible to be pledged against Federal Reserve note liabilities, it would probably be advisable to moderate somewhat the pace of acquiring agency issues.

As indicated in the following table, System holdings of agency issues grew slowly in 1971-73 but increased by nearly \$2.8 billion in 1974, and then more moderately by about \$1.4 billion in 1975, \$.7 billion in 1976 and \$1.2 billion in 1977. As a proportion of the System portfolio such holdings edged up to a little over 7 percent in 1977.

In recognition of the note collateral problem it might be well to let that proportion recede by reducing the pace of new acquisitions. However, we would stop short of recommending a complete cessation of growth in agency holdings, or a policy of making net sales or redemptions, as this would seem to run counter to the intent of Congress when it enacted authority for the System to buy agency issues. Part of the background for enacting that legislation was that System purchases would help broaden the market for agency issues and thus assist the Federally sponsored credit programs served by those agencies. A System policy of ceasing to make further net purchases of agency issues, and reverting to net sales or redemptions at maturity, would soon attract attention from participants in the market for agency issues and constituent groups served by those agencies such as homebuilders and farmers--particularly in the year ahead when the mortgage market may come under increasing upward rate pressure.

Outright Holdings of Agency Issues in System Account

(dollar amount in millions)

	Year-end holdings of Agency Issues	Change in year	Agencies as proportion of System Account, at yearend
1971	485	+ 485	0.7%
1972	1,311	+ 826	1.8
1973	1,938	+ 627	2.4
1974	4,702	+2,765	5.5
1975	6,072	+1,370	6.5
1976	6,794	+ 722	6.8
1977	8,004	+1,210	7.3

Occasional System sales of agencies could be undertaken within the context of continued long-term expansion in holdings of agency issues, but such sales would not really make a significant contribution to relieving the problem of adequacy of Federal Reserve note collateral. To be meaningful in terms of that problem, the Desk would have to be able to sell large amounts of agency issues--on the order of multiple hundreds of millions or even $1 billion or more--within a short term period, in order to get past a tight period for note collateral. In our view, the market is not equipped to handle large-scale Desk sales of this kind, compressed within a short period.[1/]

As discussed in the next section, the market could be "educated" to handle occasional, modest-sized sales of agency issues, but unless these cumulated to sizable total dollar amounts, the effort would not significantly relieve the note collateral problem. And as mentioned above, if the sales did persist and cumulated to a sizable amount over an extended period of time then the System would invite the criticism that Congressional intent was being ignored in the area of participation in the agency market.

1/ It is tempting, in this context, to contemplate the feasibility of undertaking matched sale-purchase transactions in agency issues, as such operations could theoretically have a useful large-scale effect in absorbing reserves on a temporary basis without reducing the System's holdings of securities eligible for pledging against notes. However, such operations appear to be infeasible operationally. At present, when the Desk arranges matched sale-purchase transactions, it is done in one or two (or perhaps three) issues of Treasury bills which the System holds in large size (typically about $1-1/4 to $1-1/2 billion in each bill issue). To operate in comparable aggregate size in agency issues would involve small sized amounts of many issues. Under present procedures, dealers compete by specifying the rate at which they are prepared to buy bills from the System and sell them back one day or several days later. The Desk then selects the lowest rate propositions for execution. In effect, the rate at which the bills are sold and later repurchased represents the rate the System is paying to "borrow" money for a short time, but the transaction is in the form of sales and purchases. To accomplish the same reserve effect in a multitude of agency issues, on a competitive basis, would probably require the dealer to specify an interest rate at which the System might borrow funds, collateralized by agency issues. Operations in such a format would be far more cumbersome than in bills--if feasible at all. A particular complicating factor in the accounting would be the need, in selling coupon bearing issues, to take account of coupon accruals. Recognition of losses on sales would also become a more significant factor.

2. Sell agency issues on occasion, in moderate size?

Even though it is concluded that System sales of agency issues would not be a desirable way to cope with the potential problem of adequacy of Federal Reserve note collateral, it still makes sense to consider the possibility of occasional sales of agency issues. The chief advantage of such sales, it is argued, is that they would demonstrate that the System's participation in the agency market is not a one-way street. To be useful in the implementation of a flexible monetary policy, a central bank's portfolio of securities should be liquid, and it may be said that a convincing way to establish and maintain that liquidity is to exercise, on occasion, the prerogative of selling. Even if the sales are infrequent and modest in size, and are outweighed over the long run by purchases, the principle that the System's holdings are capable of being sold to the market is a significant one.

Another advantage cited for occasional sales would be that such transactions may provide a means of meeting market demands for issues that may be in particularly short supply--possibly providing an opportunity for the System to smooth an aberration in the market's yield structure while improving the System's earnings.

Occasional sales might also offer an opportunity to reduce the System's holdings of certain agency issues--for example, those that are no longer eligible for purchase by the System Account under the guideline that rules out acquisition of agency issues eligible for purchase by the Federal Financing Bank.

A program of occasional sales would have to be undertaken with great care, after discussion with market participants to make clear the nature of System objectives, along the lines indicated above. Without such careful preparation, sales could easily be misunderstood by market participants, with unwanted effects on the market for agency issues and perhaps on financial markets generally. It would probably be best to start with the shortest maturities, out to one year or so, and consider intermediate or longer issues only after it was established that the market could handle short-term sales routinely.

The Desk did in fact undertake sales of short-term agency issues on two occasions, relatively early in the period of System outright operations in these issues. In February 1972, the Desk sold $54 million of agency issues due within six months, in conjunction with a sale of Treasury bills in the market. The sales seemed to have little impact on prices of agency issues, or on the market generally, though there was some speculation that perhaps the System was reviving "Operation Twist", since the sale of bills and short agencies had followed fairly closely a Desk purchase of Treasury coupon issues.

The second occasion was in August 1972, when the System sold $92 million of agency issues, maturing in up to nine months. While these sales appeared to have little immediate impact on the agency market itself, the operation did generate some apprehension in the market that policy might be firming--a view that was further accentuated the following day when the System sold about $300 million of Treasury bills in the market. It would be an exaggeration to describe the market's reaction to this second sale of agency issues as severe, but it was considered significant enough to exercise some inhibition over subsequent market sales of agency issues, particularly as there seemed to be no compelling reason to undertake such sales.

Several reasons were cited above in favor of developing a capability for occasional sales of agency issues. But a number of points may be made on the other side, too. First, as to the argument that sales demonstrate the liquidity of the System's portfolio, it may be noted that sales of such modest magnitude and maturity as the System would be likely to risk undertaking would merely demonstrate that, after careful preparation, the market could be educated to absorb occasional modest sales of (probably short maturity) agency issues. If the sales served no significant purpose relative to reserve management that could not be met more readily with bill sales, then the demonstrated feasibility of such modest sales would not have added significantly to the flexibility of open market operations. And given the carefully controlled conditions that would have to surround such sales to guard against market misinterpretation, the sales would not be all that much of a testimonial to the liquidity of the System's agency holdings.

As to the advantage that sales would provide an opportunity to meet special market demands for certain issues, it is questionable whether the System Account should serve such a role. Often, a particular issue is out-of-line in yield because of special tax considerations. Where this is the case, System sales of such issues might merely help the public acquire more securities enjoying certain tax advantages--so that the System could be in the position of having aided tax "avoiders".

As for providing opportunities to sell issues that the System prefers not to hold, such as those no longer eligible for System purchases, this is not of great value unless one is speaking of holdings of relatively long maturity--since the shorter maturities can soon be run off. But to contemplate System sales of longer-term issues may be courting more adverse reactions than the System would want to risk.

One reason agency sales may have made more sense in 1972 than now is that in 1972 there was no provision for rolling over the System's agency holdings at maturity. That meant that as maturities occurred, there would be an absorption of reserves whether such absorption fitted in with Desk reserve objectives at the time or not. By selling short-term issues before they reached maturity, however, the Desk could arrange to have the attendant reserve absorption occur when this meshed with reserve management objectives and not simply when the System's holdings happened to mature.

In reviewing the pros and cons of undertaking occasional System sales of agency issues, Messrs. Axilrod and Sternlight came to a "split decision". Mr. Axilrod found the arguments more persuasive in favor of developing a capability for undertaking occasional sales of agency issues--chiefly because such sales testified to the liquidity of the System's holdings and the two-way nature of the market. Also, occasional sales could provide an opportunity to dispose of holdings that were in special demand in the market or that the System preferred not to retain.
Mr. Sternlight conceded the theoretically desirable symmetry of

being able to sell as well as buy, but felt that there was little or no practical advantage to be gained from sales, while there remained some possibility of market misunderstanding of Desk motives in selling. To "educate" the market to be able to accept occasional modest-sized sales of relatively short agency issues seemed to him a somewhat sterile demonstration of flexibility.