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OF THE
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STRICTLY CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee DATE: August 13, 1986

FROM: Normand Bernard NB

Attached is a memorandum from Mr. Sternlight on the composition of the System portfolio and operations in Treasury coupon securities. This matter is listed under topic 4 in the agenda for next Tuesday's meeting of the Committee.

Attachment

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TO Federal Open Market Committee

FROM Peter D. Sternlight, Manager for Domestic Operations, System Open Market Account

SUBJECT: Composition of the System Portfolio and Operations in Treasury Coupon Issues

Over the past twenty-five years, the Federal Reserve System's portfolio of securities has grown by a substantial $163 billion, or about six-fold. This was accomplished through a combination of purchases of Treasury bills, Treasury coupon issues and Federal agency securities. By far, the chief reason for the purchases, long run, has been the increase in currency in circulation, which absorbed reserves that had to be replaced in order to meet reserve and money growth objectives.1/ The attached table shows yearly changes and end-of-year composition of the portfolio from 1960 through 1985.

The main motivation behind System purchases (or sales and redemptions of securities) has been to affect the availability of reserves in line with the instructions of the FOMC. However, the form of the System's participation in the market has served other purposes as well. For example, in the early 1960's, following an extended period in which the System's outright activity was confined to Treasury bills, the Desk began to meet part of the long-term reserve needs through purchases of Treasury coupon issues of varying maturity.

1/ One usually thinks of growth in required reserves as another major reason for the System's portfolio to be increased, long term, but the rise in currency far overshadowed the rise in required reserves, and much of the latter was met through vault cash.

This facilitated the meeting of reserve objectives while avoiding or mitigating downward pressures on bill rates which were considered an exacerbating factor in the balance of payments deficits incurred at that time. It was also suggested by some that System purchases of coupon issues could help reduce, or moderate increases in, longer term rates, although more recent discussion has tended to give only modest weight to this effect.

Outright acquisitions of agency issues began in 1971 following a period in which the supply of these issues had become fairly plentiful as various Federally-sponsored agencies assisted the flow of credit into such sectors as housing and agriculture. The operations were authorized in order to widen the base of System open market operations and, at the same time, add breadth to the market for agency securities. However, the System's agency purchases were not intended to support particular issues or issuers, and in fact the Committee set restrictive guidelines on agency purchases to avoid an over-dependence of that market on the System's participation.

Participation in the agency market has dwindled in recent years--partly in reflection of the ample supply of Treasury securities in a heavy budget deficit period. Meantime, the Desk has continued to participate on a moderate scale in the Treasury coupon market--providing in the last several years (1980-85) about 30 per cent of the net outright additions to the portfolio in this form. In recent years, this has typically entailed two or three rounds of market purchases of coupon issues annually. The last such operation was in December 1985.

When undertaking coupon purchases (or for that matter agency purchases) the chief objective of Desk operations has remained that of affecting reserve availability. At the same time, the scale of these purchases has also taken account of the need to maintain, or enhance, the liquidity of the System's portfolio, seeking to ensure that there is an ample supply of securities that could be sold or matured in as orderly a way as possible. The usefulness of this principle was demonstrated in 1984 when a sharp build-up in borrowing by Continental Illinois required the System to reduce its Government securities portfolio massively in short order.

Since the rationale for the System's continuing "routine" participation in the coupon market has been questioned from time to time, the purpose of this note is to present, for consideration by the Committee, some reasons for or against varying levels of participation in that market.

Reasons for Continued or Increased Participation in Coupon Market

1. Participation keeps a potentially useful tool in good working condition. Even if there is no urgent need for such purchases in present circumstances, the fairly consistent, albeit occasional, use of such purchases means that

they can be used, or possibly increased in more compelling circumstances without making a major event out of such entries. For example, bills could be in short supply and there could be particular concern about short-term rates, which is what motivated a return to coupon purchases in the 1960's after the "bills only" years. The dwindling participation in the agency market in recent years has led to a situation where, for better or worse, renewed use of this tool would no longer be routine. If this situation were to develop with respect to Treasury coupon issues, it could be an impediment to revival of this technique of operations.

2. Participation in the coupon market keeps the Desk in close touch with a major segment of the U. S.--and world--financial markets. While dealers are willing to tell us about developments in the market, there is no complete substitute for the knowledge that comes with actual participation.

3. The Treasury has been stressing the coupon market in its debt management, raising most of its net new money needs in this sector as it seeks to lengthen its average debt maturity. Given this trend, along with the System's leaning toward bill purchases, the System's share of total coupon issues outstanding fell off to about 9 per cent at the end of 1985 from 18.6 per cent five years earlier. Meantime, the System's share of bills edged up to 22.4 per cent from 21.7 per cent. Avoidance of future coupon purchases would accentuate these trends. While the

System's holdings need not mirror precisely the composition of the total debt, there may be a question about the desirability of the System holding an increasing proportion of that part of the debt that the Treasury is de-emphasizing and a shrinking share of the segment that is being emphasized more.

4. Occasional Federal Reserve participation in the coupon market probably adds to the liquidity of that market and adds to its performance and efficiency. Even though the System's purchases of $3-4 billion a year of coupon issues in recent years are small against the $100-150 billion net additions to outstanding coupon issues, the knowledge that the Fed is likely to be an occasional buyer probably enhances the willingness of dealers to underwrite and make secondary markets, and the willingness of other investors to take part as well. This is particularly so for the less actively traded Treasury issues, for which dealers find it relatively difficult to make markets. A few dealers have made this point to Desk officers in the context of noting an absence of System coupon purchases so far this year.

5. With a usually upward-sloping yield curve, participation in the intermediate and longer market can increase the System's earnings somewhat. Of course, this should not be pushed to the point of impairing the liquidity of the System's portfolio. In fact, under the recent practice of moderate coupon purchases, the liquidity of the portfolio has risen in both absolute and relative terms. Notably, the

proportion of bills in the System's portfolio has risen to about 47 per cent at the end of 1985 compared with about 36 per cent five years earlier.

Reasons for Reduced Participation in Coupon Market

1. Current circumstances present no compelling need for coupon purchases. If such needs do indeed become urgent, coupon purchases could be resumed, and presumably in such circumstances the Fed would be willing to be noticed as engaging in a nonroutine activity. It might even be an advantage to have the market take particular note of such operations.

2. Granted that the System portfolio currently has substantial liquidity, it may be better to have even more. Fragilities in the banking system make it difficult to have "too much" liquidity. If the System faced several near-simultaneous episodes of the Continental Illinois type, involving heavy use of the Discount Window, even the current ample liquidity of the portfolio could be dented appreciably. (On the other hand, it should be kept in mind that the legal note cover requirements could limit the possibilities for very massive reductions in the portfolio.)

3. It can be argued that the System should not buy what it is not prepared to sell--and it may be difficult to condition the market to accept System sales of coupon issues as a routine technique. (On the other hand, the possibility of occasional sales of coupon issues in appropriate

circumstances should not be dismissed altogether; occasional sales, when warranted by reserve conditions,could give the Desk another useful tool, allowing us to take account of unusual market scarcity of particular issues as well as addressing reserve needs.)

4. The argument that coupon purchases tend to produce higher earnings need perhaps not carry great weight since the System's net earnings are turned back to the Treasury anyway. Nor would greater earnings on the portfolio be particularly helpful in meeting the System's Gramm-Rudman objectives, which are geared more to expenditure levels. To be sure, a larger turnback of funds to Treasury could help the Government as a whole with regard to its deficit, but if that is the aim, the Treasury might consider selling more bills and fewer coupon issues.

5. To the extent that the Fed buys coupon issues, it is in a sense undoing the long-term funding vis-a-vis the private sector that the Treasury is going to such trouble and expense to achieve. Also, when the System buys long-term issues, they are essentially "put away", unavailable for "stripping", delivery in the futures market, or other purposes that could contribute to the efficiency of the long-term market.

6. If heavier concentration of System purchases in the bill market caused relative shortages of bills compared with coupon issues, the Treasury could respond to that by issuing more in bills and less in coupons.

Discussion

Depending on one's weighting of the foregoing points, it could be concluded that the System's participation in the coupon market should be reduced, maintained at around the pace of recent years, or increased. In the view of the Domestic Account Management, an approach close to that of recent years still seems appropriate. It would permit continued moderate but meaningful contact with the coupon market while also providing for further additions to the liquidity of the System's portfolio.

One adjustment in portfolio management that has been going on already, and could be emphasized further, is to focus the System's rollovers in the large quarterly refundings somewhat more heavily toward the shorter maturities offered in those refundings. This will help to ensure that substantial liquidity is emphasized within our holdings of coupon issues as well as in the choice between bills and coupons. A few years ago, we used to divide our rollover into new issues to match approximately the proportions of those issues being sold to the public. More recently, as the Treasury has made stronger efforts to tap the long-term market, we have tended to slant our takings somewhat toward the shorter end. This practice could be accentuated further as a means of avoiding an unintended lengthening of the System's portfolio in the wake of the Treasury's debt-lengthening efforts.

Att.

COMPOSITION OF SYSTEM PORTFOLIO
(holdings in billions of dollars)

			TREASURY BILLS			TREASURY COUPONS			AGENCIES		
Year	Total System Portfolio	Change from Previous Year	System Holdings	Change from Previous Year	As % of Total Portfolio	System Holdings	Change from Previous Year	As % of Total Portfolio	System Holdings	Change from Previous Year	As % of Total Portfolio
1960	27.0		2.9		10.7%	24.1		89.3%			
1961	28.7	1.7	3.2	0.3	11.1%	25.5	1.4	88.9%			
1962	30.5	1.8	2.4	-0.8	8.0%	28.0	2.5	92.0%			
1963	33.6	3.1	4.1	1.7	12.3%	29.4	1.4	87.7%			
1964	36.5	2.9	6.0	1.9	16.6%	30.5	1.0	83.4%			
1965	40.5	4.0	9.1	3.1	22.5%	31.4	0.9	77.5%			
1966	43.7	3.2	11.8	2.7	27.0%	31.9	0.5	73.0%			
1967	49.0	5.3	16.0	4.2	32.6%	33.0	1.2	67.4%			
1968	52.9	4.0	18.8	2.8	35.4%	34.2	1.2	64.6%			
1969	57.2	4.2	22.3	3.5	39.0%	34.9	0.7	61.0%			
1970	62.1	5.0	26.0	3.7	41.8%	36.2	1.3	58.2%			
1971	69.5	7.3	30.2	4.2	43.4%	38.8	2.7	55.9%	0.5	0.5	0.7%
1972	71.1	1.6	29.7	-0.5	41.7%	40.1	1.3	56.4%	1.3	0.8	1.8%
1973	80.4	9.3	36.9	7.2	45.9%	41.6	1.4	51.7%	1.9	0.6	2.4%
1974	86.2	5.8	38.2	1.3	44.3%	43.3	1.7	50.2%	4.7	2.8	5.5%
1975	93.3	7.1	37.7	-0.5	40.4%	49.5	6.2	53.1%	6.1	1.4	6.5%
1976	100.1	6.8	38.6	0.9	38.5%	54.7	5.2	54.7%	6.8	0.7	6.8%
1977	110.3	10.2	42.9	4.4	38.9%	59.4	4.7	53.8%	8.0	1.2	7.3%
1978	119.0	8.7	43.8	0.9	36.8%	67.3	8.0	56.6%	7.9	-0.1	6.6%
1979	129.3	10.3	50.0	6.2	38.7%	71.0	3.7	54.9%	8.2	0.3	6.4%
1980	131.3	2.0	47.0	-3.1	35.8%	75.6	4.6	57.6%	8.7	0.5	6.7%
1981	139.8	8.5	52.3	5.3	37.4%	78.4	2.8	56.1%	9.1	0.4	6.5%
1982	147.9	8.1	57.8	5.4	39.1%	81.2	2.8	54.9%	8.9	-0.2	6.0%
1983	164.3	16.4	70.9	13.1	43.2%	84.7	3.6	51.6%	8.6	-0.3	5.3%
1984	171.5	7.2	74.9	4.0	43.7%	88.2	3.4	51.4%	8.4	-0.3	4.9%
1985	190.1	18.6	89.5	14.6	47.1%	92.4	4.2	48.6%	8.2	-0.2	4.3%

Note: Data are on a "commitment" basis, hence excluding holdings under repurchase agreements or changes reflecting matched sale-purchase transactions. Changes are computed in millions before rounding to billions.