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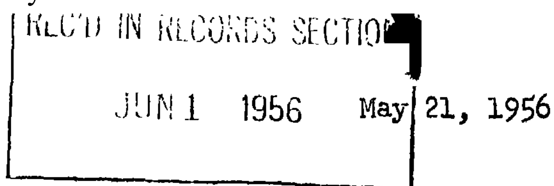
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May 21, 1956

Memorandum:

To the Members of the Federal Open Market Committee

From J. L. Robertson

Subject: Proposal pending before the Open Market Committee to authorize the Account Management to make swaps in Treasury bills.

The proposal before us seems harmless enough, particularly in the light of Mr. Sproul's memorandum of May 16. These specific objectives are stressed: (1) the acquisition of a sufficient volume of bills maturing in January, e.g., to enable us to absorb redundant reserves during that month by run-off of maturing bills rather than by selling bills of a later maturity, and (2) to enable us to sell bills to foreign central banks more conveniently. However, Mr. Sproul's summary makes clear that swaps would be considered appropriate "to maintain a balanced distribution in the Account" as well as "to provide for specific need, such as the January runoffs".

The policy drawbacks that led us to lean against the making of swaps except upon specific direction of the Committee are not particularly forceful where applied to swaps confined to bills. Consequently, I would not object to this proposal if it promised material advantages attainable in no other way, despite the possibility that, over a period of time, swapping among bills might prove to be an entering wedge to swapping in the longer maturities.

Accordingly, the nub of this matter is whether it promises substantial benefits that cannot be achieved unless we depart to this extent from our policy of avoiding swap transactions. It is not clear to me,

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however, why we cannot, over the coming months during which we will be on the buying side of the market, acquire bills of the maturities we think we will want for run-off purposes early next year. Is there any serious objection to the Account's purchasing bills of the maturities we need even though our concentration of purchases may drive up the prices and lower the yields of those maturities? Mr. Sproul's memorandum says that "the Account Management may be unable to purchase enough of the January maturities to provide for the System's January needs." What will prevent such purchases? Surely not the factor of price from the earnings point of view, since the System is not in the market for profit. If the reason is said to be the effect on the bill market, I think the Committee should have an explanation of what that effect would be and wherein its evil would lie.

Is the Authority to Make Swaps in Bills Needed at This Time?

For the following reasons, it is questionable whether the present distribution of bills in the System portfolio is likely to interfere seriously with the effectuation of appropriate credit policies in the near future:

(a) In a few weeks we will reach the period of seasonal expansion in reserve needs when purchases by the Account, rather than sales, will be appropriate. If it is advisable to balance and fill out our portfolio of bills, it should be feasible to accomplish this in the course of our purchases over the coming months, without resorting to swaps.

(b) If any sales of bills are needed for purely temporary purposes in the near future, I doubt if we will encounter any real

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difficulty in making such sales from bills now held in the portfolio.

(c) The aggregate amount of bills now held in the Account is so limited that an evening out of maturities might make our holdings of individual issues so small in amount that we could not bring about a desired reduction in reserves through run-off of our holding of the current maturity.

(d) Short-term variations in reserve needs resulting from end-of-month tightness and midmonth surpluses of reserves can probably be largely offset by the appropriate use of repurchase contracts.

(e) If, at any time in the future, substantial sales of securities from the System portfolio are needed to reduce the availability of reserves, the existing holdings of bills would be inadequate in any event. In such a case, it would probably be desirable either to sell other short-term securities or to make arrangements with the Treasury for obtaining more bills in exchange for such securities. If other securities are sold to absorb reserves, then the bill portfolio could be increased at a time when reserves need to be supplied to the market.

With respect to the handling of foreign account transactions, a better balanced distribution of the Account would no doubt be helpful under the existing practice. Some question may be raised, however, as to the propriety of effecting foreign account orders through the System Account without entering the market. It is not always certain, moreover, whether over a long period of time foreign account operations do influence the supply of reserves since most of them merely reflect portfolio shifts or shifts of unds within the market. To the extent that they represent

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net additions to the supply of reserves in the market, they could appropriately be offset where deemed desirable by outright System transactions.

Would the Practice of Swapping Interfere with the Proper Functions of the Market?

Limited swaps confined to Treasury bills of the nature and for the purpose apparently envisaged by the present proposal probably would not seriously interfere with the depth, breadth, and resiliency of the Government securities market. This is not certain, however, since dealers and other market professionals carry out a lot of fairly profitable transactions for arbitrage or other purposes through shifting holdings of Treasury bills. These operations might be handicapped at times by entrance of the System Account into the market with operations that change the distribution of maturities available, even though the total supply of securities and of reserve funds remains unchanged.

If swap transactions were carried out frequently in large amount by the Account Management, they could have the effect of interfering with the free play of market forces. This would be particularly true in case of swaps involving issues differing considerably in maturity. When the System Account sells one issue and buys another, it changes the availability of the different issues in the market and therefore tends to affect the rate structure. Such operations at times might prevent adjustments in the rate structure that reflect market preferences. They might also scare off professional operations in the market because of uncertainty as to when and how and for what purposes the System might choose to enter the market.

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In summary, it is my opinion that the present proposal appears fairly innocuous within its limitations, but it would constitute a first step away from one of our current policy principles. In view of my opinion that the benefits do not promise to be sufficiently substantial to justify it, I prefer that we do not make even this minor departure from a sound general principle except in a situation where it seems more clearly desirable than now or is likely to exist in the near future.