



BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

October 16, 1958

TO: Federal Open Market Committee

FROM: Mr. Riefler

Attached is a memorandum from Messrs. Hackley and Solomon dated October 16, 1958 concerning reserve bank participations in proposed Treasury refunding, together with a draft of letter which it is proposed be sent to Under Secretary of the Treasury Baird. It is contemplated that this topic will be discussed at the meeting of the Federal Open Market Committee to be held at 10:00 a.m. on October 21, 1958.

Attachment

REC'D IN RECORDS SECTION

OCT 17 1958

October 16, 1958

Federal Open Market Committee

Subject: Reserve Bank participation.

Messrs. Hackley and Solomon

in proposed Treasury refunding

CARDER

At present maturing issues of Treasury securities are refinanced by offering a new security in exchange for the maturing issue. This method of financing necessarily results in some attrition. It also creates "rights values" in the maturing issue which can cause complications. There has been discussion, consequently, from time to time of the feasibility of resorting to cash instead of exchange financing, i.e., the new securities would be issued for cash subscription and the proceeds would be used to pay off the maturing issue at maturity. There would be no attrition involved because the new issue would be allotted up to the full amount sought. Since the maturing issue would be paid off in cash, it would acquire no rights value in the market.

A letter of October 1, 1958 from Mr. Julian Baird, Under Secretary of the Treasury, supplemented by a letter of October 9 from Mr. Heffelfinger, Fiscal Assistant Secretary, presents certain questions that would arise if the Treasury decided to raise cash to refund about \$9.8 billion of certificates that mature December 1, 1958. Specifically, those letters refer to the possibility of the Reserve Banks acquiring the proposed refunding securities in replacement of the maturing certificates held by them. The letters raise the question, in effect, whether these refunding securities so acquired by the Reserve Banks would be subject to the \$5 billion limit stated in section 14(b) of the Federal Reserve Act on purchases of securities by the Reserve Banks directly from the Treasury.

Mr. Heffelfinger's letter enclosed tentative drafts of two circulars which might be used, alternatively, to carry out the refunding. Under Alternative "A" about \$2 billion of the new securities would be offered to the general public, with either cash or the maturing certificates being accepted in payment for the new securities, but with no allotment privilege being extended to the maturing certificates. There would be an additional offering of the same new security to the Reserve Banks in an additional amount in exchange for their holdings of the maturing certificate, with that exchange subscription being allotted in full. Alternative "B" would be substantially the same as Alternative "A", except that with respect to the \$2 billion offering to the general public, subscriptions accompanied by a tender of maturing certificates in payment would be allotted in full.

Federal Open Market Committee -2-

Under opinions rendered by General Counsel to the Committee in 1937, 1942, and 1947 it has apparently been established that the Federal Reserve Banks may "exchange" maturing securities for an equal amount of new securities as a part of a general refunding open to the general public. This position has been based on the ground that the power to make such an exchange is incidental to the basic authority of the Reserve Banks to purchase Government obligations; that the purpose of the prohibition against direct purchases from the Treasury was to prevent the Treasury from acquiring unlimited new funds by borrowing them from the Reserve Banks without going to the public; and that the acquisition of new issues, as part of a refunding open to the general public, in exchange for maturing securities acquired by the Reserve Banks in the open market would not violate the primary purpose of the law. These opinions have governed the Committee's actions to date in tendering maturing issues in exchange for new securities. In these exchanges, the Reserve Banks have not been exchanging securities with the Treasury on any basis except that open equally to the general public.

A question arises, however, if cash is used in refinancing because it will be necessary to treat the Reserve Banks somewhat differently from the general public in the refunding. The difference would be less marked under Alternative "B" since members of the general public holding the maturing certificates would be given full allotments on their subscriptions to the new securities in much the same manner that full allotments would be given to the Reserve Banks. However, it is understood that Alternative "B" would be less desirable as a practical matter since it would tend to perpetuate the undesirable feature of the maturing securities having certain "rights" value which could subject them to undue speculation in the market.

While it probably would be somewhat easier to justify acquisitions under Alternative "B" as being exempt from the \$5 billion limit, it is believed that, all things considered, acquisitions under Alternative "A" might also reasonably be considered to be exempt from the \$5 billion limit. This would be on the ground that the security is not only acquired as an exchange or refunding but also (1) the security acquired by the Reserve Banks is clearly a security which meets the test of the open market, and (2) any differences between the treatment given the general public and that given the Reserve Banks is in favor of, rather than adverse to, the Reserve Banks. In other words, the acquisition is not only an exchange or refunding, but, in addition, there do not seem to be any aspects of any effort to have the Reserve Banks acquire securities from the Treasury on terms or conditions more favorable to the Treasury than those available in the open market.

Federal Open Market Committee      -3-

At the same time it must be recognized that the provisions for special arrangements between the Treasury and the Reserve Banks tend to highlight the question and might attract criticism. In view of the safeguards outlined above, it is believed that there would be no more justification for such criticism than in the case of exchanges of Treasury bills for new issues of Treasury bills, which have been effected by the System open account for many years. However, it must be recognized that as a practical matter the possibility of such criticism exists and might be increased by the specific references in the issuing circulars to special arrangements between the Treasury and the Reserve Banks.

There is attached for consideration a draft of a letter to Mr. Baird which would state that the Committee has concluded that acquisitions by the Reserve Banks pursuant to either Alternative "A" or "B" would not be subject to the \$5 billion limit, and that subject, of course, to usual considerations relating to monetary and credit policy and to the terms eventually set for the refunding securities, the Reserve Banks would be prepared to refund some or all of their maturing certificates under either alternative.

Attachment

DRAFT

Mr. Julian B. Baird,  
Under Secretary of the Treasury,  
Washington 25, D. C.

Dear Mr. Baird:

This refers to your letter of October 1, 1958 and Mr. Heffelfinger's letter of October 9, 1958 regarding certain securities which the Treasury might issue in refunding about \$9.8 billion of certificates that mature December 1, 1958. You refer to the possibility of the Reserve Banks acquiring the proposed refunding securities in replacement of the maturing certificates held by them, and you ask, in effect, whether these refunding securities so acquired would be subject to the \$5 billion limit stated in section 14(b) of the Federal Reserve Act on purchases of securities by the Reserve Banks directly from the Treasury.

Mr. Heffelfinger's letter enclosed tentative drafts of two circulars which might be used, alternatively, to carry out the refunding. Under Alternative "A" about \$2 billion of the new securities would be offered to the general public, with either cash or the maturing certificates being accepted in payment for the new securities, but with no allotment privilege being extended to the maturing certificates. There would be an additional offering of the same new security to the Reserve Banks in an additional amount in exchange for their holdings of the maturing certificates, with that exchange subscription being allotted in full. Alternative "B" would be substantially the same as Alternative "A",

Mr. Julian B. Baird

-2-

except that with respect to the \$2 billion offering to the general public, subscriptions accompanied by a tender of maturing certificates in payment would be allotted in full.

Upon careful consideration of both the alternatives, the Federal Open Market Committee has concluded that acquisitions by the Reserve Banks pursuant to either such type of refunding would not be subject to the \$5 billion limit stated in section 14(b) of the Federal Reserve Act, and that, subject, of course, to usual considerations relating to monetary and credit policy and the terms eventually set for the refunding security, the Reserve Banks would be prepared to refund some or all of their maturing certificates under either of the proposed alternatives.

Sincerely,