BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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To: Federal Open Market Committee

From: Albert R. Koch

Subject: Official Operations in Longer-term U.S. Government Securities[1/]

In view of the fact that references are frequently made at FOMC meetings to official operations in longer-term U.S. Government securities, this memorandum attempts to summarize certain of the available statistics on these operations to date. Included are operations of the Federal Reserve System as well as those of the Treasury Department for its trust and agency accounts. This is in no sense to be considered a final over-all judgment as to the effects of these operations since I have not studied them in enough detail and a System Research Subcommittee is currently working on the matter in considerable depth.

Background

Since early 1961, the Federal Reserve has on occasion operated throughout the maturity range of U.S. Government securities instead of confining its purchases and sales of such securities almost exclusively to the short-term sector as had been the practice in prior years. Thus, to minimize downward pressures on short-term interest rates for balance of payments reasons, the System has at times provided needed bank reserves by purchasing intermediate- and longer-term rather than short-term securities. On a few occasions when short-term interest rates showed signs of

1/ A revised and updated version of some remarks recently made at a Board meeting.

moving to levels conducive to outflows of funds abroad, the System has sold short-term securities to exert some upward pressure on the short-term rate structure. The effect of such sales in tending to reduce bank reserves was offset at the time by purchases of longer-term securities.

The manner and size of these operations in longer-term Government securities has been guided throughout the period by the desire to avoid any disrupting effects on the functioning and continuity of the U.S. Government securities market. To this end, the Federal Reserve has limited its purchases of longer-term securities to amounts that were offered in the market without at the time bidding up prices of these securities. Such purchases may, of course, have had some subsequent price and yield effects.

Size of the Operations

Table 1 shows the volume of total purchases of U.S. Government securities with maturities in excess of a year as well as official purchases--those of the Treasury and the Federal Reserve--expressed in millions of dollars as well as in percentages of the total. The table shows that official purchases have averaged about 10 per cent of total purchases, with the proportion increasing with the maturity of the security. Of course, official purchases have assumed much larger proportions in certain shorter periods of time and for specific maturities of securities. As also can be seen from the Table, Federal Reserve purchases have been concentrated in the shorter end of the maturity structure whereas Treasury purchases have been concentrated in the longer end.

In general, the data suggest that official operations have been rather limited in amount, although at times Treasury purchases of the longer-term issues for its trust and agency accounts have been quite sizable.

Table 1

VOLUME OF PURCHASES OF LONGER-TERM U. S. GOVERNMENT SECURITIES

A. Total Purchases[1/]
(In millions of dollars)

	Total over 1 year	1-5 years	5-10 years	Over 10 years
1961	29,345	22,221	4,316	2,808
1962	30,654	17,707	10,184	2,764
1963[2/]	52,350	28,261	17,576	6,513

B. Official Purchases
(In millions of dollars)

	Total over 1 year	1-5 years	5-10 years	Over 10 years
Federal Reserve:				
1961	2,556	1,786	641	129
1962	1,883	1,521	326	37
1963[2/]	1,453	844	541	68
Treasury:				
1961	1,002	66	265	670
1962	513	271	119	123
1963[2/]	1,939	397	595	947
Total:				
1961	3,558	1,852	907	799
1962	2,396	1,792	445	159
1963[2/]	3,392	1,241	1,136	1,015

C. Official as Per Cent of Total

	Total over 1 year	1-5 years	5-10 years	Over 10 years
Federal Reserve:				
1961	8.7	8.0	14.9	4.6
1962	6.1	8.6	3.2	1.3
1963[2/]	2.8	3.0	3.1	1.0
Treasury:				
1961	3.4	.3	6.1	23.9
1962	1.7	1.5	1.2	4.4
1963[2/]	3.7	1.4	3.4	14.5
Total:				
1961	12.1	8.3	21.0	28.5
1962	7.8	10.1	4.4	5.8
1963[2/]	6.5	4.4	6.5	15.6

1/ Actually, total dealer purchases, excluding those from other dealers and brokers in U.S. Government securities.

2/ Through November.

Note: Totals may not add due to rounding.

These Treasury operations have been, in the main, of a short-run underwriting character and have been designed to cushion yield advances rather than to force down yields. System purchases of longer-term issues have also tended to be largest in periods following Treasury financings.

Views as to what constitutes a "limited" amount may, of course, differ considerably. Fortunately, such possible differences of view may not be of serious consequence. What is likely to be of greater importance is the market's understanding of the intentions of the official purchases, that is, whether or not the market feels that the authorities have longer-term interest rate objectives.

Effect of Operations on Federal Reserve Bank Liquidity

One question that always comes up concerning Federal Reserve operations in longer-term U.S. Government securities is the effect such operations have had on Federal Reserve Bank liquidity. Table 2 shows the maturity distribution of Federal Reserve holdings of such securities currently and in mid-February 1961, about the time when recent System purchases in longer-term securities began.

The Table shows, first, that the inexorable passage of time has led to the maintenance of the liquidity of the Federal Reserve Banks over the past three years, despite the purchases of longer-term securities. Approximately two-thirds of Federal Reserve holdings of U.S. Government securities still have a maturity of less than a year. The proportion was a little less, about three-fifths, in 1961.

Secondly, the large shift--over $20 billion--of Federal Reserve holdings of U.S. Government securities from the 1-5 year category to the under 1 year category as a result of the passage of time over the past

Table 2

MATURITY DISTRIBUTION OF FEDERAL RESERVE GOVERNMENT SECURITY HOLDINGS[1/]
(In billions of dollars)

	Within 1 year			1-5 years	5-10 years	10 years and over	Total
	Total	Treasury bills	Other				
Outstanding February 15, 1961	15.9	2.6	13.3	9.3	1.2	0.3	26.6
Outstanding December 10, 1963	22.6	4.2	18.4	8.6	2.3	0.2	33.6
Change	+ 6.7	+1.6	+ 5.1	-0.7	+ 1.1	- 0.1	+ 7.1
Change due to passage of time	+20.5	--	+20.5	-19.5	- 0.7	- 0.3	--
Change due to exchanges and redemptions	-18.8	-3.5	-15.3	+14.7	+ 0.4	--	- 3.7
Change due to market transactions	+4.9	+5.0	- 0.1	+ 4.1	+ 1.5	+ 0.2	+10.5

1/ Excluding repurchase agreements.

three years, has been due in part to the fact that a large proportion of Federal Reserve purchases of coupon issues have been in fact quite short, that is, issues maturing in less than three years.

Effect of Operations on the Functioning of the Market for Longer-term U. S. Government Securities

One characteristic of the U.S. Government securities market that has troubled some observers over the past couple of years has been the apparent preoccupation of participants in the market, particularly the dealers, in attempting to predict future official operations in longer-term issues rather than trying to assess the effects of market forces themselves. For example, an apparent immediate consequence of Federal Reserve buying in the longer-term U.S. Government securities market is a marked tendency for dealers to restrict their operations to token offerings while they, as well as longer-term investors, wait until they can see where prices are likely to settle after the official purchases end. Dealers and other investors have also tended to take longer positions in regular and advance refundings, feeling that official purchases would be forthcoming in the after-market.

These developments need not necessarily have lasting deleterious effects on the market for longer-term U.S. Government securities. They can have such effects, however, if (1) investors think longer-term interest rates are being kept artificially and unsustainably low, or (2) if official purchases are not forthcoming as expected after a large-scale debt lengthening operation and, as a result, the dealers incur sizable losses. In the first case, longer-term investors are likely to stay shorter than they otherwise would and, in the second case, the underwriting function of the dealers might be seriously impaired.

Table 3 shows the ownership of longer-term U.S. Government debt recently as compared with that at mid-1960 and at other interim periods. Average ownership over a period of several months has been shown in the Table in order to minimize both seasonal and random irregularities in the monthly data.

The Table shows that nonbank as well as commercial bank holdings of longer-term U.S. Government securities have increased considerably in recent years. Some longer-term investors may be staying shorter than they otherwise would have as a result of official intervention in the longer-term market, but many others are apparently still willing to commit their funds in the longer-term area.

Effect of Operations on Other Capital Markets

A secondary purpose of initiating Federal Reserve purchases of longer-term U.S. Government securities in early 1961 was to facilitate new capital financing and investment by business corporations and State and local governments. Table 4 suggests that this purpose was probably achieved in part at least, although there are obviously more important determinants of corporate and municipal capital market financing.

In 1961, for example, business corporations floated $12 billion of new securities. The Table also shows that the volume of capital financing by business corporations and municipalities has continued sizable to date, with State and local government financing rising to a new record. The Table also shows that throughout this period the Treasury has been able to do some substantial debt lengthening through issuing securities with maturities in excess of five years, particularly via the advance refunding route.

Table 3

OWNERSHIP OF U.S. GOVERNMENT SECURITIES MATURING IN MORE THAN 5 YEARS
(In billions of dollars)

Period	Total	Official Accounts			Held by the Public			
		Total	Federal Reserve	Federal Agencies	Total	Commercial Banks	Government Security Dealers	All Other
Average Outstanding:								
April - Sept. 1960	42.3	5.5	1.4	4.0	36.8	9.0	0.1	27.6
July - Dec. 1960	43.1	5.6	1.4	4.1	37.5	9.4	0.2	28.0
July - Dec. 1961	46.4	7.7	2.5	5.2	38.7	9.3	0.1	29.3
July - Dec. 1962	53.7	9.0	2.4	6.6	44.7	12.7	0.2	31.8
April - Sept. 1963	59.8	9.9	2.3	7.6	49.9	14.5	0.3	35.2
Change:								
July - Dec. 1960 to April - Sept. 1963	+16.8	+4.3	+0.9	+3.5	+12.4	+5.1	+0.1	+7.2
April - Sept. 1960 to April - Sept. 1963	+17.6	+4.4	+0.9	+3.6	+13.1	+5.5	+0.1	+7.6
Passage of time:								
1961 - Sept. 1963	-16.4	-2.0	-1.0	-1.0	-14.4	-8.8	N.A.	-5.6

Table 4

CAPITAL MARKET FINANCING
(In billions of dollars)

	1961	1962	1963
Private new capital issues of:			
Business corporations	12.0	9.8	10.3[1/]
State-local governments	8.5	8.6	9.0[1/]
Treasury issues maturing in more than 5 years allotted to the public:			
Total	9.7	14.2	14.9
For cash	-	4.2[2/]	2.5
Regular refundings	1.4	3.6	2.5
Advance refundings	8.3	6.4	10.0

1/ Estimated
2/ Includes a cash refinancing of $2.1 billion.

Effect of Operations on Longer-term Interest Rates

Finally, there is the question of the effects of official operations in longer-term U.S. Government securities on interest rates, particularly on the cost of long-term borrowing by business corporations and State and local governments. In my view, the large flow of private savings plus the substantial increase in the supply of long-term U.S. Government securities, mainly through advance refundings, have continued to be the primary determinants of interest rates on longer-term U.S. Government securities over the past few years.

The decline in longer-term rates in the capital markets generally last year when short-term rates were rising, as shown in Table 5, was no doubt due much more to the large transmission of liquid funds to long-term

markets through financial institutions, particularly commercial banks, than to official purchases of longer-term issues. Moreover, the more moderate rise in longer-term rates than in short-term rates this year is quite typical of movements in the interest rate structure in periods of expanding economic activity and reduced monetary ease, when official intervention in the longer-term market was absent or minimal.

Table 5

SELECTED INTEREST RATES

	Government Securities				Aaa Municipal bonds	Aaa Corporate bonds
	Treasury bills 1/		3-5 year issues	Long-term bonds		
	3-mo.	6-mo.				
Dec. 1960	2.25	2.50	3.51	3.88	3.12	4.35
Dec. 1961	2.60	2.88	3.82	4.06	3.32	4.42
Dec. 1962	2.87	2.91	3.44	3.87	2.93	4.24
Nov. 1963	3.52	3.65	3.97	4.10	3.17	4.33

1/ Market yields

Federal Reserve and Treasury purchases of coupon issues, however, probably have had important marginal and temporary influences on longer-term interest rates. It is extremely difficult to judge, however, as to the more lasting interest rate effects. Such a judgment depends very much on one's assumption regarding the effects of interest rate developments, as they actually occurred on Treasury debt lengthening operations, particularly on the size and frequency of advance refundings.

Assuming that the Treasury had to do considerable debt lengthening over the period in any case, my guess is that rates on U.S. Government

bonds as well as those on other capital market instruments probably have been fluctuating around a slightly lower average level than they would have if the System and the Treasury had been out of the market for longer-term Government issues. Another effect of official operations in longer-term U.S. Government securities (including financings as well as purchases) has probably been to increase Government yields somewhat relative to those on other capital market instruments.