BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

April 9, 1969

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Holland

There is enclosed a copy of a memorandum to the Committee from Governor Maisel dated April 7, 1969, and entitled "Recommendation on Report of Treasury-Federal Reserve Study of the U.S. Government Securities Market." It is expected that the memorandum will be discussed at the next meeting of the Committee in conjunction with the contemplated discussion of the Report, copies of which were distributed earlier.

Robert C. Holland, Secretary,
Federal Open Market Committee.

Enclosure

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 8, 1969

To Federal Open Market Committee

From S. J. Maisel *SJM.*

Subject: Recommendation on Report of Treasury-Federal Reserve Study of the U.S. Government Securities Market

I suggest that the report of the joint Treasury-Federal Reserve Study of the U.S. Government Securities Market be carefully edited to make clear that it is concerned only with the technical functioning of the U.S. Government securities market. This is only one, and many would consider a minor one, of the many objectives of Federal open market operations. While a careful reading of the report may make clear its narrow scope of reference, there are numerous places particularly in the discussions of purchases and sales of coupon and agency issues where it is possible to obtain an impression that the report is analyzing and discussing general Federal Reserve policy objectives.

I also suggest that the conclusion of the report, namely, that

> "Under current market circumstances, outright operation in Federal agency securities would not facilitate, in any material way, the achievement of System reserve objectives."

be tabled until such time as a committee, to be established, reports on the relationships between agency purchases and general Federal Reserve policy objectives.

I believe my concern with adoption of the present report can be made clear by contrasting the discussion leading up to the assignment of this topic to the study group and the statement of the assignment as outlined in the report with the analysis actually contained in the report and the report's conclusions.

At the FOMC meeting of March 1, 1966 (pp. 38-39), I raised the general question of amending the continuing authority directive to authorize System transactions in agency issues. The FOMC agreed that the fundamentals of the subject might well be considered by a joint System-Treasury committee to study the Government securities market. At the November 1, 1966, meeting Mr. Mitchell in advocating outright transactions pointed out:

> "Mr. Mitchell reiterated his view that the Committee should go further now. In his opinion authorizing outright transactions would be consistent with the position the Board had taken at the time the legislation was under consideration in Congress, and it would be appropriate on other grounds also. He did not think the Committee would be trying to influence the prices of agency issues in any manner other than that in which it now influenced Treasury security prices. The Committee put funds into some sector of the market to achieve monetary objectives--which might be defined in terms of reserves, money supply, total deposits, interest rates, or other variables. He saw operations in agency issues as a further means of achieving monetary objectives."

This statement was followed again by general agreement that the fundamental questions surrounding outright purchases of agency issues should be studied by the joint committee.

In the report of the study group, this general charge was summarized as follows:

> "In view of the permissive legislation and the development of the Agency market, consideration needs to be given as to whether Federal Reserve outright transactions in Agency issues, including FNMA and Export-Import Bank participation certificates, would further System objectives, help to develop a broader Agency market, and enhance public policy objectives generally."

In the following paragraph of the report certain public policy objectives are spelled out in the following manner:

> "(2) Among the more important market reasons advanced for System outright operations in Agency issues (including PC's) are: (a) such issues are in effect debt of the U.S. Government, are in practice as risk-free as direct U.S. Government debt, and therefore should be treated on the same basis as direct Treasury debt by the Federal Reserve; (b) a willingness by the System to undertake outright transactions in all Agency issues, on a limited basis, would increase the marketability of the issues, would tend to place Agency issues on a more common footing with direct debt of the Government, insofar as investors are concerned, and would reduce somewhat the interest rate spread between Agencies and direct Federal debt; (c) Agency issues are sometimes in such large supply, relative to market demand, that they lead to over-all credit market pressures which might be most expeditiously moderated through Federal Reserve operations in the Agency market; (d) such operations may at times provide a degree of needed support to areas, such as housing, that might be under undue temporary pressure; and (e) Agency issues may be a useful supplement to open market operations in direct Treasury securities at times--when, for example, the floating supply of Treasury issues is temporarily thin."

In the discussion which follows, however, it is clear that the joint committee did not consider as its charge nor did it analyze the general questions of public policy raised in the FOMC discussions of this matter nor even the narrower issues contained in the above quotation from the report itself.

Rather the analysis of the report deals with only one aspect of the general problem--that summarized in paragraph (9) on page 100:

> "Under present circumstances, operational difficulties would be encountered by the Trading Desk in executing transactions for System Open Market Account. The size of individual Agency issues is generally quite small in comparison with

> Treasury coupon issues,[1] and as a consequence the amounts of individual issues that can be readily bought or sold in the secondary market tend to be correspondingly limited. An attempt by the System to conduct transactions in the amounts that are customary in Treasury coupon issues--and meaningful from the standpoint of System objectives--could therefore have a disproportionate impact on prices and yields in the Agency market. The availability and size of Agency issues would make it most difficult for the System to undertake more than token operations if undue market dominance is to be eschewed.
>
> 1/ The average size of an Agency issue is about $300 million compared with $2-1/2 billion for the typical Treasury coupon issue."

This shift in emphasis primarily to a consideration of the existence or non-existence of technical problems in contrast to a careful weighing of the costs and benefits to over-all policy objectives becomes even clearer in paragraph (1) of the conclusions of this section (page 101). The first sentence says

> "System open market operations must, of course, be conducted with a view to the furtherance of the monetary and credit policies of the Federal Open Market Committee."

On the other hand, while not clear the second sentence seems to define System reserve objectives as merely equivalent to the functioning of the U.S. Government securities market. It is this far narrower sentence which is carried forward to the conclusion of the entire report:

> "...under current market circumstances, outright operations in Federal agency securities would not facilitate, in any material way, the achievement of System reserve objectives."

To summarize my concerns: (1) Many readers of the report may feel that the System fails to differentiate among public policy objectives; System objectives; System reserve objectives; and the techniques whereby the System handles day-to-day relationships with the market. Clearly this is not the case.

(2) The report contains no analysis of whether or not System public policy objectives would be enhanced by outright purchases of agency issues. It includes in its statements a partial list of the public and monetary policy objectives that some believe would be enhanced by such operations, namely,

> "...(b) a willingness by the System to undertake outright transactions in all Agency issues, on a limited basis, would increase the marketability of the issues, would tend to place Agency issues on a more common footing with direct debt of the Government, insofar as investors are concerned, and would reduce somewhat the interest rate spread between Agencies and direct Federal debt; (c) Agency issues are sometimes in such large supply, relative to market demand, that they lead to over-all credit market pressures which might be most expeditiously moderated through Federal Reserve operations in the Agency market; (d) such operations may at times provide a degree of needed support to areas, such as housing, that might be under undue temporary pressure; ...."

However, it does not carry out an analysis of these or other objectives. It states that System operations might have important price effects and perhaps cause other technical difficulties. It fails, however, to relate the possible disadvantages of such technical difficulties to the gains for public and System policy objectives that might arise from the purchase of agency issues.