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November 10, 1970

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Broida

Enclosed are two staff memoranda, dated today and entitled "Effects of System Buying of Treasury Coupon Issues on Longer-Term Interest Rates," and "Federal Reserve Open Market Operations in Federal Agency Issues."

These memoranda have been prepared in response to the Committee's request at its meeting of October 20, 1970. It is contemplated that they will be discussed at the meeting on November 17.

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Arthur L. Broida, Deputy Secretary, Federal Open Market Committee.

Enclosures

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<u>CONFIL</u>	ENTIAL (FR)	November 10, 1970	
то:	Federal Open Market Committee	SUBJECT: Effects of Sy Buying of Treasury Co	stem [Carded
FROM:	The Staff	Issues on Longer-Term Interest Rates	-

This memorandum responds to the request of the Open Market Committee for an evaluation of the arguments for and against a program of sustained System buying of Treasury coupon issues over the weeks ahead. The memo starts with a discussion of the objectives, channels of effect, and possible dimensions of such a program and then considers the pros and cons of attempting to achieve these objectives in the manner proposed.

I. <u>OBJECTIVES</u>

System purchases of Treasury coupon securities have been suggested at this time as a means of establishing, or accelerating in time, some downward momentum in longer-term interest rates. Although security market yields have already turned down from their recent peaks, yields on corporate and municipal bonds are still relatively high, reflecting the pressure of unusually heavy fall borrowing. And the margin by which long-term rates exceed short-term rates is very wide. Those now advocating active buying of Treasury coupon issues generally assume that long rates will decline further over the months ahead, eventually dropping to below their earlier 1970 lows. The objective of a buying program is, therefore, to accelerate -- and possibly accentuate -- the decline of long rates - 2 -

that would be expected to develop over time in any event. The ultimate purpose, of course, would be to help stimulate spending on homes and by State and local governments, and to moderate weakening in business plant and equipment outlays.

Of course, a program of Desk buying of coupon securities is not the only type of System action that might exert downward pressure on longer-term rates. Should the Committee decide that such a goal is desirable, it might try to accomplish this objective through a shift in the maturity sector of System buying operations alone, through such a shift taken in combination with changes in other policy instruments, or through changes in other policy instruments alone. Without prejudging what, if any, mix of actions might be most appropriate to meet policy requirements at this time, the analysis in this memo centers solely on operations in coupon issues -assuming other policy instruments unchanged.

Given such an assumption, any buying program would constitute a change in current operational procedures but not a change in monetary policy as described in the current directive calling for some easing in credit market conditions and a moderate growth in the aggregates. Of course, there would be somewhat greater emphasis, however, on the credit market conditions part of the directive as it applies to long-term interest rates. To effectuate this shift in emphasis the System would simply shift the weight of its reserve supplying operations toward intermediate- and longer-term issues - 3 -

from the Treasury bill sector of the market. There might be some secondary effects on bank liabilities and assets and reserve requirements that would affect the amount of reserves supplied. But it is not expected that such effects would be large.

II. CHANNELS OF EFFECT ON LONGER-TERM RATES

Desk buying of Treasury coupon securities influences longer-term rates both directly, through the immediate market effects of increased System demands for intermediate- and longer-term Treasury issues, and indirectly, through the effects market interpretations of the System's purpose may have on general interest rate expectations. The direct market effects of Desk operations in the Treasury coupon market itself may be appreciable in the short-run, given strong present expectations of a decline in interest rates on Government securities. In particular, dealers might well bid investors aggressively in order to replace securities sold to the System. The resulting fall of Treasury coupon yields would enhance the relative attractiveness of yields on mortgages, Federal Agency securities, and corporate and municipal bonds -- encouraging investors to shift funds into these other markets.

There is question, of course, as to how large, or long lasting, downward effects on longer-term interest rates in these other markets would be, given the overall magnitude of such markets relative to the likely size of induced increases in fund flows. It should be noted, however, that even - 4 -

if observed long-term ratesdeclines were quite small, the objectives of the coupon operations would have been attained if the reason for the limited reduction was an increase in State and local government security offerings and/or a rise in mortgage activity.

The significance of the indirect interest rate effects of System coupon purchases would depend on how the character of the System operation affected market views of monetary policy and the economic and financial outlook. If the program of coupon buying strengthened market expectations that longer-term interest rates would decline within a framework of national policy likely to foster resumption of economic expansion at a pace largely free of demand inflation, this should help to stretch out some of the heavy demands currently putting pressure on capital markets, and speed up the commitment of funds by long-term investors. In these circumstances, it would help to achieve the desired downward momentum of longerterm interest rates. But if coupon operations led instead to fears that the Federal Reserve was interfering unduly with the functioning of the free market or that monetary policy was becoming overly expansionary, this could tend to divert investors from participation in long-term markets and work against the objective of lower rates. Of course, the particular conditions of the economic environment at the time of operations would have a great deal to do with whether such fears actually developed and how long they were sustained.

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The shift in focus of Desk buying from short- to longerterm Treasury securities would also tend to exert some direct upward pressure, or reduce downward pressure, on short-term rates relative to what otherwise would have been the case. If purchases of coupon issues were so large as to require some offsetting sales of Treasury bills to prevent the release of unwanted reserves, the strength of offsetting effects on short rates would, of course, be intensified. The extent of these direct effects on Treasury bill and other short-term rates, however, would presumably be considerably smaller than those on longer rates since short-term markets generally are so much larger and broader than capital markets. But to the extent that short-term rates were strengthened, the competitive position of banks and other depositary institutions in bidding for funds would be weakened marginally, thus tending to offset partially the beneficial effects sought in long-term markets through System coupon operations.

III. <u>DIMENSIONS</u>

Any program for System buying of Treasury coupon issues would need to allow for considerable desk flexibility in its implementation, since the actual volume of purchases needed would be dictated in part by the manner in which the market responded to the System's initiative. Because the stated objective of the program would be to exert downward pressure on longer-term rates, however, the Desk's - 6 -

approach to buying coupon issues would have to be more aggressive than in recent years. Under recent procedures purchases of coupon issues have been carried out in a manner expressly designed to minimize the impact of System buying on market rates; hence purchases have typically been limited to periods when there was a ready supply of coupon securities available in the market. During the closing weeks of recent years, for example, the volume of coupon security purchases by the Desk has ranged from zero in 1968 to \$185 million in 1967. Effective implementation of the proposed program would thus seem to require a more active and sustained operation than in the recent past, possibly as large as the ones undertaken in the spring of 1967 and the early years of the 1960's. $\frac{1}{2}$

A relative moderate program of coupon buying might focus on purchasing such issues during weeks in which reserve supplying operations were required, and selling Treasury bills in weeks when reserves had to be absorbed. Over the rest of the year the gross injection of reserves in weeks when reserves have to be supplied may run from \$1.5 to \$2.0 billion with the net reserve injection amounting to around \$1.0 billion. 2/However, most of this need for reserves is heavily concentrated in a few key weeks. To convey

<u>1</u>/ Appendix Table shows the magnitude and maturities of System purchases in these earlier coupon buying episodes.

^{2/} The specifics of projected weekly reserve needs are shown in Appendix B.

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the sense of the Committee's intent, it would be important to have relatively sustained buying rather than a seesaw pattern of heavy purchases followed by quiescence. Moreover, the closing weeks of the year involve more than usual uncertainty in the projection of the factors affecting reserves so that the Desk usually accommodates a sizeable part of the year-end need for reserves with repurchase agreements. In this way seasonal reversals in reserve flows after the turn of the year are accommodated smoothly with a minimum of short-run market disruption. <u>In toto</u>, therefore, a System purchase program centered largely in weeks when reserve supplying operations are needed might be limited to \$300 to \$500 million altogether between mid-November and year-end. Such an operational objective would involve spreading purchases across the full range of Treasury maturities, only a limited portion of which would be in the longestterm issues where the market is very thin.

A more aggressive program for acquiring coupon issues -say \$500 million to \$800 million in the seven week interval of remaining seasonal net reserve supplying operations -- would probably require sizeable operations in weeks when a release of reserves was not needed. This would neccessitate some offsetting sales of Treasury bills to keep the net release of reserves under control, assuming for purposes of this analysis no concurrent change in aggregate targets. In addition, by using swap operations in this way, System buying of coupon issues could be extended into the early 1971 period of seasonal reserve absorption, if such a move seemed desirable. - 8 -

In earlier periods of active System buying the volume of coupon offerings acquired in a single month ran as high as \$470 million and in total for two consecutive months as high as \$900 million. (See Appendix Table A.) However, most of these earlier coupon buying episodes occurred shortly after large Treasury refunding or advance refunding operations when there was a ready supply of longer-term securities available in the market. While settlement on the Treasury's present November refinancing -- in which two new longer-term notes were offered -- occurs on November 16, the relative availability of Treasury note and bond offerings in the secondary market over the next few weeks would depend importantly on the strength of market expectations of still lower interest rates. To the extent System purchases and other factors maintained strong anticipations of lower rates, the System operation could exert greater downward pressure on yields than in earlier buying episodes without involving very large overall purchases. But if present holders of coupon issues concluded that the outlook was for not much further decline in rates and decided to take profits, System purchases could be sizeable with a lesser effect on long rates.

IV. THE PROS AND CONS

To a large extent, the arguments for and against the desirability of embarking on a sizeable Desk operation in coupon issues depend on one's view of the likely future course of economic activity. - 9 -

Beyond this, there are also continuing differences of opinion regarding the general efficacy of operations in coupon issues as a means of affecting interest rate spreads. The weight of academic and market opinion seems to have swung around since the early 1960's to the view that even sizeable System operations in coupon issues can have little lasting impact on the structure of interest rates. Nevertheless, it may be contended that what is at issue now is not the lasting effect on the structure of interest rates but the desirability of helping to correct a temporary distortion in rate relationships being caused by the heavy recent and prospective volume of capital market financing.

In the rest of the memo pro and <u>con</u> arguments are listed two for/possible approaches to System coupon purchases: one a moderate program in the \$300 to \$500 million range associated with buying confined largely to weeks of reserve need, and the other a more aggressive program involving purchases in the \$500 to \$800 million range. It should be noted that not all of the arguments listed <u>for</u> <u>or</u> against are mutually consistent.

A. <u>Moderate Buying of Coupon Issues</u>. The arguments favoring this program include:

 Under pressure from heavy fall borrowing by businesses and State and local governments, long-term rates have been quite sticky despite much sharper declines in short-term rates, + 10 +

and spreads of long over short rates have consequently become very large. Long-term rates may need to be lower if the forecasts for even limited economic recovery in 1971 are to be realized, since lower interest costs could help to dampen the evident slowdown of business capital spending and to stimulate needed outlays for housing and State and local government capital projects. The Federal Reserve can help to accelerate the needed declines of long rates by purchasing Treasury coupon issues, even if only in moderate volume.

2. Even a moderate System operation could be effective at this time because market expectations of lower interest rates have strengthened recently. In this environment the System buying would help to dramatize to would-be borrowers the likelihood that they will be able to obtain desired long-term funds at significantly lower rates by delaying their financing. If borrowers actually began to act on this presumption, lenders would become more willing to bid for long-term investments to lock up high yields; demands for longer-term funds could be more smoothly accommodated at declining yields; and in time there would be no further need for System operations in coupon issues.

3. The shift in System buying is natural at a time when borrowers have shifted the weight of their demand toward longer maturities. It would help, in effect, to take securities off the market in maturity ranges where the relative supplies are largest. - 11 -

4. Keeping the operation to relatively moderate proportions would tend to allay dealer and investor apprehension about the possible technical market complications of the System's shift of emphasis. The operation could be readily explained as one different only in degree from what market participants have been used to, so they should be able to fold it into their pattern of operations without undue difficulty.

5. A moderate buying program in coupon issues would be more consistent with System efforts to achieve a controlled economic expansion rather than a more aggressive approach. Operations on a moderate scale would thus reduce the risk that observers would misread the System's action as part of, or foreshadowing, a policy of aggressive sustained monetary ease. And it might be helpful in strengthening expectations that a policy of measured stimulation would produce lower interest rates over the months ahead.

6. The Committee could revert to the present approach to coupon purchases easily and with minimal adverse consequences if and when that seemed desirable.

The arguments that could be advanced against this proposal include:

1. It would be a mistake to try to force feed declines in long rates or to suggest a further aggressive easing of monetary policy at this time when the likely strength of the expected 1971 recovery is being obscured by the General Motors strike. Since - 12 -

the strike is essentially a temporary economic despresant, the System should avoid committing itself to the objective of lower long-term rates until it becomes clearer how the economy is likely to respond once the strike is over. Should the System make such a commitment, it might find itself supplying more reserves than intended, as in 1968, because the economy performed more strongly than is currently forecast.

2. There is no real need/coupon buying operations in any event since long-term rates most recently appear to have turned down significantly as a result of basic market forces.

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3. If it were considered desirable for the System to try to induce lower long-term rates at this time, further action on general monetary policy instruments would be a much more effective way to achieve this objective. A general move to ease credit market conditions would reduce short-term rates, encourage investors to reach out for longer-term market instruments, and thus exert downward pressure on long rates as well. For a moderate program of System coupon operations to exert a significant impact on long rates, even temporarily, it would have to influence market expectations about the general course of monetary policy. In the absence of such an influence, the direct effects of System buying on long rates would tend to be fleeting, since market professionals would soon arbitrage them out through offsetting changes in their own positions. - 13 -

4. Even a moderate step-up in System purchases of would coupon issues at this time/probably raise general questions regarding the overall posture of monetary policy. For example, market participants would probably wonder whether the implied objective of lower long-term rates had taken precedence in the Committee's hierarchy of policy goals over the maintenance of moderate growth in the monetary aggregates. Question would thus arise whether the System was likely to reinforce the initiative of Its coupon buying operation by more aggressive easing of general monetary instruments as well. As has already been indicated, creation of this type of market uncertainty about System policy could prove to be counter-productive at this time.

5. Disengagement might not be so easy as it appears on its face since a new operational approach would generate a presumption that it would be continued. For this reason it would be better not to start a new approach unless it could be expected to continue.

B. <u>Aggressive Buying of Coupon Issues</u>. The arguments in favor of this alternative include:

1. To be most effective in reducing long-term rates, the proposed System operation in Treasury coupon issues should be an aggressive one. This would mean sizeable continuing purchases and probably an extension of the operation beyond the immediate seasonal reserve supplying period, with offsetting sales of Treasury bills to control the release of reserves. The evident sluggishness of the - 14 -

economy suggests that the objective of accelerating in time the generally expected decline of long rates should have a high priority. Otherwise there is a strong possibility that economic recovery in 1971 will fall short of forecasts, once the expected catch-up expansion associated with the GM strike settlement and the strikehedge building of steel inventories is over.

2. While sizeable Treasury bill sales needed to offset the reserve effect of coupon purchases would tend to some extent to hold bill yields above levels that would otherwise prevail, this tendency would probably not be too significant since short-term markets are so large. To the extent bill rates were held up, this would help some to limit the incentive for banks to repay high cost Euro-dollar borrowing.

3. Market participants could accommodate themselves to System operations in coupon issues once the new <u>modus operandi</u> became clear. Admittedly, expanded operations could cause some to withdraw from the markets while they assessed the new development and others to be concerned about the policy's implications for the longer-run. But these concerns could be dealt with directly by official discussion of the rationale for such operations in the context of overall policy objectives.

4. The Committee could revert to a less active role when the economy began expanding again at a desirable rate. While such a reversal at a later date might contribute to an upward movement in rates, that would then be appropriate from a policy standpoint. - 15 -

Arguments that might be advanced against this alternative include:

1. The more aggressively the System pushes yields lower through coupon purchases, the greater is the risk that it will overstay monetary stimulation when the economy resumes growth. This could be a real problem since the effects of the GM strike may be temporarily exaggerating the observed sluggishness of the economy, and there is a significant risk that activity for 1971 will snap back more rapidly than those advocating an aggressive coupon buying operation expect.

2. A pronounced shift in the maturity spectrum of System purchases would require large offsetting sales of shortterm issues and tend to hold short rates somewhat higher than they would otherwise be, while long-term rates were tending downward. Since the spread between short and long-term rates is important to the process of encouraging investors to shift into longer-term municipal securities and mortgages, System operations that had the effect of holding short-term rates up might to some extent be self defeating in terms of their stated objective.

3. The risks of a yield backlash from fears of an overly expansive monetary policy increase sharply with the size of the coupon purchases undertaken. It is doubtful that official statements could quell the suspicion that heavy System coupon operations - 16 -

were a part of a more general policy of aggressive and sustained easing. Money market participants would feel that the System's aggressive buying was propelling prices to levels that could not be sustained without indefinite continuation of such buying.

4. Substantial purchases of intermidiate and longerterm Treasury issues tend to reduce the average life of the outstanding Treasury debt in the handssof the public. This is no great problem in the case of intermédiate-term issues where the Treasury can issue additional amounts, but in the case of longterm debt, this unfunding damages the Treasury debt structure in a way that cannot be repaired under the existing constraints of the 4-1/4 per cent interest rate ceiling.

REC'D IN RECORDS SECTION

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APPENDIX A

MAJOR PERIODS OF DESK OPERATIONS IN TREASURY COUPON SECURITIES, 1961-1965-1/

VOLUME OF SECURITIES ACQUIRED (In millions of dollars)

	TOTAL	1-5 <u>YEARS</u>	OVER 5 YEARS
1961 - March	373	312	61
April	441	298	143
May	469	210	259
July	425	306	119
November	285	244	41
1962 - March	367	357	10
November	441	246	195
1963 - March	307	230	77
August	362	190	172
1964 - August	430	187	243
September	231	108	123
1967 - May	211	107	104
June	333	185	148

1/ Monthsselected are those in which gross purchases of coupon issues either aggregated in excess of \$275 million or, when taken together with operations in the preceding month, averagedaround \$275 million or more per month over the two-month period.

APPENDIX B

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ECORDS SECTION

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PROJECTED WEEKLY CHANGES IN BANK RESERVE NEEDS (In millions of dollars)

Reserve week ending	Weekly change in <u>reserve needsl/</u>
1970 - Nov. 11	+10
18	+95
25	+615
Dec. 2	+470
9	+80
16	-80
23	-305
30	+200
Jan. 6	+565
Gross Reserve Release over Period	2,035
Jan. 13	-370
20	-495

1/ (-) indicates need for System to absorb reserves.

NOTE: Change in reserve needs reflects System open market operations through 2:30 p.m., October 10, 1970. Pattern of reserve needs includes effects of projected changes in member bank deposits, taking account of the 2-week lag in required reserves.

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CONFI	DENTIAL (FR)	November 10, 121970				
TO:	Federal Open Market Committee	SUBJECT: Federal Reserve Open	•			
FROM:	The Staff	Market Operations in Federal (Carden	1			

This memorandum is designed to bring up to date the main points considered by the Federal Open Market Committee in its earlier discussions of Federal Reserve operations in agency issues. In June and July 1969, the Federal Open Market Committee discussed at length the question of whether the Federal Reserve should undertake operations in agency issues. Memoranda submitted to the Committee at that time and earlier covered the various pros and cons of the proposal and laid out tentative guidelines for experimental operations in agency issues should the Committee decide to give the go-ahead sign for such operations. (Copies of the memoranda are attached as Appendixes B-D.) The tentative operating guidelines were based on the view that agency operations should not be undertaken in special support of any particular area of the agency market, but should conform with the reserve and other objectives of System policy. While no Committee policy decision was undertaken, it appeared that the guidelines generally met with the Committee's approval.

Because of various reservations about the desirability of the proposal, action was postponed several times and the matter was dropped after the meeting of October 7, 1969. The Committee's reluctance to undertake operations in agency issues at that time, even on a limited experimental basis, was based on a number of factors, including the relatively modest volume of activity in - 2 -

the agency market (apart from sales of new issues), fears of pressures that might develop for support of individual agency issues, and the hope that Treasury plans to consolidate agency indebtedness might achieve more orderly marketing of new agency obligations. The latter development could presumably minimize the difficulties for System operations by increasing the size and tradeability of individual issues and by reducing problems of potential discrimination among issues when dealing in a fragmented market.

Unfortunately, the past year has witnessed a number of developments toward greater fragmentation of the agency market. $\frac{1}{}$ Several new agencies have entered the market as borrowers on their own -- among them the Farmers Home Administration, the Federal Home Loan Mortgage Association, and H.U.D. -- and more new entries are expected, including the new National Postal Service. The Treasury Department seems to have little control over these new agencies and even over some of the older agencies which have become entirely owned by private interests, though managed mainly by political appointees. As a result, while some agency issues are larger and more tradeable than before, the total number of small and relatively untradeable issues has not decreased and may increase, and the number of different offices involved in marketing new issues has grown. Only the Farm Credit Administration has moved toward some consolidation of debt offerings, and even in this instance the number of such issues has not been reduced.

^{1/} For details of developments in Federal agency markets since the Treasury-Federal Reserve Study, see Appendix A.

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One of the principal reasons for advocating operations in agency issues has been that over a period of years the agency market has become broader and more active, even to a point where on some statistical measures it is more active than the market for some of the direct Treasury debt in the form of coupon issues. There is no doubt that the agency market has continued to develop in terms of trading volume and in dealer positioning. While statistically it appears that the System could now operate in the market with less risk of becoming a dominant factor than earlier, it is not clear that this is actually so. Much of the reported trading volume in agency issues represents the initial placement of the offerings, made under the stimulus of relatively large inducements to salesmen by way of commissions. While dealer activity in the secondary market has been increasing, the trading in size is limited to a number of the larger new issues having shorter maturities and much of it takes place shortly after the new issue has been brought to market. The secondary market for somewhat more seasoned agency issues is still of relatively limited breadth and resiliency.

Another point to consider is that entry into the agency market at this time probably would not be very significant as part of a near-term effort to reduce long-term interest rates. If the System did begin agency operations, common prudence -- for reasons indicated in the attached memorandum on "guidelines" -- would - 4 =

call for confining operations to short-term issues that are relatively tradeable and staying out of longer-term issues which trade very little. Still, to the extent that any System operations did help broaden the market for Federal agency issues, it might tend to increase the availability of funds to housing and other Federally supported credit programs and thus ease credit conditions to some extent, particularly in mortgage markets.

APPENDIX A

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RECENT DEVELOPMENTS IN THE FEDERAL AGENCY SECURITIES MARKET*

The joint Treasury-Federal Reserve study of the U.S. Government securities market explored the possibility and desirability of System outright operations in Federal Agency securities. $\frac{1}{}$ Certain technical difficulties for outright transactions in this market were noted, but it was recognized:

. . . that market conditions could develop--for example, as a result of further growth in the agency market, the development of less frequent and larger agency issues, or the availability of a large floating supply of agency securities--which might make outright operations in agency issues in the market by the Federal Reserve appear more desirable.²/

The Agency market, it was also noted, had more and smaller individual issues outstanding than the market for Governments. However, the market was observed to be fairly homogeneous even though it consisted of obligations of several different Agencies. The study concluded that large outright transactions in agencies might under prevailing conditions have an excessive influence on the market. On the other hand, small operations might not significantly aid the market's functioning. In the meantime, the System should continue to make repurchase agreements against Agencies, which were begun in late 1966.

^{*} Prepared by staff of the Government Finance Section at the Board.

^{1/} The summary report of the study was published in April 1969. However, the staff study by Janice Peskin, Federal Agency Debt and its Secondary Market, on which many of its conclusions concerning the Agency market are based, is dated November 1967. Much of the data in that study run through the second quarter of 1967.

^{2/} Report of the Joint Study, April 1969, p. 42.

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This memorandum will review the development of the market for Federal Agency securities since the time of these earlier conclusions. In summary, the evidence indicates that the volume of outstanding Agency issues has grown very rapidly, but that most of this growth is accounted for by issues of maturities of less than a year. Dealer positions and transactions in longer-term Agencies are still quite small relative to those in the direct Treasury market. Hence, while System outright transactions in the short-term Agency market now might be technically more feasible than earlier, the reduction with respect to longer-term Agency issues is no better than before. Even in the short-term area, although there are more large size Agency issues outstanding, operations would be more complicated than with short-term U.S. Treasury issues. Current spreads of yields on Agency securities over those on Treasury issue, are not appreciably larger than they were in late 1968 for longer-term Agency issues, following the recent substantial declines in interest rates. And the wider spreads that have recently prevailed on short-term issues also seem to be narrowing.

Growth in Debt Outstanding

Federal Agency debt has grown very sharply in recent years. At the end of 1965, the combined debt of the six regular borrowers in the Agency market totaled \$14.1 billion. $\frac{3}{}$ By the second quarter of 1967--the last date shown in the study--it had increased to \$18.0 billion. Between December 1968 and December 1969, such debt jumped from \$22.2 to \$31.5 billion, an increase of 42 per cent. During the first eight months of 1970 it advanced another 21 per cent to \$38.1 billion.

^{3/} Issues of FHLB, FNMA (excluding PC's), FLB, FICB, Banks for Cooperatives and TVA.

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Table 1

Federal Agency Debt Outstanding (In billions of dollars)

	Total	Hous	sing		arm Cred		Addendum: Total U.S Marketablo	
	Agency Debt	FNMA	FHLB	FLB	FICB	COOPS	TVA	Debt
December 1968	22.2	6.4	4.7	5.5	3.6	1.4	.6	236.8
December 1969	31.5	10.5	8.4	6.1	4.1	1.5	.8	235.9
August 1970	38.1	14.0	10.1	6.5	5.0	1.5	1.0	240.5

Participation Certificates

	Total	GNMA1/ EX-IM	CCC
December 1968	12.2	9.1 1.9	1.1
December 1969	10.2	8.1 1.8	.3
August 1970	8.8	7.3 1.5	

 $[\]frac{1}{1}$ This column shows the PC's that were originally issued by FNMA, but for which GNMA, is now acting as trustee.

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This total does not include participation certificates, which have been declining in amounts outstanding and which generally no longer trade actively in the secondary market, since none have been sold since mid-1968. The total of GNMA, EX-IM and CCC participation certificates outstanding at the end of 1968 totaled \$12.2 billion. By August 1970 this level had declined to \$8.8 billion.

About 82 per cent of the rise in regular Agency debt between December 1968 and August 1970 was accounted for by sharply increased borrowings by FNMA and FHLB, as these Agencies sought to help channel funds into the housing and home credit industries during a prolonged period of tight money. The combined debt of the two housing-related Agencies equaled 63 per cent of the total Agency debt outstanding in August 1970.

For comparison, it should be noted that while Agency debt rose 72 per cent to \$38.1 billion between December 1968 and August 1970, the marketable direct U.S. debt advanced by only about \$4 billion (or 2 per cent) to \$240.5 billion. While seasonal changes in both classes of debt, especially in Governments, are ignored here to simplify the analysis, the comparison remains striking. In August 1970, 61 per cent of the total Agency debt was due within a year (with 10 per cent of the debt consisting of discount notes), 34 per cent matured in 1 to 5 years and 5 per cent fell due after 5 years. As a result, there is only \$12.9 billion currently outstanding in 1 to 5 year Agency debt and \$2.1 billion

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Table 2

Maturity Structure of Agency and Government Securities (In billions of dollars)

	Within 1-year Bills or Other _disc. notes		1-5 years	<u>1-5 years</u> Over <u>5-years</u>				
			Agencies					
December 1968	2.6	11.6	6.3	1.8	22.2			
December 1969	3.8	16.6	9.3	1.8	31.5			
August 1970	3.7	19.3	12.9	2.1	38.1			
			Governments					
December 1968	75.0	33.6	68.3	59.9	236.8			
December 1969	80.6	37.6	73.3	44.4	235.9			
August, 1970	81.9	28.0	91.1	39.6	240.5			

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in over 5 years, in contrast to \$91.1 and \$39.6 billion, respectively, in direct Government marketable debt. Hence, the potential volume of System operations in intermediate and longer-term securities in the Agency market is much smaller than in regular Government securities. Recently, however, both the FHLB and the FNMA have indicated an interest in issuing longerterm securities from time to time. The last time that a security with more than five years' maturity was issued by these agencies was in March 1970 when the home loan banks sold a \$350 million 10-year issue.

Dealer Activity in Agencies

Despite the large overall growth in Agency debt in recent years, dealer positions and transactions have increased only moderately, as shown in Table 3. In the third quarter of 1970, 69 per cent of dealers' positions in Agencies consisted of issues due within a year. Positions in Agency issues of more than a year amounted to only \$244 million as compared to \$649 million in Treasury issues of comparable maturity. Dealer transactions in longer-term Agencies averaged \$195 million a day compared to \$441 million for Treasury securities of like maturity. Thus, while dealer inventories and transactions in Agencies have grown <u>in toto</u>, dealer activity still is small compared to direct Government debt, especially in the over one-year area.

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Table 3

Dealer Positions and Transactions (quarterly averages, in millions of dollars)

	Agencies		Go		
	W/1 year	<u>Over 1 year</u>	Bills	Other W/1 year	<u>Over 1 yr</u> .
		Pos	<u>itions</u>		
1968 - IV	416	257	3,068	259	672
1969 - I	319	169	2,068	288	134
II	391	355	2,013	300	363
III	282	256	1,628	268	361
IV	334	227	2,632	143	338
1970 - I	328	278	2,547	268	434
II	462	195	2,377	280	467
IIIp	545	244	2,874	397	649
		Transaction	8		
1968 - IV	176	102	1,937	152	406
1969 - I	229	82	2,036	123	336
II	262	119	1,852	155	342
III	222	112	1,828	155	338
IV	267	151	2,034	128	410
1970 - I	238	235	2,029	169	471
II	231	161	1,655	129	335
III	221	195	1,733	164	441

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Gross New Agency Issues

While the changes in total Agency debt outstanding give the magnitude of net new money raised in recent years, a further gauge of the size and increasing importance of the market is the level of gross new borrowing. Gross new Agency issues in the fourth quarter of 1968 totaled \$3.5 billion but by the last quarter of 1969 had risen to \$6.7 billion. In the first quarter of this year, gross borrowing by Agencies reached a peak level of \$8.7 billion, reflecting especially the very big financings by the housing related Agencies. Nevertheless, the average size of individual Agency issues still amounts to only \$300 to \$400 million, which represents an increase of about \$100 million since 1967. Detailed data are shown in the table on the following page.

	-9+	
(quartei	GROSS NEW AGENCY ISSUES tly totals, millions of	<u>1</u> / dollars)
1968 -	IV	3,5 21
1969 - [.]	I	4,652
	II	5,939
	III	6,053
	IV	6,742
1970 -	I	8,718
	II	6,957
	III	7,011

1/ As of offering dates. Excludes discount notes sold by FNMA and TVA.

	Individual Issues							
Agencies	Outstandings as	es Issued ig. 1970						
	Avg. Size	Peak Size	Avg. Size	Peak Size				
Fed. Home Loan Banks	36 9	625	432	850				
FNMA	214	550	323	500				
Banks for Cooperatives	313	352	307	391				
Fed. Intermediate Credit Banks	357	401	490	656				
Federal Land Banks	169	407	299	442				
TVA	55	70	67	100				

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Innovations

A number of important innovations have occurred in the Agency market during 1970. For instance, beginning in March, the Federal Intermediate Credit Banks and Banks for Cooperatives began combining their monthly financings into a single offering date, thus reducing to some extent the number of individual Agency financings, although the number of new security issues was not reduced. Moreover, starting in May the Government National Mortgage Association began to guarantee certain issues of FNMA and FHLB as to both principal and interest. Finally, in October a new entity under the aegis of the Federal Home Loan Bank System--the Federal Home Loan Mortgage Corporation--sold its first obligations. In contrast to the usual method of marketing new Agency debt through a fiscal agent, the securities were underwritten by a syndicate. The syndicate technique had been used earlier in the marketing of FNMA and Ex-IM participation certificates.

During 1968, the operations of FICB, Banks for Cooperatives and the secondary market function of FNMA were taken out of the Federal budget, reflecting the conversions of these Agencies to full private ownership. FHLB's and FLB's never were included in the new unified budget, since they had become privately owned at an earlier date. In the future, there could be further changes and growth in the Agency market as new Federal or Federally-sponsored instrumentalities issue debt. Now under consideration are debt issues to raise money for -11-

an urban bank or an environmental loan authority, the supersonic transport, and the U.S. Postal Service. Such issues could add perhaps another \$4 billion a year to Agency financings, when and if these plans are implemented. <u>Yields and Yield Spreads</u>

Yields on regular new issues in the Agency market reached a peak in the last uqarter of 1969, when the Intermediate Credit Banks priced an offering of 9-month debentures to yield 8.80 per cent. At the same time, the constant maturity yield series for Agencies reached an all time high, with 6-month Agencies averaging 8.35 per cent, 1-year issues 8.49 per cent and 3-year maturities 8.28 per cent. In all three cases, the averages were more than 2 percentage points above their levels of a year earlier.

Short-term Governments also reached peak yield levels in the last quarter of 1969, with 6-month maturities averaging 7.64 per cent (investment yield), 1-year issues 7.55 per cent and 3-year maturities 7.77 per cent. Intermediate and longer-term Governments peaked during the first half of 1970.

In the case of both Agencies and Governments, these high yield levels reflected the cumulative effects of a prolonged and severe period of tight money. In the Agency market, a special contributing factor-which in itself was related to the tight monetary conditions--was the very large supply of new issues. Partly due to the sharp increases in gross new offerings, the spreads between Agencies and Governments widened during 1969 relative to 1968 and had diminished only moderately by the

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third quarter of 1970. More recently, however, as short-term rates have declined further, the yield spreads of Agency securities above Treasury issues have narrowed considerably, as Table 4 shows. Judging by the most recent behavior of the yield spreads, it seems that the Agency market, despite its rapid growth in size, is returning to its previous competitive position relative to the Treasury market.

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Table 4

Yields and Yield Spreads (quarterly averages, per cent)

	6	months .	<u>1</u> /	1-year		3-year			5-year			
	Agens.		spread	Agens.	Govts.	spread	Agens.	Govts.	spread	Agens.		spread
1968 - IV	6.04	5.94	.10	6.06	5.84	.22	6.11	5.75	.36	6.09	5.77	.32
1969 - I	6.66	6.54	.12	6.68	6.36	.32	6.71	6.31	. 40	6 .7 2	6.33	.39
II	7.11	6.64	.47	7.21	6.57	•64	7.21	6.53	. 68	7.18	6.51	.67
III	8.11	7.03	-4 8	8.17	7.65	. 52	8.04	7.46	•5 8	7.82	7.20	.62
IV	8.35	7.64	.71	8.49	7.55	• 94	8.28	7.77	.51	8.17	7.52	.65
1970 - I	8.08	7.57	.51	8.26	7.55	.71	8.25	7.73	.52	8.17	7.73	.44
II	7.62	7.17	.45	8.04	7.45	.59	8.16	7.72	•44	8.21	7.77	•44
111	7.29	€.72	•57	7.51	6.94	•57	7.86	7.38	•48	7.97	7.49	•48
Week Ending Oct. 23	6.76	6.44	.32	6.95	€.39	.5 6	7.28	7.03	.25	7.54	7.1 €	.38

 $\underline{1}$ / Govts. on investment yield basis.

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Table 4 (cont'd.)

Yields and Yield Spreads (quarterly averages, per cent)

	Corporate Aaa new issue	Agencies 5-years	Spread
1968 - IV	6.62	6.09	.53
1969 - I II III IV	7.06 7.32 7.75 8.32	6.72 7.18 7.82 8.17	.34 .14 07 .15
1970 - I II III	8.45 8.94 8.51	8.17 8.21 7.97	.28 .73 .54
Week 10/23	8.64 Corporate Aaa <u>new issue</u>	7.54 Govts. 5-years	1.10 Spread
1968 - IV	6.62	5.77	. 85
1969 - I II IT IV	7.06 7.32 7.75 8.32	6.33 6.51 7.20 7.52	.73 .81 .55 .80
1970 - I II III	8.45 8.94 8.51	7.73 7.77 7.49	.72 1.17 1.02
Week 10/23	8.64	7.16	1.48

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REC'DAR RECORDS SECTION

NOV 121970

APPENDIX B

June 20, 1968

CONFIDENTIAL (FR)

POLICY ISSUES #9 U.S. GOVERNMENT SECURITIES MARKET STUDY FEDERAL RESERVE OUTRIGHT TRANSACTIONS IN AGENCY ISSUES

Problem

The Federal Reserve now makes repurchase agreements against Federal Agency issues under authority of the amendment to the Federal Reserve Act that permits the System to buy and sell in the open market any obligation which is a direct obligation of, or fully guaranteed by, any Agency of the United States. This amendment was originally passed for a 1 year period in September 1966, and was subsequently renewed for 1 year. 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 the development of a broader Agency market, and enhance public policy objectives generally.

Discussion

(1) 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 debt by the Federal

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Reserve; (b) a willingness by the System to undertake outright transactions in all Agencies, even on a limited basis, would increase the marketability of the issues, would tend to place Agency issues on more a common footing with direct debt of the Government, insofar as investors are concerned, and would reduce the interest rate spread between Agencies and direct Federal debt; (c) Agency issues, including PC's, 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; and (d) 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.

(2) Among the more important market problems likely to be encountered by System outright transactions in Agency issues are: (a) the small denominations and trading market for many individual Agency issues; (b) the risk of uneven and disproportionate price effects from System operations in particular Agency issues; and (c) difficulties in choosing Agency issues to buy or sell, given the frequency of new issues (averaging about 4 per month) and the desirability of not supporting the market for particular Agencies.

(3) The capacity of the market for Agency issues to absorb System operations, while not becoming dominated by such operations depends broadly on the over-all size of the market, the size and market - 3 -

availability of individual issues, and the nature of trading activity. Indicators of market performance that bear on those points show that the over-all market has expanded in breadth and depth in recent years, and in the short-term area as a whole (within one year) appears comparable to, or even more active than, the short-term Treasury coupon market. At the same time, however, there are more individual issues of relatively small size, and large market transactions in particular issues are often more difficult to execute than in the Treasury coupon area. A good deal of the trading activity in the Agency market is accounted for by the frequency of financings, but activity in short-term issues outside of financing periods holds up fairly well and has grown in recent years.

(4) Dealer positions in Agency issues (including PC's) have increased markedly since the early 1960's, with the increase reflected both in issues maturing within and beyond a year. Net dealer positions averaged about \$114 million in 1961 and \$365 million in 1967. About onethird of net positions in 1967 was in securities maturing in over a year. The average level of positions in Agency issues fluctuates widely, and shows characteristics not very different from positions in Treasury coupon issues.

(5) The rise in dealer positions and transactions in Federal Agency issues largely reflects the increase in volume of the Agency debt, with outstanding Agency issues (including marketable PC's) held by the public rising from \$8.4 billion in mid-1960 to \$22.9 billion at the end of 1967. As of the latter date, issues maturing in a year or less - 4 -

amounted to \$11.2 billion, and in over a year to \$12 billion; nearly half of the latter were marketable PC's. (By way of comparison, outstanding Treasury coupon issues maturing in a year or less held by the public at the end of 1967 totaled \$17.9 billion, and those maturing in over a year totaled \$91.5 billion; bankers' acceptances outstanding amounted to \$4.3 billion).

(6) A critical question is whether the data on the Agency market are indicative of the size and activity of a single basically homogeneous market or whether there are really several smaller markets for various types of Agency issues. (As with other markets there are differences by maturity of issue, with the longer end, as earlier noted, less active than the shorter end and attractive to different investor groups). The evidence gathered appears to indicate that the Agency market is fairly homogeneous. There are rather small yield differences as between issues of similar maturity of the various Agencies; that is to say, a rather smooth yield curve can be derived from Treasury coupon issues. With respect to how investors may view Agency issues, the ownership data (using data for the nonguaranteed issues of the five major Agencies) indicate that investor groups do not appear to show any very significant preferences for one Agency as against another (with the exception of the relatively greater preference of nonbank financial institutions for FHLB issues, presumably due to the holdings by savings and loan associations of such issues)--although, or course, some investor groups have a larger proportion of Agency issues taken together than do others.

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(7) Dealers were divided in their views as to the desirability of Federal Reserve outright transactions in Agency issues. A major argument of those who advised against such transactions was the probability of strong political pressures to support particular issues or financings. Some dealers, in fact, attached great weight to this consideration, both in its implications for the System's continued ability to conduct open market policy in an environment that was relatively free from day-to-day political pressures and in its implications for the viability of the Federal Agency market itself. Some dealers also stressed the possibly disturbing impact on the secondary market of relatively large and, by nature, discontinuous Federal Reserve operations.

On the other hand, a number of dealers felt that the shortterm sector of the Agency market could accommodate, on both the buy and sell sides of the market, more than token Federal Reserve transactions, although not all of such dealers favored the transactions. Dealers who did recommend such operations thought they would enhance the prestige of the Federal agency securities market, stimulate investor activity in such obligations, and tend to lower rates on Agency issues and bring them into closer alignment with yields on U.S. Government securities of comparable maturities. Some small-scale outright transactions in the Agency market have been undertaken by the Desk acting for Treasury investment accounts, but thus far the great bulk of acquisitions of Agency issue and PC's by these accounts has been directly from the issuers. - 6 -

(8) 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 shall in comparison with Treasury coupon issues $\frac{1}{}$ 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, and would render most difficult, if not impossible, the implementation of more than token System operations intended to have a minimum impact on market quotations.

Agency issues are more readily available for trading in the period immediately after they are first brought to market. However, System transactions during or immediately following a financing period might tend to disrupt the orderly distribution of these new issues. Moreover, in light of the fairly homogeneous nature of the over-all agency market noted above, there arises the policy issue of whether or not the System should remain entirely out of this market in periods when any Agency is conducting a financing. In such a case,

^{1/} The average size of an Agency issue is about \$300 million compared with \$2-1/2 billion for the typical Treasury coupon issue.

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very few open periods would be available during the year when the System would be free to conduct transactions in Agency issues. Indeed, total new offerings of the five major Agencies (Federal Land Banks, Federal Intermediate Credit Banks, Banks for Cooperatives, Federal National Mortgage Association, and Federal Home Loan Banks) average about four each month and there are in addition periodic offerings by other Agencies, including FNMA and Export-Import Bank participation certificates.

Conclusions

(1) System objectives would not be materially furthered by System willingness to undertake outright transactions in Federal Agency securities at the present time and under current market circumstances. Operational difficulties would seriously limit the size, scope, and opportunities for such transactions, especially on the selling side of the market. These difficulties would stem in part from the likelihood that relatively moderate System operations would exert a sizable and uneven impact on market prices and yields. Moreover, the frequent marketing of new Federal Agency issues would considerably reduce opportunities for meaningful operations without interference with the orderly marketing of the new issues. The System would also encounter technical difficulties when its holdings of particular Agency issues matured unless special and preferential arrangements were made with the Agencies for their replacement. The - 8 -

problem has been overcome in the case of direct Treasury debt where facilities exist for the automatic roll-over of Treasury notes and bonds held by the System and where bidding is feasible for a desired amount of new Treasury bills to replace maturing issues.

(2) A broadening of market instruments for the conduct of open market operations may in itself be a worthwhile objective for the longer-run, if operational difficulties can be resolved. It is doubtful, however, that marginal transactions in Federal Agency issues would make any real contribution at the present time to the effectiveness of open market operations in supplying or absorbing bank reserves, given the large current and prospective market availabilities of direct Treasury debt. Continued growth in the Federal Agency securities market, both absolutely and relative to the Treasury market, would of course counsel a reexamination of this conclusion.

(3) It is not clear that occasional and marginal System operations in Agency securities would serve to improve the functioning of the Agency market. Such operations might tend to unbalance the market by giving rise to uncertainties and perhaps to false hopes which would be hard to dispel. Sizable, frequent, and significant System operations in Agencies would under current circumstances tend to exert a dominating influence on the Federal Agency market. The result might be to inhibit the market's continued development by impairing its functioning as a free, self-reliant, and effective mechanism for executing transactions. - 9 -

(4) System operations in Agency issues would be made more attractive and feasible, if the variety of Agency issues were reduced and especially if individual Federal Agencies were to consolidate their new issues into fewer but larger offerings, possible under the aegis of a single marketing agent that distributed the funds raised to the individual Agencies. Such a development would tend to make Agency issues available in larger and more tradeable blocs and thereby facilitate more sizable transactions without marked effects on market quotations. Moreover, the frequency of Agency financings could be reduced as could the potential periods of System inactivity in this market. In general, the problems raised by the multiplicity of Agency securities and the allocation of transactions among them would be eliminated.

(5) It is recognized that market conditions could develop-for example, as a result of further growth in the Agency market, the development of less frequent and larger Agency issues, or the availability of a large floating supply of Agency securities--which might make outright operations in Agency issues in the market by the Federal Reserve appear more desirable. Meanwhile, the System should continue to make repurchase agreements against Federal Agency securities. Such Rp's, which were first undertaken in late 1966, have proved to be a useful supplement to regular Rp's against direct Treasury obligations, given the sometimes limited collateral immediately available to nonbank dealers and the System's need for large transactions. Moreover, repurchase transactions are not subject to the operational problems involved in outright purchases or sales outlined above. Authorized for public release by the FOMC Secretariat on 8/21/2020 CORDS SECTION

NOV 121970

APPENDIX C

June 18, 1969.

To: Federal Open Market Committee Subject: Experimental Open Market Operations in From: Alan R. Holmes Federal Agency Issues.

Pursuant to the discussion at the meeting of the Federal Open Market Committee on May 27, 1969, this memorandum suggests guidelines for conducting experimental outright open market operations in Federal Agency issues. No effort is made to discuss the pros and cons of such operations from a technical, policy, or political point of view. The guidelines suggested are in effect a response to the question, "How would you go about conducting operations in Agency securities if the Committee were to direct you to do so?" The suggestions are designed to minimize the technical problems that would be involved in conducting outright operations in Agency issues.

As the Committee knows, outright System open market operations in Agency issues will be more complicated than operations in U.S. Treasury issues, because of the fragmented nature of the market, the frequent financing operations of the respective Agencies, and the special concern of each Agency for marketing its own new issues to best advantage. To minimize these problems the guidelines suggest confining System operations to individual issues above a specified minimum size, with a view to restricting the number of issues with which the Desk would have to deal. At the same time, this limitation might encourage Agencies to increase the size (and reduce the number) -2-

of individual offerings, a procedure endorsed by the joint Treasury-Federal Reserve study of the Government securities market.

The guidelines assume -- in line with Governor Robertson's memorandum of May 5--that the Federal Reserve would be entering the Agency market as an adjunct to and for the same purposes as its outright purchases and sales of direct U.S. Treasury issues, rather than to support any particular sector of the market. Because of legal uncertainties about the ability of the Federal Reserve to roll over its holdings of Agency issues at maturity, the guidelines suggest that issues held by the System be allowed to run off at maturity. This in turn leads to the suggestion that the holding by the System of any individual issue be strictly limited in order to avoid an unwanted impact on bank reserves and also to avoid forcing on the private market the Agency securities that the System could not roll over on maturity. The legal aspects of System rollovers deserve further study, and there are practical problems that would have to be worked out with the Agencies involved even if legal doubts could be satisfied. Explanatory comments are included in the guidelines to clarify the technical reasons for these and other features of the proposals.

It should also be noted that the guidelines assume that tax-exempt Government Agency issues--either direct or guaranteed-would not be appropriate vehicles for System open market operations. -3-

This assumption is based partly on the inadequacy of secondary markets for such issues, and partly on the conclusion of a 1963 inter-Governmental committee (in which the Federal Reserve participated) questioning the desirability and propriety of Federal Government guarantees of tax-exempt issues. (See Appendix A for excerpt from Committee Report.) Additional study would be needed if the Open Market Committee wanted to explore further the possibility of open market operations in such tax-exempt issues.

Finally, it should be made clear that while technical problems can be surmounted, operations in Government Agency securities cannot--at least under present circumstances--be as neat and simple as operations in direct Treasury securities. While the guidelines attempt to minimize the technical problems, there are many possibilities for misunderstanding both with the market and with individual Agencies. This suggests that if the Committee decides that it is desirable to undertake outright operations in Government Agency securities the approach be gradual and cautious with special attention to avoiding any disruptive effects on either the secondary market or the marketing of new issues. It further suggests that before operations are undertaken the principles underlying the conduct of open market operations in Agency issues be made clear to the Agencies, to the dealer market and to the general public. Because of the need to feel our way if the System -4-

should decide affirmatively to undertake operations in Agency issues, the guidelines adopted should be regarded precisely as guidelines rather than as rigid rules. They should be subjected to constant review and revision as the experiment proceeds.

The eight suggested guidelines follow:

1. System open market operations in Government Agency issues are an integral part of total System open market operations designed to influence bank reserves, money market conditions, and monetary aggregates.

2. System open market operations in Government Agency issues are not designed to support individual sectors of the market or to channel funds into issues of particular Agencies.

Comment on Guidelines 1 and 2

Outright operations in Agency issues would normally be conducted in conjunction with similar operations in direct Treasury issues. In practice I would expect to follow up a go-around to buy or sell Treasury bills with a request to dealers to offer or bid for Agency issues. The amount of Agencies bought or sold would depend on availability or demand. Since supply and demand are apt to be spotty, the proportion of Agencies included in any given day's operation would vary, and careful attention would have to be paid to the price effects of System operations. The principle of purchase - 5 -

or sale at best price would of course prevail. It would take some experimentation to see whether Agency operations could best be accomplished on a full go-around basis or whether dealers should merely be encouraged to show us offers and bids throughout the day.

3. As an interim experimental objective, the System should aim at building up a portfolio of Agency issues of from \$100 to \$250 million over a period of two to three months, with the amount and timing dependent on the ability to make net acquisitions without unduly affecting the market.

Comment on Guideline 3

In the long run System holdings of Government Agencies relative to direct Treasury debt will require the careful attention of the Committee and the Committee staff with relative availability an important, but not the only, consideration. In the short run, however a modest portfolio target would probably be helpful in getting us under way. Within the context of net acquisition of the size indicated, it would be wise to establish early in the game the principle of System sales of Agencies at times when the System is absorbing reserves.

4. System holdings of maturing Agency issues will be allowed to run off at maturity.

Comment on Guideline 4

Current procedures involved in the marketing of new Agency issues do not provide for the exchange of maturing issues on the -6-

basis that the System now exchanges its holdings of Treasury issues. There apparently are legal questions as to whether the requirement of Section 14(b)(2) of the Federal Reserve Act, that System purchases or sales of Agency issues be made "in the open market," would permit special arrangements with Fiscal Agents, selling groups or syndicates whereby new issues may be channeled into the System portfolio on an exchange or other basis, even assuming such arrangements would be acceptable to the borrowing Agencies. The legal questions involved in replacing maturities through special arrangements with the borrowers should be given further consideration by Counsel, and if these questions can be resolved, discussion of practical procedures should be undertaken with the borrowing Agencies.

5. Purchases will be limited to individual fully taxable issues larger than \$300 million, for which there is an active secondary market and which have a maturity at the time of purchase of less than two years.

Comment on Guideline 5

The effect of this guideline would be to limit the number of individual Agency issues eligible for purchase and sale by the Federal Reserve from an unmanageable level to about 32 issues, accounting for over half the marketable Agency debt maturing in two years or less. (See Appendix B for data on number and size of issues by Agency.) Issues of this size are more readily tradeable and the -7-

existence of at least a minimal secondary market should mean that System operations would have less impact on prices and rates than would be the case with smaller individual issues. The existence of a minimum size cut-off for issues eligible for System operations might--although one cannot be certain--encourage Agencies to increase the size and reduce the number of individual issues. This in time should lead to a greater number of more tradeable Agency issues and generally better secondary markets. It would appear d esirable to start off with operations in short-term Agency debt (two years maturity or less), but there would seem to be little reason why the experiment could not be extended to longer-term issues at an early stage. Presumably operations in longer-term Agency issues would be coupled with System operations in coupon issues, but again this would have to depend on availability.

6. System holdings of any one issue at any one time will be limited to 10 per cent of the entire issue. There will be no specific limit on aggregate holdings of any one issuing Agency.

7. No new issue will be purchased until two weeks after the issue date.

Comment on Guidelines 6 and 7

The purpose of these two guidelines is to try to minimize the impact of System purchases and holdings of large amounts of individual Agency issues on the market price of those issues, to -8-

minimize the replacement problem at maturity, to avoid affecting-insofar as possible -- the pricing of new issues, to avoid either the appearance or the fact of direct System support of any new issue, and to ward off possible pressures from borrowing Agencies, Fiscal Agents, selling groups or syndicates. We have no way of telling in advance whether operations based on market supply and demand would result in a balanced System portfolio of issues of the several borrowing Agencies, although Agency repurchase agreements did result in a reasonably good distribution of agreements among the various Agencies. We shall have to be alert to the possibility that the timing of purchase and sale operations may inadvertently discriminate between Agencies. The frequency of new Agency issues will also represent a continuing problem of minimizing or avoiding operations in closely competitive outstanding Agency issues in order to avoid charges that the System either cleaned up the market to help the new issue, or that it wrecked the market by selling.

8. Initially, all purchases, sales and holdings of Agency issues will be for the Account of the Federal Reserve Bank of New York.

Comment on Guideline 8

The recommendation that operations in Agency issues initially be undertaken for Account of the Federal Reserve Bank of New York is made solely to simplify accounting procedures in the experimental -9-

stage of operations. It will take some time to implement computer accounting procedures to handle the distribution of Agency holdings in the System Open Market Account. After a suitable program has been worked out there would be no problem in including Agencies in the Open Market Account. Even before this was done, it would be possible, if the Committee so desired, to participate earnings or losses (monthly or quarterly) among the Reserve Banks on the basis of their participation in the System Open Market Account.

Continuing Authority Directive

Governor Robertson's memorandum of May 5 addressed to the Committee proposes a revision in paragraph 1(a) of the Continuing Authority directive that would authorize operations in Federal Agency securities, and would provide a separate leeway of \$200 million within which the aggregate amount of Agency obligations could be increased or decreased during periods between Committee meetings. An alternative version is attached as Appendix C to this memorandum. The alternative version is designed to provide for Agency operations to be conducted for the account of the Federal Reserve Bank of New York initially, and to fold the leeway for operations in Agencies into the over-all leeway of \$2 billion. The purpose of the latter suggestion is to avoid any possible implication that operations in Agency issues are in any way to be distinguished from the totality of System open market operations. Increasing the total leeway by -10-

10 per cent could create the impression that the total volume of reserves supplied by the System might somehow be increased through Agency operations, rather than that Agency operations would substitute for a portion of operations in direct Treasury issues. In addition, an authority that included the possibility of a specific increase in Agency holdings in each period between Committee meetings (adding up to about \$3 billion for a full year) might lead to false hopes (or fears) about the volume of Agencies the System intended to purchase. While obviously none of these implications are contained in Governor Robertson's proposals, any possibility of misunderstanding should be avoided. Public communication of the general limitations contained in the guidelines would probably provide sufficient information about the likely scope of System intentions.

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Appendix A

Extract from "Report of the Committee on Federal Credit Programs to the President of the United States, Transmitted by the President to Agencies with Responsibilities for Federal Credit Programs on February 11, 1963", pages 18-19.

V. LOAN GUARANTEES AND INSURANCE

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B. Guarantees of Tax-Exempt Obligations

(1) Two of the present loan guarantee programs--the indirect guarantees of obligations issued by local authorities for urban renewal and public housing--involve guarantees of the obligations of State and local government instrumentalities. From time to time, guarantees of other types of municipal obligations are proposed. This raises the question of whether the Federal Government should guarantee tax-exempt obligations, especially since under the Public Debt Act of 1941, it cannot issue direct obligations exempt from Federal income taxation.

(2) State and local governments now receive substantial indirect benefits from the Federal income tax exemption on income from municipal obligations. As a result, these governments can usually sell their obligations on a much lower yield basis than other issues of comparable quality. The tax exemption makes such obligations very attractive to institutions and individuals in relatively high income brackets. As a result, a sizable loss in Federal revenues occurs, which is greater than the saving in the cost of State and local financing.

(3) Guarantees of tax-exempt obligations tend to expand the volume of such securities issued. The Committee, therefore, recommends that no program in the future be authorized which involves guarantee of tax-exempt obligations because (a) the cost in tax revenues to the Federal Government would generally exceed the benefits of tax exemption received by borrowers, (b) such federally guaranteed tax-exempt securities would be superior to direct Federal obligations themselves, and their increasing volume would adversely affect Treasury financing, and (c) the availability of increasing amounts of high-grade tax-exempt issues would tend to attract funds from investors that should appropriately seek risk-bearing opportunities.

(4) In addition to the substantial advantages from the tax exemption privileges available for State and local borrowing, two additional types of aid which do not involve guarantee of tax-exempt obligations could provide any additional necessary credit assistance:

(a) Any local community waiving its tax exemption privilege might be authorized to borrow for specific high priority needs with the aid of a Federal guarantee; and

(b) Local communities might be authorized to receive capital grants sufficient to permit borrowing the remainder in the market on reasonable terms.

Appendix B

DISTRIBUTION OF MARKETABLE AGENCY ISSUES BY SIZE OF ISSUE AND MATURITY AS OF JUNE 12, 1969

	UNDER 2 YEARS		OVER 2 YEARS	
Fed. Int. Credit Banks	<u>NO</u> .	TOTAL AMOUNT (In millions of dollars)	<u>NO</u> .	<u>TOTAL AMOUNT</u> (In millions of dollars)
A A NA	2	-	-	
\$ 0-199 200-299	0	0	0	0
300 and over	1 8	293 3,729	0 0	0 0
JOO and OVEL	o	3,725	0	0
Federal Home Loan Banks				
\$ 0-199	0	0	0	0
200-299	5	1,025	Ő	Ő
300 and over	11	4,496	Õ	Ő
Bank for Coops				
\$ 0-199	0	0	0	0
200-299	4	992	0	0
300 and over	1	352	0	0
FNMA - Debentures				
\$ 0-1 99	2	262	б	703
200-299	3 5	750	3	7 00
300 and over	5	2,100	2	700
FNMA - P.C's				
\$ 0-1 99	12	465	36	1,175
200-299	0	0	0	0
300 and over	4	2,235	12	4,795
Federal Land Banks				
\$ 0-199	8	7 49	7	908
200-299	7	1,562	4	914
300 and over	3	1,137	1	446
EX-IM Bank P.C's				
\$ 0-199	0	0	1	150
200-299	2	500	1	250
300 and over	Ō	0	2	200

Appendix B

-2-

	UNDER 2 YEARS		OVER 2 YEARS	
T.V.A. Notes & Bonds	<u>NO</u> .	TOTAL AMOUNT (In millions of dollars)	<u>NO</u> .	TOTAL AMOUNT (In millions of dollars)
\$ 0-199 200-299 300 and over	4 0 0	380 0 0	5 0 0	275 0 0
SUMMARY				
\$ 0-199 200-299 300 and over	26 2 2 <u>32</u>	1,856 5,122 14,049	55 8 <u>17</u>	3,211 1,864 <u>6,841</u> *
	80	21,027	80	11,916

*Mostly P.C.'s, many of which are of very limited marketability.

Note 1 - The foregoing tabulation does not include discount notes of FNMA and EX-IM Bank, CCC Certificates of Interest, Farmers Home Administration insured notes or tax-exempt housing bonds guaranteed by P.H.A. for which there are practically no secondary markets.

Note 2 - If the limit on the size of issues purchased was lowered to \$250 million, the eligible list would be increased by these amounts:

AGENCY	<u>NO</u> .	TOTAL
F.I.C.	1	\$ 293 million
Bank for Coops	1	288 "
FNMA Debentures	3	750 "
Federal Land Banks	1	278 "
EX-IM Bank P.C.'s	<u>2</u>	<u> </u>
	8	\$2,109 "

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Appendix C	REC'D IN RECORDS SECTION NOV 121970

Possible amendment to paragraph 1(a) of Committee's continuing authority directive

(a) To buy or sell U.S. Government securities AND OBLIGATIONS THAT ARE DIRECT OBLIGATIONS OF. OR FULLY GUARANTEED AS TO PRINCIPAL AND INTEREST BY, ANY AGENCY OF THE UNITED STATES in the open market AT MARKET PRICES. from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for-the-System-Open-Market-Account-at-market-prices and;-fer-such-Account; to exchange maturing U.S. Government securities with the Treasury or allow them to mature without replacement; provided that TRANSACTIONS IN U.S. GOVERN-MENT SECURITIES SHALL BE FOR THE SYSTEM OPEN MARKET ACCOUNT AND TRANSACTIONS IN AGENCY OBLIGATIONS SHALL BE FOR THE ACCOUNT OF THE FEDERAL RESERVE BANK OF NEW YORK; AND PRO-VIDED FURTHER THAT the aggregate amount of such U.S. GOVERNMENT securities AND AGENCY OBLIGATIONS held in such AccountS at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than \$2.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

APPENDIX D

CONFIDENTIAL (FR)

REC'D IN RECORDS SECTION NOV 121970 June 20, 1969

To:Federal Open Market CommitteeSubject:Considerations againstFrom:Alan R. HolmesFederal Reserve operations in
Agency issues at this time.

This memorandum, requested at the last meeting of the Federal Open Market Committee, sets forth considerations that argue against proceeding with System outright operations in Government Agency issues at the present time. It does not consider the technical problems of System operations, which have been amply covered elsewhere.

1. Unsettled status of Agency financing

One of the major problems facing the Administration and the credit markets over the next year is the expected growth of financing by Government agencies outside the Federal budget. Outstanding Government-guaranteed and Government-sponsored loans are scheduled to show a net increase of \$20.9 billion in fiscal 1970 compared with \$13.7 billion in fiscal 1969. The growth of Agency financing outside the budget raises serious questions about the total level of Government spending and casts doubts on the traditional use of the budget deficit or surplus as a measure of Federal fiscal stimulus or restraint.

In addition to more financing by old-line agencies a number of new agencies designed to finance social welfare programs are in various stages of formation. Areas involved include, among others, housing, urban redevelopment, urban transit, the supersonic jet, anti-pollution, and exports. -2+

This proliferation of Agency financing outside the Federal budget--much of it on the basis of Government-guarantee of private financing--raises the risk of further fragmentation of the Agency market. The Treasury and the Budget Bureau are currently engaged in efforts to control both the volume and flow of this new financing, but many questions remained unresolved.

There are many arguments for, and some against, centralized financing of Government-sponsored financing programs, either directly by the Treasury or by a centralized financing agency. Federal Reserve operations in Agency issues would be facilitated by the consolidation of Agency debt operations, and it would appear unwise for the System to commence operations until the new Administration has formulated its own approach to Agency debt operations and worked out methods of control.

2. Problems of Agency operations in a period of monetary restraint

Starting Federal Reserve operations during a period of severe monetary restraint is almost certain to be interpreted as a move to channel funds into particular areas of the economy. The move would be expected by many in Congress and elsewhere to provide more in the way of support for housing or for exports than the cautious, objective approach outlined in Governor Robertson's memorandum and reflected in the suggested guidelines could deliver. It might, furthermore, be difficult to start operations in Agency issues without conveying the impression that the Federal Reserve was backing away from an over-all -3-

posture of restraint. Current marketing problems would whet the appetite of the financing Agencies for special access to Federal Reserve credit, and as new guarantee programs came into being local pressures for Federal Reserve support of individual projects would be bound to grow. All in all, current market conditions are not conducive to an objective experiment in operations in Government Agency issues.

3. Treasury financing and Agency operations

One of the arguments in favor of Federal Reserve operations in Government Agency issues is to provide an additional instrument for open market operations that would be useful in periods of temporary shortages of Treasury bills. With the Treasury about to move into a period of seasonal deficit financing, there is not apt to be any such shortage of Treasury bills. Dispersion of System open market operations over a broader range of instruments--particularly with the market uncertain as to how much System buying power would be shifted away from direct Treasury debt--could put added upward pressure on Treasury bill and other short rates at a time when seasonal pressures were already strong.

4. Decision to operate in Agencies probably not reversible

As noted earlier, the times are not conducive to an objective experiment in Agency operations. Once the System has announced its intention to operate in Agencies, it would appear extremely difficult -4-

to draw back, even if the experiment proves unsuccessful in the sense that System operations tended to have an exaggerated impact on the Agency market or had to be kept so small as to be insignificant. Thus the System would be under continual pressure from its critics to expand the scope of its operations in Agency issues in order to further certain social objectives, all of which might be desirable in themselves, but which might be incompatible with the over-all needs of monetary and economic policy. These expenditures might better be financed directly by the budget, where social priorities can be better ordered. There is a risk that System operations in Agency issues will tend to encourage extra-budgetary spending rather than encouraging the Congress and the Administration to establish desirable priorities for over-all Government spending.