



To Members of the Federal Open Market Committee and  
Presidents of Federal Reserve Banks not presently  
serving on the Federal Open Market Committee

From Robert G. Rouse, Manager, System Open Market Account

Enclosed is a copy of a memorandum on the swaps discussion  
that took place at the last meeting of the Committee. Mr. Gaines who  
was present has volunteered these comments on the discussion to me in  
an effort at clarification.

C O N F I D E N T I A L -- (P. R.)  
OFFICE CORRESPONDENCEFEDERAL RESERVE BANK  
OF NEW YORK

OCT 12 1956

DATE September 19, 1956

TO Mr. Rouse  
FROM T. C. GainesSUBJECT: Swaps in Treasury bills  
reconsidered

The discussion at the September 11 meeting of the Federal Open Market committee brought up at least two points that seem to require further clarification on the proposal now before the Committee to authorize the Manager of the System Account to enter into swaps in Treasury bills. The following notes were intended to clarify my own thinking on these matters, and I thought you might be interested in them.

One apparent misunderstanding turns on the meaning of the suggestion that these swaps would ordinarily "initiate" with the market. The swaps would initiate with dealers in the sense that the dealers would show the Trading Desk swaps they were attempting to work out in the market. But the decision as to whether to execute the swap would be the Account Management's--and it would be expected that much the largest part of all such swap possibilities would be rejected. Occasionally, when the swap would help to accomplish a System portfolio objective, the Trading Desk would react favorably. Initiative would clearly rest with the Account Management; the dealer would initiate the transaction only in the sense that a merchant who displays his products in a shop window initiates sales with his customers. Of course, all dealers would be notified immediately upon approval by the Committee that the System Account would be able to participate in bill swaps in the future, and this would be followed by regular reminders to each dealer, so that we could expect all dealers to show us their swaps day by day as a matter of regular procedure.

Another matter that I believe needs clarification is the suggestion that adoption of the bill swaps proposal would be in conflict with a sound principle of Federal Reserve action. I am not certain that I am clear on the

principle that is involved. At its meeting in December 1953, the Federal Open Market Committee adopted a policy of restricting transactions for the System Account to the purpose of providing or absorbing reserves. This policy explicitly excluded offsetting purchases and sales of securities for the purpose of altering the maturity pattern of the System's portfolio. The principle was that the Federal Reserve System should buy or sell Government securities only to influence bank reserves. However, as I understand this "principle" it is an operating rule that is subsidiary to and derives from the broader principle that the Federal Reserve System should conduct its operations in the Government securities market in such a manner as to promote the greatest breadth, depth, and resiliency in the market.

If my understanding is correct, therefore, the basic principle with which the Committee was concerned when it prohibited swaps was the avoidance of transactions that might confuse the market or inhibit trading. The present proposal is contrary to this principle if swaps in Treasury bills would have these effects upon the market. The remarks of the leading dealers with whom the proposal has been discussed and of the market specialists who handle System Account operations would suggest that just the opposite effect upon the market is likely to result. No one pretends, of course, that the occasional swaps the System Account might enter into would be a major influence toward broadening the Government securities market; but it has been suggested that to the extent that limited amounts of Treasury bills from the System Account might occasionally be available to dealers on swaps, then to that extent dealers would be better able to match off their customers' demands for particular maturities against the supply of bills available. In other words, dealers would have another customer, in addition to their present bank and nonbank customers, to whom

they could turn when they were seeking a swap that would release to the market bills currently in demand.

I believe that if we look behind the form of the swap transactions that have been proposed we find that they are consistent with the broad principles the Committee has adopted. It is not the form of the transaction but its effect upon the development of a broader, more self-reliant Government securities market that is relevant. The weight of the evidence, as I have been able to interpret it, is that swaps in Treasury bills for the System Account if handled in a professional fashion should have no harmful effects on the market and might have some beneficial effects.