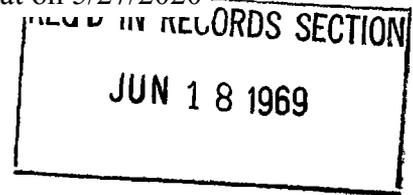




BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551



June 18, 1969

CONFIDENTIAL (FR)

TO: Federal Open Market Committee
FROM: Mr. Holland

There is enclosed a copy of a memorandum from the Manager of the System Open Market Account dated today and entitled "Experimental Open Market Operations in Federal Agency Issues." This memorandum was prepared pursuant to the discussion at the meeting of the Committee on May 27.

At that meeting it was suggested that the Committee also would find helpful a list of the considerations that argued against proceeding with outright operations in agency issues at this time. Mr. Holmes is preparing such a list and it will be forwarded to you shortly.

A handwritten signature in cursive script, appearing to read "Robert C. Holland".

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

Enclosure

JUN 18 1969

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)

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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.

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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

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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

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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

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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

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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 desirable 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

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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

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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

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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.

JUN 18 1969

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.

IN RECORDS SECTION
JUN 18 1969

Appendix B

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

	<u>UNDER 2 YEARS</u>		<u>OVER 2 YEARS</u>	
	<u>NO.</u>	<u>TOTAL AMOUNT</u> (In millions of dollars)	<u>NO.</u>	<u>TOTAL AMOUNT</u> (In millions of dollars)
<u>Fed. Int. Credit Banks</u>				
\$ 0-199	0	0	0	0
200-299	1	293	0	0
300 and over	8	3,729	0	0
<u>Federal Home Loan Banks</u>				
\$ 0-199	0	0	0	0
200-299	5	1,025	0	0
300 and over	11	4,496	0	0
<u>Bank for Coops</u>				
\$ 0-199	0	0	0	0
200-299	4	992	0	0
300 and over	1	352	0	0
<u>FNMA - Debentures</u>				
\$ 0-199	2	262	6	703
200-299	3	750	3	700
300 and over	5	2,100	2	700
<u>FNMA - P.C's</u>				
\$ 0-199	12	465	36	1,175
200-299	0	0	0	0
300 and over	4	2,235	12	4,795
<u>Federal Land Banks</u>				
\$ 0-199	8	749	7	908
200-299	7	1,562	4	914
300 and over	3	1,137	1	446
<u>EX-IM Bank P.C's</u>				
\$ 0-199	0	0	1	150
200-299	2	500	1	250
300 and over	0	0	2	900

Appendix B

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	<u>UNDER 2 YEARS</u>		<u>OVER 2 YEARS</u>	
	<u>NO.</u>	<u>TOTAL AMOUNT</u> (In millions of dollars)	<u>NO.</u>	<u>TOTAL AMOUNT</u> (In millions of dollars)
<u>T.V.A. Notes & Bonds</u>				
\$ 0-199	4	380	5	275
200-299	0	0	0	0
300 and over	0	0	0	0
<u>SUMMARY</u>				
\$ 0-199	26	1,856	55	3,211
200-299	22	5,122	8	1,864
300 and over	<u>32</u>	<u>14,049</u>	<u>17</u>	<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:

<u>AGENCY</u>	<u>NO.</u>	<u>TOTAL</u>
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>500</u> "
	8	\$2,109 "

JUN 18 1969

Appendix CPossible 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 for 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. GOVERNMENT 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 PROVIDED 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;