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

December 12, 1977

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida

Attached for your information is a memorandum from Messrs. Holmes and Sternlight, dated today and entitled "System Account Sales of Bills in the Market."

This memorandum was prepared in response to questions raised by Governor Lilly at the FOMC meeting on November 15, 1977.

Attachment

CONFIDENTIAL (FR)
CLASS II FOMC

December 12, 1977

TO: Federal Open Market Committee

FROM: Alan R. Holmes, Manager
System Open Market Account
and
Peter D. Sternlight, Deputy
Manager for Domestic
Operations

SUBJECT: System Account Sales of Bills in the Market

In response to questions raised by Governor Lilly at the meeting of the Federal Open Market Committee on November 15, this memorandum reviews several recent instances of outright Treasury bill sales by the System--prior to the sales undertaken on October 31, 1977. From June 1974 through June 1977, there were five occasions when the System Account sold bills overtly in the market. Such sales have been fairly infrequent in recent years, as it has been more convenient to absorb reserves through direct sales of bills to foreign accounts, run-offs of maturing bills at auctions, and sales under matched-sale purchase transactions.

In the five instances from mid-1974 to mid-1977, there was a projected need to absorb reserves for several weeks. In three of the cases, the System was in the process of adjusting the funds rate lower, but the rate was on the low side of the objective--or below it--when the market entries were made. In one of those sales (January 1976) there was little market reaction, while in the other two (February 1975 and December 1976) the sale tended to reduce recent price gains in the market.

There were also two cases of sales when the funds rate was _not_ in the process of being reduced. In one of these (June 1974) the funds objective was unchanged at the time of the sale but was raised soon afterward; the sale tended to stem a price rally. In the other instance (June 1977) the funds objective had been raised a week before the sale, and was being held steady; the sale had little market impact.

There is thus some tendency for outright bill sales by the System to have a depressing effect on market prices, although it is not a universal or entirely certain reaction. It seems to depend on a variety of surrounding circumstances. Based on the experience of the recent previous outright bill sales, it would have seemed reasonable on October 31, 1977, to have expected some market reaction, though perhaps not a very large one.

None of the five bill sales noted above occurred in quite the relationship to a Treasury coupon financing operation that characterized the October 31 sale--although the sale in February 1975 occurred only a few days after the auction dates for a quarterly financing operation, and the sale in December 1976 was just a few days after an auction of four-year notes.

A more detailed account of the October 31 bill sale and the five preceding sales is appended to this memorandum.

The feature of the October 31 sale that market participants found unsettling was that the System sold bills under circumstances that appeared to signal a firmer policy stance, and that this was undertaken during a Treasury financing operation. Yet there have been several instances of policy being made firmer during financing periods in recent years. The frequency of such financing operations has made it less feasible to observe the same sort of "even-keel" constraints that used to prevail, while at the same time the Treasury's use of auctions has reduced the need for such contraints. Indeed, in the period from the third quarter of 1975 up to October 1977 there were thirteen periods of Treasury financing (measured from announcement date to payment date) when the System changed its funds rate objective--six increases, six decreases and one reversal in which a small increase was rescinded a week later. The instances of funds rate increases and of a policy reversal are summarized below.

In three of the periods when there were increases in the funds rate objective--the May 1976 quarterly financing, the August 1977 quarterly financing, and the five-year note sale in late September 1977--the System raised the funds rate both before and after the auctions. Market participants were generally aware of the firming although there was some uncertainty about the System's objective on particular days. Market yields rose between announcement dates and the auctions, and yields on the new issues rose after the auctions.

In the case of the four-year note in May-June 1976 and the four-year note in May-June 1977, the funds rate objective rose between the announcement date and the auction, and then held steady until payment date. Market yields rose between the announcement and auction dates (though only slightly in May 1977). After these two auctions, the new issues declined in yield as the market learned that no further firming was taking place.

The quarterly refunding operation in May 1977 was preceded by a small increase in the funds rate objective, and there was a further rise in the objective just after the Treasury's announcement. Funds soon traded above the desired objective, and did so through the day of the first auction, giving market participants only a limited fix on the current objective. However, with reserves expected to be in ample supply, and facing the possibility of a further increase in the objective soon afterward, the Desk did not immediately provide reserves. Funds moved still higher the day of the second auction, to a level above where it was anticipated the objective would soon be, and the Desk provided reserves. The rate objective was indeed raised further after the auctions, but the market had anticipated this when they bid and market rates on the new issues changed little after the auctions.

The instance of a policy reversal was in March 1976, at the time of a four-year note auction. A slight firming was initiated on the announcement day of the note. As often happens, the market exaggerated the extent of this firming, but by the time of the auction the Desk was able to counter the excess firmness, indicating the modest intended extent of the move. Also by the auction date, in light of weaker aggregates, the funds rate objective was returned to its earlier level, though the market did not perceive this clearly for several more days. Market yields in the four-year area rose about 12 basis points from announcement date to auction date, while the new issue fell about 15 basis points from auction date to payment date. The pattern of rate changes was broadly similar to that in the recent October-November 1977 episode, although the firming move and reversal in 1976 came earlier in the financing period.

System Sales of Treasury Bills - June 1974 - October 1977

1. Friday, June 7, 1974. System Account sold $300 million of bills in the market. Federal funds objective at the time was 11 1/4 - 11 1/2 percent. Growth in aggregates looked strong and there was a possibility that a higher objective would be sought. In fact, a higher trading level was sought late that week as Committee raised upper limit on funds to 11 3/4 percent and Desk shortly raised objective to 11 1/2 - 11 3/4 percent. At time of the bill sale there was a need for reserve absorption. Market was rallying in response to a decline in latest published weekly money supply and some prime rate declines. The System's sale cooled the rally.

2. Thursday, February 6, 1975. System Account sold $161 million of bills in the market between final auction date on quarterly financing (January 30) and payment date (February 18). Account Management was in midst of reducing funds rate objective from 6 1/2 to 6 1/4 percent, as approved by Committee the previous day. Funds were trading at 6 1/4 and threatening to go lower. Sizable reserve excesses were projected. The Desk's action surprised many market participants and reduced earlier gains in the Government securities market.

3. Thursday, January 8, 1976. System sold $506 million of bills in the market. Funds rate objective was 5 percent, having been reduced from 5 1/8 percent in previous week. Money market was comfortable, with funds trading at 4 13/16 to 4 7/8, while large reserve excesses were projected. Market reaction was quite mild, perhaps because further easing was still anticipated in view of weak data on the economy and money growth.

4. Friday, December 3, 1976. System sold $261 million of bills in the market. System was in midst of seeking a lower funds rate. In the two preceding weeks, the objective had been cut from 5 to 4 7/8, and then to 4 3/4 percent. At time of Desk entry funds were at 4 9/16 and 4 5/8 percent. Large reserve excesses were projected. A major rally was under way in the securities market, reflecting money supply declines and a reported increase in unemployment rate. The System's sale slowed the market rally. A four-year note had been auctioned on November 30, to be paid for on December 7, but dealers had largely distributed their awards of the note, at premium prices, by the time of the System's sale of bills in the market.

5. Thursday, June 2, 1977. System sold $576 million of bills in the market. Funds rate objective had been raised to 5 3/8 percent in previous week. Funds were trading at 5 5/16 and 5 3/8 percent. Large reserve excesses were projected. The Desk had just concluded arrangement of four- and seven-day matched sale-purchase transactions announced the previous day. The bill sale had little market effect.

6. Monday, October 31, 1977. System sold $368 million of bills in the market. Funds rate objective was in process of being raised from 6 1/2 to 6 1/2-5/8 percent. A further rise in the objective was likely to be called for in a few days, unless the aggregates turned weaker. Funds were trading readily at 6 1/2 percent and there was widespread view in market that this objective would remain unchanged for the near term.

The previous Friday, Account Management had anticipated that funds might firm slightly from opening 6 1/2 percent rate without overt Desk action, in view of then-current reserve projections, some modest System sales of bills to foreign accounts and some early terminations of repurchase agreements arranged the previous day. Instead of firming, funds eased slightly to 6 7/16 percent and System promptly executed three-day matched-sale purchase transactions in the market--in an amount intended to return the funds rate to 6 1/2 or a shade higher. Funds traded that afternoon at 6 7/16 - 6 1/2. The absence of significant firming may have been because reserve availability was much greater than projected--float exceeded estimates by $3 billion and member bank borrowing bulged above earlier levels. Against background of relatively comfortable money market, dealers bid enthusiastically on Friday for the Treasury's three-year note--the first issue to be auctioned in the November financing package.

On Monday morning, having learned of very large reserve miss, Desk entered market early to absorb reserves through three-day matched-sale purchase transactions. At time of entry, funds had not yet begun to trade but were quoted 6 7/16 to 6 1/2 percent. After Desk entry, funds traded at 6 1/2, and remained there through the morning even though Desk had drained an amount of reserves that was designed to impart some greater firmness. Market participants still believed System's funds objective was 6 1/2 percent, as they prepared to bid for Treasury's 10- and 30-year issues on Tuesday and Wednesday. Reserve projections at this point did not indicate excesses in the current week, but given recent record of underestimates and fresh bulge in borrowing it did not seem unreasonable to withdraw more reserves.

Against this background, the Account Management decided to sell bills outright on Monday, along with bill sales for foreign accounts. Some market reaction was anticipated, and considered appropriate in the course of indicating a somewhat firmer System stance, but the market reaction considerably exceeded the Account Management's expectations as many market participants jumped to the conclusion that a sharply higher funds objective--6 3/4 percent or higher--was intended. Over the next two days, prompt Desk moves to provide reserves helped to contain the reaction and remaining Treasury auctions were well bid for at rates perhaps 1/8 percent higher than had been anticipated before the Monday bill sale. By the following Friday the aggregates appeared significantly weaker and the Account Management returned to a 6 1/2 percent funds rate objective. This reversal augmented the market's puzzlement over the Desk's actions on October 31, and added to the feeling of some observers that "a mistake" had been made.