

MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Monday, April 17, 1972, at 4:30 p.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Coldwell
Mr. Daane
Mr. Eastburn
Mr. MacLaury
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Sheehan
Mr. Winn

Messrs. Francis, Heflin, Mayo, and Swan, Alternate Members of the Federal Open Market Committee

Messrs. Morris, Kimbrel, and Clay, Presidents of the Federal Reserve Banks of Boston, Atlanta, and Kansas City, respectively

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Messrs. Altmann and Bernard, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Messrs. Boehne, Bryant, Green, Hersey, and Hocter, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Melnicoff, Deputy Executive Director, Board of Governors
Mr. O'Connell, General Counsel, Board of Governors
Messrs. Keir and Pierce, Advisers, Division of Research and Statistics, Board of Governors

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Mr. Wendel, Chief, Government Finance Section,
Division of Research and Statistics, Board
of Governors

Miss Eaton, Open Market Secretariat Assistant,
Office of the Secretary, Board of Governors

Messrs. Parthemos, Taylor, Scheld, Tow, and
Craven, Senior Vice Presidents, Federal
Reserve Banks of Richmond, Atlanta,
Chicago, Kansas City, and San Francisco,
respectively

Messrs. Bodner and Nelson, Vice Presidents,
Federal Reserve Banks of New York and
Minneapolis, respectively

Mr. Garvy, Economic Adviser, Federal Reserve
Bank of New York

Mrs. Greenwald, Economist, Federal Reserve
Bank of Boston

Chairman Burns noted that at its meeting of March 21, 1972,
the Committee had deferred discussion of three matters. He had
called today's meeting, in advance of that planned for tomorrow,
to insure that there would be adequate time for discussion of
those matters.

Turning to the first of the items in question, the Chairman
noted that the Secretariat had distributed two memoranda regarding
proposed procedures for making historical Committee records avail-
able to the public.^{1/} He asked Mr. Broida to comment.

Mr. Broida said the Secretariat recommended that it be
authorized to make certain historical records of the Committee
available for inspection by interested persons through the last
year for which FOMC minutes had been released--at present, 1966.

^{1/} Copies of these memoranda, which were dated March 14 and
April 11, 1972, have been placed in the Committee's files.

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As noted in the March 14 memorandum, such action had been contemplated for a long time but the matter was being raised now because a specific request had been received from Professor Karl Brunner for access to such records.

Mr. Broida noted that the present recommendation, described in the April 11 memorandum, called for making records available on a more limited basis than proposed earlier. The change had been made in light of reactions by some Committee members to the original proposal. The Secretariat suggested that it be authorized to make available the so-called "Group I documents"--mainly the green ^{1/} and blue ^{2/} books, eventually the red books, ^{3/} and their predecessor and successor documents, if any; and the weekly and monthly reports of the Manager, but not those of the Special Manager.

In reply to a question by Mr. Mitchell, Mr. Broida said the Special Manager's reports were not included because they might from time to time contain sensitive passages--for example, confidential information relating to the internal affairs of foreign central banks--of the sort that had been withheld when Committee minutes were released. Any such passages could be identified only by reading through all such reports, and it did not seem desirable

^{1/} The report, "Current Economic and Financial Conditions," prepared for the Committee by the Board's staff.

^{2/} The report, "Monetary Aggregates and Money Market Conditions," prepared for the Committee by the Board's staff.

^{3/} The report, "Current Economic Comment by District," prepared for the Committee by the staff. This report was initiated in May 1970.

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to devote scarce staff resources to that work at present, since no requests for access to the Special Manager's reports had been received.

Mr. Daane said he had some reservations about making the staff reports--particularly the blue book--public at this time. He wondered whether the blue book might not be subject to misinterpretation if users were not fully informed regarding the manner in which it was used by the Committee.

Mr. Brimmer remarked that he had talked with Professor Brunner last week about the kinds of materials which he would like to examine. While Mr. Brunner had not gone into great detail on the subject, it was clear that his interest lay in the area of domestic monetary policy rather than foreign currency operations and that he would want to have access to the blue books as well as other regular staff reports relating to that area. He (Mr. Brimmer) would not anticipate a problem of the kind that concerned Mr. Daane since the staff reports in question would be used in conjunction with the minutes. The decision to release the minutes had been the really important one; to make the staff reports available would be simply to fill out the record.

Mr. Brimmer added that the staff had first begun preparing a report known as the blue book in the fall of 1965. Since the last meeting of the Committee he had examined samples of the

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predecessor documents to both the blue and green books and had concluded that their release would be appropriate.

Chairman Burns observed that to the extent those earlier documents differed in form from those the staff was currently preparing, any one consulting them might draw mistaken inferences about the nature of the current reports. However, that consideration could be taken to support a shorter lag in the release of the staff materials rather than a longer lag.

Mr. Maisel remarked that release of the documents in question would facilitate studies of the conduct of monetary policy by economic researchers. Such studies could be of great benefit to the System and he thought they should be encouraged.

Mr. Morris agreed with Mr. Maisel. He added that scholars probably would find it difficult to understand some parts of the Committee's policy deliberations as reported in the minutes unless they had access to the underlying staff documents.

Mr. Robertson commented that release of the staff documents would clearly be consistent with the spirit of the Public Information Act. Personally, he would be prepared to make public not only the documents covered by the Secretariat's recommendations but also other Committee materials, withholding only materials that would reveal information received in confidence from foreign central banks and governments or that might damage the nation's international relations.

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Mr. Coldwell noted that under the letter of the Public Information Act release of the documents was not legally required since one of the statutory exemptions related to internal communications, such as inter-agency and intra-agency memoranda.

Messrs. Heflin and Francis expressed the view that the course the staff recommended was in the public interest.

Mr. Daane said he should note that in his judgment the staff's present recommendations were much better than those they had made earlier.

Chairman Burns remarked that the sentiment of the Committee appeared to be in favor of approving the recommendations contained in the staff memorandum of April 11.

The Secretariat's recommendations for making historical Committee records available to the public, as contained in the memorandum dated April 11, 1972, were approved.

The Chairman then noted that a staff committee consisting of Messrs. Axilrod, Scheld, and Sternlight, which had been appointed at the FOMC meeting of January 11, 1972, to study certain issues relating to repurchase agreements, had submitted its report on March 7, 1972.^{1/} He asked Mr. Axilrod, who had served as chairman, to summarize the recommendations of the staff committee.

Mr. Axilrod said the staff committee unanimously recommended that the FOMC amend the language of paragraph 1(c) of its continuing

^{1/} A copy of this report has been placed in the files of the Committee.

authority directive to provide that, unless otherwise expressly authorized, interest rates on repurchase agreements should be established by competitive bidding. At present RP rates were set by the Desk, subject to the provision of the continuing authority directive that they should not be less than the discount rate or the latest auction rate on three-month Treasury bills, whichever is lower. While no upper limit was specified, in practice RP rates were not ordinarily set higher than the discount rate. The staff committee thought that the use of an auction technique would have two main advantages: It would minimize the possibility that changes in RP rates would be viewed as signaling future changes in the discount rate, and it would virtually eliminate the element of subsidy now involved when the discount rate was low relative to short-term market rates.

Secondly, Mr. Axilrod continued, the staff committee recommended that, if an auction approach were adopted, repurchase agreements be authorized with both bank and nonbank dealers rather than, as at present, with nonbank dealers alone. Bank dealers had been growing in relative importance in recent years and their positions in Government securities now amounted to roughly 25 per cent of total dealer positions. While the staff committee was unanimous in that recommendation also, it did not consider the issue to be of major importance.

Mr. Axilrod noted that a draft of an amendment to paragraph 1(c) of the continuing authority directive, embodying the two proposed changes, was shown in an appendix to the report. He went on to say that the staff committee also had been asked to review the manner in which the RP instrument had been used by the Desk. The evidence indicated that use of the RP instrument had increased considerably in recent years. While some reasons for that development were presented in the staff report, the basic causes were not wholly clear. However, the staff committee believed that open market operations probably could be conducted with somewhat less use of RP's than during the past year. At the same time, it believed that the instrument was serving a useful purpose in operations, and there appeared to be no persuasive reasons for abandoning it.

Chairman Burns asked what the consequences might be if RP's were in fact discontinued.

Mr. Axilrod replied that the market probably would function less efficiently, in the sense that day-to-day fluctuations in rates would be greater. RP's typically were used to meet large reserve needs that were expected to be highly temporary, and when they were made the market was aware that the reserves supplied would be withdrawn again shortly. If such temporary needs were met by buying securities outright, dealers involved would not have the assurance that the large reduction in their positions resulting from the System's purchases was temporary, and they might well adjust

prices and yields more sharply than if they knew the securities were shortly to be sold back to them.

Mr. Robertson said he concurred in the staff's suggestion for making less use of repurchase agreements. When the FOMC had first authorized RP's it had indicated that they were to be used sparingly. In his judgment, use had not been sparing.

Mr. Mitchell asked whether the staff would expect the Desk to announce in advance of each auction the amount of RP's to be made.

Mr. Axilrod replied that while such a procedure might have advantages, the issue seemed to be one of operating technique rather than of principle.

Mr. Holmes said he was not persuaded that the Desk should commit itself to making pre-determined amounts of RP's. Such a course was likely to result in large movements in RP rates, and sometimes in lower rates than desirable.

Mr. Daane asked the Manager for his views with respect to the staff committee's recommendations in general.

Mr. Holmes said he thought the report was a persuasive one and that the Committee should proceed to experiment with the suggested auction technique. However, he was not sure that the technique would completely eliminate effects of RP transactions on market expectations. In any particular auction it was inevitable--and reasonable--that some, and perhaps most, dealers would be shut out even though they had bid at what they considered a reasonable

rate--perhaps one at which they had bid successfully in a previous auction. And while the System presumably would not announce the average price set in the auction, market participants would have a good idea of rates, and the negative reaction of unsuccessful bidders might have a market effect--particularly in tight money periods.

Mr. Holmes noted that the staff committee recommended that RP auctions be open to bank as well as nonbank dealers on equity grounds. While he agreed that the extensive use of RP's in recent years had at times discriminated against bank dealers, he thought the equity situation was more complicated. Dealer banks, of course, had direct access to the Federal funds market and to the discount window, and they had the tax and loan account payment privilege in certain Treasury financings. Perhaps more important, however, was the ability of a dealer bank to issue "due bills"--that is, the bank's own promises to deliver a specific issue of Treasury bills. While System RP's had financed from 3 to 7 per cent of nonbank dealer positions in recent years, due bills had financed from 30 to 40 per cent of bank dealer positions.

In light of those considerations, Mr. Holmes continued, he had some reservations about opening RP auctions to bank dealers. However, he saw no objections to undertaking an experiment. Perhaps it would be found that bank dealers would not bid aggressively in such auctions.

Chairman Burns asked whether the inclusion of bank dealers might not be interpreted as the extension of a special privilege to the banks involved. If so, it might be desirable to proceed cautiously.

Mr. Holmes replied that the inclusion of bank dealers might well be given such an interpretation. In any case, the question of the relationship between bank and nonbank dealers was complicated by the fact that the Treasury was now considering a request from a nonbank dealer for permission to obtain the tax and loan account payment privilege through its clearing bank. The dealer could then participate in a Treasury financing with payment to the tax and loan account in its clearing bank and be compensated by that bank for the temporary use of the funds. It was his understanding that an inquiry had just been received from the Treasury as to whether or not the Board would interpret such an arrangement as calling for payment of interest on demand deposits prohibited by Regulation Q. If that was not the Board's interpretation and the arrangement was approved by the Treasury, the competitive position of nonbank dealers would be improved. That might be an appropriate occasion for the System to open RP auctions to bank dealers.

Mr. Mitchell remarked that he did not think bank dealers would consider the right to participate in RP auctions to be very much of a privilege, considering the number of dealers against whom they would be bidding.

Mr. Daane said he would favor experimenting with an auction approach of the kind recommended by the staff. However, he was not sure the auctions should be opened to bank dealers, considering the alternative sources of funds available to them. There seemed to be no necessity to include bank dealers, at least at the outset, and they could always be included at a later time should that appear desirable.

Mr. Brimmer asked whether an adequate volume of bids would be expected if the auctions were limited to nonbank dealers.

Mr. Holmes replied that the volume of bidding would vary from time to time, since it would depend on the dealers' needs for funds and the costs of alternative sources.

Mr. Mayo said he was inclined to agree with Mr. Mitchell. He did not think that borrowing at the discount window should be considered an alternative source of funds for bank dealers, since banks with dealer departments in most cases keep the operations of those departments separate from those of the rest of the bank and do not borrow at the discount window to finance their dealer positions. On the whole, the only risk he saw to the inclusion of bank dealers in the auctions was that of uninformed criticism.

In reply to a question, Mr. Axilrod said the staff committee had considered the question of possible limitations on the securities that could be covered by RP's, assuming the auctions were open to both bank and nonbank dealers. Two of the three staff members thought

that bank dealers should be permitted to offer only dealer department securities and not those in the bank's investment portfolio, and that both bank and nonbank dealers ordinarily should be allowed to offer securities only from their own positions and not "customer" securities.

Messrs. Mitchell and Heflin said they would favor such a limitation.

Mr. MacLaury asked whether the exclusion of customer securities would not be a change from present practice.

Mr. Holmes replied that dealers were now invited to round up customer securities only when it appeared that the Desk would otherwise be unable to arrange a sufficient volume of RP's. The procedure presumably would be the same under an auction approach.

In reply to a question by Mr. Daane, Mr. Holmes said that in periods of tight money the use of an auction technique might produce a ratchet effect, leading to successively higher rates on RP's. Whether that would in fact happen could be determined by experimenting with the technique.

Mr. Kimbrel asked whether the inclusion of dealer banks would pose a question of equity between those banks and banks without dealer departments.

Mr. Holmes replied that while such a question might be raised, he personally would not consider the procedure inequitable

since dealer banks performed a function in making markets for Government securities.

Mr. Mitchell remarked that enlarging the number of participants in the auction by including bank dealers would have the advantage of reducing the subsidy element in the RP rate.

Mr. Robertson said he thought it might well be charged that the System was extending a special privilege to a few large banks.

Chairman Burns said that superficially, at least, there would appear to be some validity to such a charge.

Mr. Daane said he thought that opening the auctions to bank dealers would raise questions of equity not only with respect to other banks but also with respect to nonbank dealers since, as had been noted earlier, banks had access to various alternative sources of funds.

Mr. Maisel observed that if bank dealers had important advantages over other dealers in obtaining funds they presumably would not bid aggressively in the RP auctions.

Mr. Robertson said he would not favor permitting bank dealers to participate in RP auctions at this point since they might thereby often be able to acquire Federal Reserve funds at rates below the discount rate. The Committee could reconsider the question later, after it had gained experience with the auction technique.

Mr. MacLaury said it was his understanding that repurchase agreements were now limited to nonbank dealers mainly because, with RP rates set by the Desk, it could be said that the System was subsidizing bank dealers whenever the RP rate was below the discount rate. In his opinion, however, if RP rates were market-determined through competitive bidding, the need for concern on that score would be eliminated.

In reply to a question, Mr. Axilrod said the staff committee was not certain about the precise consequences of opening the RP auctions to bank dealers. Personally, he would be surprised if they participated heavily as a regular matter, and he thought the rates at which they bid would generally be lower than for nonbank dealers, who did not have direct access to the Federal funds market. Ordinarily, he would expect competitive bidding to result in an RP rate a little above the Federal funds rate.

Chairman Burns observed that while he did not feel strongly about the matter he thought there might be some advantages to permitting only nonbank dealers to participate in the RP auctions initially, without prejudice to the possibility of including bank dealers at a later point. He asked whether the staff thought such a course would create problems.

Messrs. Axilrod and Holmes responded in the negative. Mr. Holmes added that the course mentioned would, in fact, simplify matters from the operational point of view.

Mr. Hayes said he would favor experimenting with an auction technique limited to nonbank dealers while reserving judgment with respect to the desirability of including bank dealers.

The Chairman then remarked that the Committee appeared to favor experimentation with an auction technique for repurchase agreements, but sentiment was divided on the desirability of including bank dealers at the outset. He suggested that an informal poll be taken on the latter question.

The poll indicated that a majority of the members favored excluding bank dealers, at least initially.

By unanimous vote, paragraph 1(c) of the continuing authority directive with respect to domestic open market operations was amended to read as follows:

To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, and prime bankers' acceptances with maturities of 6 months or less at the time of purchase, from nonbank dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

Mr. Coldwell then proposed that the Committee discuss the suggestion in the staff committee's report that operations might be conducted with somewhat less use of repurchase agreements than in the recent past.

Messrs. Hayes and Daane indicated that they did not find the report to be persuasive on that point.

Mr. Coldwell noted that, according to the staff report, the Desk had entered into roughly \$51 billion of RP's in 1971. That figure was substantially above the 1970 volume of \$39 billion and nearly double the \$27 billion volume of 1969. Meanwhile, the volume of outright transactions declined last year, to about \$15.5 billion from about \$17.5 billion in 1969 and 1970. It seemed to him that the Desk was "meddling" in the market through RP's--that is, moving in and out to a greater extent than necessary. He was disturbed by the implication that the Desk was aiming at highly precise control of market conditions. The extensive use of RP's on Wednesdays, the last day of the statement week, and on Fridays, just before the weekend, was particularly disturbing in that regard.

Chairman Burns remarked that while he had not studied the matter closely it was his impression that the Desk was relying a little too heavily on the RP instrument. In any case, the sharp uptrend in the volume of repurchase agreements seemed to indicate either that RP's were being over-utilized now or that they had been under-utilized earlier.

Mr. Mitchell said he was not sure such an inference was warranted. The volume of RP's probably was most closely related to the total amount of payments made through the banking system, and he suspected that figures on the latter for recent years would show a growth rate about like that for RP's.

Mr. Morris suggested that the step-up in the use of RP's might be related to growing difficulties in estimating the Treasury's balance.

Mr. Holmes said he was not sure what factors were most important. In his judgment further study of the matter was required.

Mr. Hayes remarked that he would support the proposal for study, in view of the importance of the question Mr. Coldwell had raised.

There was general agreement that the staff should study further the factors underlying the recent increase in the rate of use of RP's.

Chairman Burns then noted that a memorandum from the Manager, on the subject of operations in Government agency issues, had been distributed on March 9, 1972.^{1/} He asked Mr. Holmes to comment.

Mr. Holmes observed that operations in agency issues had proceeded relatively smoothly since they were authorized by the Committee last August, and the System's portfolio had been built

^{1/} A copy of this memorandum has been placed in the Committee's files.

up to about \$800 million. There were still some technical problems, such as the length of time required to complete a go-around, but they were not serious enough to be disturbing.

However, Mr. Holmes continued, a potential problem was posed by one of the guidelines governing operations in agencies--number 6, which limited System holdings of any one issue to 10 per cent of the amount of the issue outstanding. That limit had already been reached for two issues, and System holdings were now 5 per cent or more of outstandings for another 14 issues. The Desk was, of course, required to reject offers of any issue at the limit, even though it might be priced attractively relative to other issues.

For that reason, Mr. Holmes said, he had recommended in his memorandum that the Committee revise the guideline in question to increase the limit on System holdings of individual agency issues from 10 to 25 per cent of the amount outstanding. Subsequently, however, Mr. Mayo had suggested that if such a change were made the Committee should concurrently place a 10 per cent limit on System holdings of the issues of any one agency. He (Mr. Holmes) thought that suggestion had considerable merit; it provided ample leeway for operations while maintaining the principle that the System should play only a modest role in the market.

Mr. Robertson said the proposed 25 per cent limit struck him as rather high. In his judgment some lower limit--such as 20 per cent--would be preferable.

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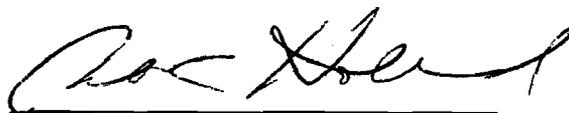
Mr. Daane concurred in Mr. Robertson's comment.

In the course of further discussion a number of members indicated that they favored an amendment to guideline 6 along the lines of Mr. Mayo's suggestion. In response to a question by the Chairman, a majority expressed a preference for a 20 rather than a 25 per cent limit on holdings of any individual agency issue.

By unanimous vote, guideline 6 for the conduct of System operations in Federal agency issues was amended to read as follows:

System holdings of any one issue at any one time will not exceed 20 per cent of the amount of the issue outstanding. Aggregate holdings of the issues of any one agency will not exceed 10 per cent of the amount of outstanding issues of that agency.

Thereupon the meeting adjourned.


Secretary