

REC'D IN RECORDS SECTION

NOV 29 1960



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

November 28, 1960.

TO: Federal Open Market Committee

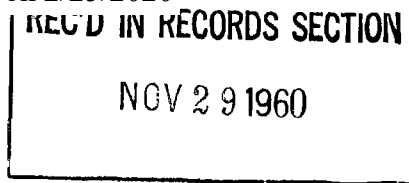
FROM: Mr. Sherman

For your information, there is enclosed a copy of a memorandum prepared by Mr. Thomas and dated November 23, 1960, entitled The Practical Logic of "Bills Preferably."

A handwritten signature in cursive script that reads "Ralph A. Young".

Ralph A. Young, Secretary,
Federal Open Market Committee.

Enclosure



November 23, 1960.

The attached statement presents a brief summary of some of the practical operating aspects of "bills preferably". It does not attempt to comprehend the, perhaps more fundamental, reasons relating to interest rate relationships and general market performance for confining Federal Reserve operations to short-term securities.

Woodlief Thomas

Attachment

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November 23, 1960.

THE PRACTICAL LOGIC OF "BILLS PREFERABLY"

Practical reasons why Federal Reserve open market operations should generally be confined largely to Treasury bills may be stated in a few simple propositions.

1. In its operations the System generally finds it necessary over the course of a year to sell almost as many securities as it buys, and sales are commonly made in large amounts over short periods.

2. It must, therefore, be a guiding principle of System operations that practically all securities purchased should be of the types that are readily salable or can be redeemed at maturity in rather large amounts without creating serious difficulties for the market or the Treasury.

3. It has nearly always been impracticable for the System to sell, or redeem at maturity, securities other than bills in amounts large enough for System purposes. This is the case for two reasons:

- (a) The market prefers bills, because of their distinctive features, and will absorb larger amounts of bills than of other securities.
- (b) With the existing structure of the outstanding public debt, the Treasury is nearly always prepared to issue as many securities other than bills as the market will absorb.

4. The present System portfolio of securities, other than occasional repurchase contracts, is composed mostly of securities other than bills, that have been acquired over the years and never sold. Further acquisitions of such securities would necessitate a reduction in System's holdings of bills.

5. It may be concluded, therefore, that with the existing structure of the Federal Reserve portfolio and of the public debt in general, Federal Reserve operations should be conducted principally, if not entirely, in bills. Purchases of other securities in amounts sufficient to affect the interest rate structure could not be made without necessitating offsetting sales of bills and thus building up an unduly illiquid System portfolio. Securities could not be sold to absorb temporary redundancies in reserves without undesirable effects on the Government securities markets.

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These practical reasons, it should be kept in mind, are aside from certain fundamental reasons for confining System operations to short-term securities. These other reasons, which have been fully discussed elsewhere, include the possible effects of System operations upon the depth, breadth, and resilience of the market, upon the attitudes of investors toward the rate structure and their willingness to invest in longer-term securities, and upon the reliability of market changes as signals of basic conditions with respect to saving and investment.

The above-stated propositions may be more fully elaborated and supported by facts as to the current situation and by the experience of the past. Some of the more important pieces of supporting evidence are summarized briefly below.

1. Although System operations are very large, total sales and redemptions in the course of a year are usually approximately as large as purchases. In a period in which there is a net gold inflow, a net return of currency from circulation, or a reduction in reserve requirements, sales may need to exceed purchases. Gross annual purchases by the System, including repurchase contracts, have often exceeded \$10 billion, and sales and redemptions have usually totaled almost as much. During the past four years outright purchases have varied from an annual total of \$2.5 billion to one of \$6.7 billion and gross annual sales and redemptions have varied from \$2.5 billion to \$4.2 billion. Total repurchase contracts acquired in the course of a year varied between \$3.5 billion and \$7.2 billion. The largest net change in the System's total portfolio was an increase of \$2.1 billion in 1958; in other years net

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changes have varied between a small decrease in 1957 and relatively small increases in 1959 and 1960.

2. The System should not purchase any securities it cannot readily sell or redeem at maturity. Although the System portfolio is so large that almost any continuous selling operation or any net decrease in the portfolio over an extended period is likely to be only a small portion of total holdings, from a market standpoint operations are quite large over short periods of time and the System must avoid obtaining a portfolio distribution that will hamper its necessary operations at any time. Purchases of long-term securities, for example, to cover seasonal or other temporary reserve needs and subsequent sales of short-term securities after those needs have passed could quickly deplete the System's portfolio of short-term securities. A similar result would ensue from any attempt to engage in what are in effect swaps -- purchases of long-term securities and sales of bills -- so as to affect the rate structure without improperly affecting the supply of reserves.

3. It is nearly always impracticable for the System to sell in the market or redeem any securities other than bills.

(a) The market itself prefers bills and therefore will more readily absorb sales with a minimum of impact. This is true because of the distinctive features of bills -- principally their short and well-distributed maturities, which make possible redemptions at convenient dates. The market preference for bills is an adequate, fundamental reason why the Federal Reserve must prefer bills. The volume of trading in other

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issues -- even in those maturing in less than a year -- is only a fraction of current trading in bills. Positions in other issues maintained by dealers are also much smaller both in dollar volume and relative to amounts outstanding than is the case with bill positions. Only around Treasury financing periods do dealers increase their trading activity in these other issues. For the System to sell them at such times, or to redeem maturing issues without replacement, might endanger the success of Treasury financing or discourage holdings of such issues by others.

(b) The existing structure of the outstanding public debt is so distorted with respect to the large proportion of short-term securities that the Treasury is nearly always anxious to issue more longer-term obligations. Under these circumstances, if additions are made to the market supply of such issues, they can and should be made by the Treasury, rather than by sales from the Federal Reserve portfolio. In the case of certificates and short-term notes and bonds, the market, as well as the System portfolio, is already surfeited with them, and refunding operations by the Treasury are large and frequent. System sales from its portfolio would merely add to the redundant market supply and create difficulties for Treasury refinancing.

4. The Federal Reserve portfolio is already composed mostly of securities that cannot be readily marketed in the amounts and at the times when sales may be necessary. Holdings of bills and of repurchase contracts taken together have fluctuated in the twelve months ending October 26 between \$1.5 billion and \$3.0 billion.

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Sales in the course of a year amount to two or three times the maximum holdings of bills and repurchase contracts. Sales necessary to adjust reserve availability often exceed \$100 million in a single day and several hundred million dollars in a week. The System must hold enough bills of different maturities to permit sales of such magnitude to be made without temporary distortions in the rate pattern.

Holdings of securities other than bills maturing in less than a year have generally amounted to around \$16 billion in the past year or more, and those maturing in over one year to around \$7 or \$8 billion, totaling close to 90 per cent of the total portfolio. Shifts in the maturity distribution of issues other than bills have reflected approaches to maturity of securities held and exchanges during refunding operations.

The large holdings of issues other than bills and repurchase contracts were practically all acquired over the course of years in supporting weak sectors of the market. On most occasions when the System has attempted to support any particular sector of the market, purchases have exceeded a billion dollars, requiring offsetting sales of other issues. Support of bonds in 1947 and 1948 required purchases of \$10 billion, largely offset by a reduction in holdings of bills. Few of the securities thus acquired have ever been sold or redeemed at maturity.

Additional purchases by the System of securities other than bills when reserves are being supplied and sales of bills when reserves need to be absorbed could quickly deplete the

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System's already small portfolio of bills. Since System operations to adjust the availability of reserves are relatively large and frequent, a substantial portfolio of bills is needed to make possible prompt sales in appropriate amounts.

5. For these practical reasons, System operations need to be confined almost wholly, if not entirely, to purchases and sales of bills. Purchases of other short-term securities may be made at times without distortion of the rate structure or interference with saving-investment patterns, but the securities acquired should be readily salable when and if necessary to absorb reserves. Purchases by the System of longer-term securities in an endeavor to affect the structure of interest rates could not be effective unless made in large amounts. Purchases in such amounts would give the System a portfolio so illiquid that its operations to absorb reserves when necessary would be hampered. Sales of longer-term securities in amounts necessary for that purpose would most likely seriously upset the market for Government securities and probably interfere with Treasury financing operations. These practical difficulties would be in addition to the broad questions of the advisability and feasibility of endeavoring to influence the rate structure in such a manner.