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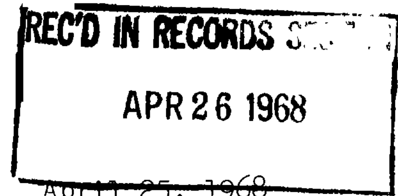

~~April 25, 1968~~

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

From Alan R. Holmes

Subject: A Flexible Rate for Repurchase Agreements

At its meeting on April 2, 1968, the Federal Open Market Committee approved a request by the Trading Desk to experiment with a flexible rate on repurchase agreements with nonbank dealers. It was agreed that the initial experiment should be a modest one and that the matter would be studied further with a view to developing criteria for determining the appropriate rate at any given point in time. This paper reviews the recent experience with repurchase agreements at rates above the discount rate, sets forth the rationale for continuation of this practice--still on an experimental basis--and proposes objective criteria for the establishment of rates appropriate to market conditions.

Recent Experience

On Thursday, April 4, shortly following outright purchases of bills in a market go-around, the Trading Desk contacted each dealer firm, including the bank dealers, to indicate the intention of the Federal Reserve to experiment with a more flexible rate on repurchase agreements. The following paragraph summarizes the matters discussed:

> "The Federal Reserve has been concerned, as a matter of operational technique, with the lack of flexibility in its rate on repurchase agreements with nonbank dealers. For example, at present there is a substantial differential between the RP rate and the rate on other sources of dealer financing and other market interest rates. On some occasions, we have felt inhibited in the use of repurchase agreements at the discount rate to supply reserves, because that rate was so much lower than the rate on alternative financing sources. At other times, of course, the System has used a rate below the discount rate when existing market rates made that appropriate. We propose, therefore, to introduce, in an experimental way, some greater degree of flexibility into the Federal Reserve's RP rate, relating that rate more closely to current rates. By way of example, if RP's were to be offered to the nonbank dealers today, consideration would be given to a rate such as 5 1/8 per cent. We would emphasize that this is a matter of operating techniques, rather than of general monetary policy. No public announcement will be made."

There was relatively little adverse comment during the initial discussion with dealers. One or two firms felt that the action might place some additional upward pressures on rates for Treasury bills, and a few felt that this move might be construed as part of the general tightening in monetary policy. Later the same day, in view of the apparent need to provide some additional reserves, the Desk offered repurchase agreements to the dealers at 5 1/8 per cent, making a total of $201 million of such agreements for four days. An additional $33 million repurchase agreements were made against bankers' acceptances for a seven-day period.

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Treasury bill rates rose 5 to 10 basis points over the course of that day, bringing the three month issue to 5.27 per cent at the close. Part of the upward pressure, no doubt, reflected the psychological influence of the new repurchase rate, but more importantly the rate movement appeared to be related to the general upward movement in dealer financing costs, which by this time reached 6 3/8 per cent for new loans at the New York City banks (a new high level for the year), and to increased selling pressures. Such pressure was clearly reflected in the dealers' response in a System go-around to purchase Treasury bills earlier that morning. The dealers offered about $1.3 billion of Treasury bills in response to the Desk's request for cash offerings--an amount that represented about 70 per cent of the dealers total trading position in bills at the time. With Desk purchases aggregating only about $225 million, there was considerable disappointment which contributed to the upward rate pressures that subsequently developed.

There was some further discussion in the press and in market letters over the next few days regarding the new technique, but additional agreements were negotiated at a 5 1/8 per cent rate on April 5, 11, 15, and 16, with little further comment from market participants on the implications of this action. Among the comments that were made, some dealers expressed surprise that the repurchase rate had not been moved up somewhat further. Rates for most Treasury bills had risen another 10 to 20 basis points over the interval, mainly in response to the Treasury's announcement of weekly additions to the six-month bill auctions. The three-month issue temporarily reached 5.46 per cent in the weekly auction on April 15, then receded to 5.37 per cent bid by the close on April 16. With rates on Treasury bills close to (or above) the upper end of the range evisaged by the Committee, and in view of the desirability of keeping the experiment modest, the Desk, however, stayed with the 5 1/8 per cent repurchase rate rather than move it up to a higher level.

After the increase in the Federal Reserve discount rate announced on April 18, there was no need to provide reserves through repurchase agreements, and hence no further opportunity to experiment with varying rates on repurchase agreements. It is the view of the Trading Desk staff, however, that small changes in that rate would tend to have less significance than the original move, which had broken a precedent of many years standing. This view would be reinforced if the criteria used in setting rates were clearly understood by the market.

Rationale for a Variable Repurchase Rate

The rate on repurchase agreements with nonbank dealers has virtually always been set at the prevailing discount rate, except during periods of relatively easy monetary conditions when lower rates have been used with some frequency in order to maintain competitiveness. Until recent years, the discount rate was quite appropriate as the basis for repurchase agreements since Federal funds trading was typically at or below the Federal Reserve discount rate even in periods of restrictive monetary policy. Since the advent of the premium rate for Federal funds in late 1964, this situation has changed.

The effect of Federal funds trading above the discount rate was not very significant initially. The premium rate for Federal funds held generally in a 1/8 to 1/4 per cent range above the discount rate until the spring of 1966, and accordingly dealer lending rates and other market rates of interest

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were not significantly above the prevailing discount rate. As money market conditions tightened further in the summer and fall of 1966, however, the Federal funds rate moved up more sharply, and bank lending rates to dealers assumed an even larger spread above the discount rate, reaching a margin of almost 2 1/2 per cent in the latter part of that year.

As a result of this change in the relationship between money market rates and the discount rate, repurchase agreements provided nonbank dealers with a considerable subsidy, with financing at a considerably lower rate than available elsewhere--and a lower rate than that being earned on most Government securities in portfolios. In consequence, in the summer of 1966 some members of the Committee expressed reservations over the use of the repurchase mechanism. The Desk concurred in these reservations and raised the possibility of using higher repurchase agreement rates at that time. The difficult conditions then prevailing and the tender state of market expectations, however, argued against any such change in practice, and the subsequent realignment of the discount rate and market rates which followed the easing of policy in late 1966 and early 1967 made the question academic once again.

It seems clear that any periods of monetary restraint in the future, as at present, may well be accompanied by a premium rate for Federal funds that will also be reflected in other market rates of interest. The Committee, in fact, in delineating the range of money market variables that it considers desirable, has often included a Federal funds rate well above the discount rate. Therefore, it seems appropriate that the repurchase agreement rate, which was quite properly at the discount rate when Federal funds fluctuated around that level, should now be reconsidered in the light of changing money market practices, which the Committee has accepted. To continue making RP's at the discount rate may provide an increasingly large subsidy to nonbank dealers if monetary conditions should tighten further; but to hold fast at the discount rate, and then make a change only when the spread becomes unusually wide, would tend to have even greater impact on market expectations.

Criteria for Establishing Rates

At the April 2 meeting of the Committee, several members recommended that a flexible repurchase agreement rate be based on clear guidelines related to market rates--lest wide discretionary latitude appear to endow the RP rate with unduly great significance. In light of the experience thus far, and the rationale described above, the use of objective guidelines would appear highly desirable, at least for normal operating purposes.

Given clear and objective criteria, there is little risk that the repurchase rate would take on new and special significance, or that it might call into question the significance of the discount rate. The rate used on repurchase agreements is not posted, but set only when the agreements are actually being made, and such agreements are made only at the System's initiative. There are many periods of time, sometimes fairly lengthy, when there is no need to make repurchase agreements. Once the present link is dropped, there is no need, and perhaps little likelihood, of a direct connection being drawn between the repurchase rate and the discount rate.

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In our view, the appropriate fulcrum for the RP rate is the rate on Federal funds. That is the rate that tends to be the basis, with modest upward or downward variations, for setting dealer financing rates in various forms. When trading in Federal funds did not exceed the discount rate level, the latter was the appropriate basis for setting the RP rate, but now that the Federal funds rate departs rather freely from the discount rate, the RP rate can appropriately display similar flexibility. A rate about 1/4 of 1 per cent below the Federal funds rate would seem to be quite appropriate. In terms of current operations, with the Committee expecting the Federal funds rate to fluctuate around 6 per cent, this would suggest a rate of about 5 3/4 per cent on repurchase agreements. This rate provides a sufficient spread from other lending rates to insure that the System can provide reserves in size through repurchase agreements when that is appropriate. It also is close enough to market rates to avoid the concern over providing an undue advantage to nonbank dealers.

While the Committee might consider the above approach for normal operating purposes, it would be desirable to retain a greater degree of flexibility to deal with specific market situations in which the Committee might wish to approve use of the rate on repurchase agreements as an additional tool in achieving certain objectives. In the present environment the 5 3/4 per cent RP rate noted above would be about 1/4 per cent above the three-month bill rate, and this could help exert upward pressure on that rate. Generally, when Treasury bill rates were moving below a level that the Committee felt was desirable, a higher rate on repurchase agreements could help to achieve the System's objectives. On the other hand, if the Federal funds rate were to move significantly higher in relation to the discount rate, then consideration could be given to a repurchase agreement rate at a spread greater than 1/4 per cent from the Federal funds rate. Otherwise the repurchase rate could chase the Federal funds rate higher in an escalating spiral that might not accord with System objectives. Generally, when Treasury bill and other market rates are under strong upward pressure, or when unusually high dealer financing costs pose a particular problem to the functioning of the market, the Committee might wish to approve a lower than normal rate for repurchase agreements as a means of dealing with these conditions.

If the Committee agrees with the above rationale and criteria, the Desk will continue to experiment along these lines with a flexible repurchase rate in the period ahead. After additional study and experience the procedures may be evaluated further, and operating techniques can be adjusted if the Committee sees that to be desirable. We would propose not to depart from the procedure described above as normal without further consultation with the Committee.