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

March 11, 1974

CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Arthur L. Broida

Enclosed is a copy of a memorandum from the System Account Manager, dated today and entitled "Recommended changes in paragraph 1(a) of authorization for domestic open market operations." It is contemplated that this memorandum will be discussed at the forthcoming meeting of the Committee.

The Committee's Senior Economist concurs in Mr. Holmes' recommendations, and the General Counsel finds no legal objections to them.

Enclosure

March 11, 1974

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Holmes

SUBJECT: Recommended changes in paragraph 1(a) of authorization for domestic open market operations

At the FOMC meeting on July 17, 1973, it was suggested that consideration be given to the possible need for enlarging the current $2 billion leeway (specified in paragraph 1(a) of the authorization for domestic open market operations) for making net changes in the System Account's holdings of U.S. Government and Federal agency securities between meetings of the Committee.[1/] As indicated in the review in the second part of this memorandum, there has been a marked increase in recent years in the maximum net variation in System Account holdings between meeting dates, and the frequency of instances of "near exhaustion" of the leeway has increased in recent years. Within the past year, I have found it necessary to ask for a temporary enlargement of the leeway to $3 billion on three occasions (March and July 1973 and January 1974). These factors suggest that it would be timely to enlarge the leeway permanently to $3 billion, and I so recommend.

In addition, I recommend three technical changes in paragraph 1(a). One of these is intended to make it clear--as it was in the language employed prior to March 1964--that the leeway refers to

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1/ The last permanent increase in the leeway (from $1.5 to $2.0 billion) was made in December 1965.

changes in System Account holdings calculated on a "commitment" basis. This can be done by inserting a parenthetical phrase reading "including forward commitments" following the phrase referring to System Account holdings in the statement relating to the leeway.[1/]

The second technical change recommended is the deletion of the phrase "on a cash, regular, or deferred delivery basis" from the statement relating to purchases and sales of securities in the earlier part of paragraph 1(a). Since the phrase includes all delivery bases that might be employed, it serves no useful purpose. A recommendation is also before the Committee to delete the same phrase from paragraph 1(b), relating to bankers' acceptances.

The third technical change is the addition of the phrase "including securities of the Federal Financing Bank," in the first sentence of paragraph 1(a). The background for that recommendation can be found in my memorandum to the Committee entitled "System purchases of Federal Financing Bank Securities" of today's date.

If these recommendations are approved, paragraph 1(a) will read as follows (deletions are shown by cancelled type and additions by capital letters):

1/ A similar phrase was included in the leeway clause prior to March 1964. At that time the Committee approved an amendment to the clause for the purpose of clarifying the language in certain other respects, and when the new language was transcribed the reference to forward commitments was inadvertantly omitted. The omission was first noticed last autumn.

"(a) To buy or sell U.S. Government securities, INCLUDING SECURITIES OF THE FEDERAL FINANCING BANK, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, ~~on a cash, regular, or deferred basis,~~ for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (INCLUDING FORWARD COMMITMENTS) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than $3.0 ~~$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."

Considerations suggesting need for larger leeway

The justification for a larger leeway for change in the System Account between meetings may be seen in the table attached to this memorandum. The "average leeway used" has increased from $642 million in 1968 to $941 million in 1972, and to just over $1.3 billion in 1973. The table also traces the frequency of instances when use of the leeway exceeded $500 million, $1.0 billion, $1.5 billion, and $2.0 billion. Especially noteworthy is the increased frequency of changes in excess of $1 billion, and those in excess of $1.5 billion. For even where the $2 billion limit was not breached, any time the use of the leeway exceeded $1.5 billion, it meant that special attention had to be given to this factor, in some very marginal degree affecting the types of operations undertaken by the Account Management in order to reduce the possibility of exhausting the available leeway. While use of the leeway exceeded $2.0 billion only once during 1973, the change in the System Account was larger than $1.96 billion in three other intermeeting periods.

The reasons for the larger use of leeway in recent years rest in the increased variation in market factors affecting reserves, and to some degree in the somewhat longer average time interval between meetings. The chief culprit among market factors is the greater variation in Treasury balances at the Federal Reserve Banks, as indicated in the lower portion of the attached table. In turn, the greater variation of Treasury balances reflects the Treasury's policy in the past year or two of seeking to keep a greater proportion of its balances at the Reserve Banks and less at commercial banks. This means that Treasury balances at the Reserve Banks tend to build up sharply after tax dates, but then to run down more sharply than before as total balances decline just prior to new tax dates. In part, too, growth in the economy has engendered larger swings over short periods in other factors affecting reserves such as currency movements, float, and required reserves.

Maximum Change in System Holdings of Marketable Government and Agency Securities during Periods between FOMC Meetings

	Cumulative Frequency					
	Less than $500 mil.	Greater than $500 mil.	$1.0 bil.	$1.5 bil.	$2.0 bil.	Mean of maximum absolute changes (millions of dollars)
1968	6	8	1	0	0	642
1969	5	9	3	1	1	724
1970	3	10	4	1	0	867
1971	4	9	5	0	0	809
1972	4	8	5	3	0	941
1973	1	11	8	4	1	1,303

Average Monthly Change in Treasury's Balance at Federal Reserve Banks

	End of month (millions of $)
1968	215
1969	207
1970	316
1971	297
1972	546
1973	855