REPORT ON OPEN
MARKET OPERATIONS

Reporting on open market operations, Mr. Sternlight made the following statement:

Desk operations sought a firming of money market conditions during the period since the last meeting of the Committee, as growth in M_1 bulged above the Committee's specified range. For about the first week of the interval, the Desk aimed for reserve conditions consistent with Federal funds remaining around 4 3/4 percent or a shade higher--as initial estimates pointed to considerable strength in April aggregates but suggested that April-May growth would be within the indicated bounds. By the end of April, however, a revised assessment indicated that M_1 growth was likely to be considerably above its specified range for the two-month period, although M_2 was expected to be near the middle of its range. Taking account of both aggregates, it was clear that a System response was warranted--and given that the Treasury was about to undertake its May refunding, it was desirable to make that response apparent to the market promptly. Accordingly, the Desk began in the final days of April to seek a funds rate around 5 percent or a shade higher--anticipating that if further data confirmed the strength shown by late April then a further firming in the funds rate would be appropriate. The funds rate in fact worked higher over the May 4 statement week--the week that included the Treasury's note and bond auctions--and the Desk provided only modest resistance to the firming as it was expected that a further increase in the funds rate objective to around 5 1/4 percent would soon be called for.

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The data on aggregates reviewed around May 4 confirmed the excessive growth of M_1 in April, and pointed to April-May growth well above the Committee's range. Estimates of M_2 growth had been moderated somewhat from a week earlier, but taking the two measures together, monetary growth was expected to be around the top of the range. Thus a move to the 5 1/4 percent top of the funds rate range adopted at the last meeting was in order. To provide further room for response to still more excessive growth in aggregates, the Committee agreed on May 6 to raise the upper limit on the funds rate objective to 5 1/2 percent, with the additional leeway to be used only if growth in the aggregates showed significant further strength. As it has turned out, that further significant strength has not developed and the Desk has continued to aim for Federal funds in the neighborhood of 5 1/4 percent. So far in this statement week, the rate has averaged 5.34 percent.

Partly because of the strength in deposit growth, which boosted required reserves, and also reflecting a sharp rise in Treasury balances at the Reserve Banks in the latter half of April, the Desk faced unusually large reserve needs during the recent period. Outright purchases included $835 million of Treasury coupon and agency purchases in the market and nearly $2.6 billion of bills bought from foreign accounts. Substantial use was also made of repurchase agreements and matched sale purchase transactions to add or withdraw reserves temporarily. For several days in late April the market supply of securities available for repurchase agreements was insufficient to meet System needs, and the Treasury was cooperative in moderating its calls on tax and loan accounts and even made a large

temporary redeposit of balances to commercial banks. This helpful Treasury posture was in their own interest too, since without it the money market could have been much tighter--to the detriment of the Treasury's ongoing financing program.

As it was, the Treasury's May financing proceeded quite well, as underwriters and investors appreciated by the time of the auctions that the System was taking a firmer stance. The rates paid--7.28 percent on $2.85 billion of 6 3/4 year notes, and 7.77 percent on $1 billion of 29 3/4 year bonds--were somewhat above the rates expected when the Treasury announced its terms on April 27, but the market adjusted smoothly and good bidding interest developed at modestly higher rates. The adjustment process was facilitated by the low level of dealer inventories, and by the fact that the Treasury was paying down about $1/2 billion in its mid-May refunding operation. Dealers took on sizable amounts of the new issues but distributed them quickly and by the end of the period dealer inventories of over-1-year Treasury maturities were about $1.3 billion lower than at the start of the interval, and in fact were net short by some $400 million. For a time the two new issues traded below their issue prices but price gains in the last few days carried them up to or above issue price.

A net paydown is also entailed in the regular monthly auction tomorrow of 2-year notes. It was anticipated yesterday that the notes might sell at around 6.25 percent--up from 5.87 percent for a similar issue a month earlier. For most short and intermediate term coupon issues, yields rose about 20 to 50 basis points over the period, while yields on longer maturities were up by some 15 to 20 basis points.

Rates responded to a combination of influences, including the evidence of economic expansion and continued inflation, as well as steep money supply growth and less accommodative System policy. The rate increases appear to have been fairly well anticipated by the markets, however, and caused little anguish.

Likewise, while most bill rates rose some 40 to 50 basis points over the period, the increases came against a background of substantial activity and declining inventories, and hence were not a cause of great concern to the market. Steady and sizable paydowns of bills by the Treasury have alleviated the market's task of adjusting to higher short-term money rates, as dealer inventories have declined in this area too. In yesterday's weekly auction, 3- and 6-month bills were sold at about 5.00 and 5.23 percent respectively, up from about 4.49 and 4.71 percent four weeks earlier.

A variety of other short-term market rates also increased by roughly similar amounts over the interval, and this led last Friday to a 1/4 percent increase in the prime rate by most major banks, to 6 1/2 percent. Although the prime rate increase came earlier than most market participants expected, the move has been taken well in stride.