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

December 13, 1977

TO: Federal Open Market Committee

FROM: Arthur L. Broida

Attached for your information is a copy of a letter from Roger Altman, Assistant Secretary of the Treasury, to the Department of Justice regarding the petition for a writ of certiorari in the matter of Merrill v. FOMC.

Attachment

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

December 9, 1977

Dear Ms. Babcock:

This transmission is forwarded in support of the Federal Open Market Committee's (FOMC) petition for a writ of certiorari in the matter of Donald R. Merrill v. Federal Open Market Committee of the Federal Reserve System, No. 76-1389 (D.C. Cir. Nov. 10, 1977).

In its petition of December 1, 1977, the FOMC forwarded certain arguments concerning the financial market effects which might result from the immediate disclosure of the monthly FOMC directive to the Manager of the System Open Market Account at the Federal Reserve Bank of New York. It is to these arguments that this communication is addressed.

The FOMC directive customarily includes an initial objective for the Federal funds rate (the rate of interest at which banks lend reserve balances to other banks) expressed in numerical terms and a range within which the rate may be varied by the Manager on his own authority. The FOMC in its petition argues that the "announcement effect" from immediate disclosure of significant policy changes, such as a change in the target rate of 1/2 of 1 percent, could have sharp and, at times, disruptive effects on the market value of fixed income securities. Equities and, perhaps, foreign exchange rates could also be affected and large speculative profits could accrue to the most sophisticated market participants.

At present, as the FOMC's petition discusses in some detail, the market adjusts gradually to changes in the FOMC's policy as it perceives FOMC's intent from the Manager's market actions. As a consequence of the sharper market fluctuations which would result from immediate disclosure, dealer underwriting risks would be increased.

Since dealers would surely seek increased compensation for such higher underwriting risks, increased financing costs for the Federal Government would appear to be a clear consequence of immediate disclosure.

To illustrate the basis for Treasury's concern, it is indeed a fact that all markets -- fixed income, equity, and exchange -- have in recent years become increasingly sensitive to perceived changes in the monetary policy of the Federal Reserve System. This development is clearly evident in the behavior of market participants immediately before and after the Federal Reserve System's weekly release of key financial statistics, especially the statistics relating to the monetary aggregates. Large changes in the monetary aggregates have resulted in large changes in security prices, some of which might properly be characterized as extreme in light of subsequent developments.

Moreover, because the market reaction to the release of these statistics is frequently unpredictable and potentially destabilizing, Treasury debt managers have avoided financing operations on these days, whenever, possible, to minimize the possibility that the pending release of the statistics might distort the bidding process and the actual release have an adverse effect on the subsequent distribution of the issue. Since the Treasury must conduct over 100 separate financing operations each year, the need to forego 20% of the financing calendar days has already significantly complicated the scheduling of financing operations.

While the weekly release of financial statistics reflects financial developments that have already taken place, the monthly policy directive represents future policy intentions based upon the FOMC's current estimates of future economic and financial developments. This raises additional problems affecting the conduct of Treasury financing operations.

The market is likely to try to discount announced future policy intentions immediately, without regard to the necessarily somewhat tentative nature of such intentions. Under the present procedure, the Manager of the System Open Market Account can use his judgement and discretion in effectuating changes in interest rate levels in an orderly fashion and in light of new economic and financial information as it becomes available. Immediate disclosure, however, could result in the market trying to make the whole adjustment immediately, without due consideration to the possibility that new data would require modifications in the directive in subsequent weeks. Moreover, there is also the possibility that such market adjustment would go even further on the basis of unwarranted projections of policy into the future.

Thus, there would appear to be real cause to conclude that immediate release of the policy directive would tend to increase market volatility, and that this would be especially serious at any time the new directive revealed any change in the currently perceived policy.

It is also significant that the Federal Reserve System has been somewhat reluctant to rely on certain of its policy instruments, including changes in the discount rate and reserve requirements, because of an "announcement effect" that is analogous to the "announcement effect" of an immediate release of the directive.

It is also clear that an increase in market volatility is likely to be translated directly into increased financing costs for the Treasury Department.

The Treasury relies on a network of bank and nonbank dealers for the underwriting and secondary distribution of its security issues. Firms in this dealer network take into account a wide array of market considerations in assessing the risks involved in the underwriting commitments they make in each Treasury financing. Among these considerations, price stability is of major importance.

Thus, to the extent that the immediate release of the FOMC's monthly directive would tend to increase market volatility, and thereby to increase the underwriting risks of the dealer community, the cost of Treasury financing would rise with the taxpayer bearing the ultimate burden.

Other borrowers in security markets would also be subject to similar increased costs for the same reason, and the net effect could be some overall reduction in the efficiency of U.S. capital markets.

Because the benefits to be derived from immediate disclosure of the directive appear small compared to the potential for market disruption and increased Treasury borrowing costs, the Treasury Department supports the FOMC's petition for a writ of certiorari.

Sincerely,

Roger C. Altman

Ms. Barbara Allen Babcock
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Civil Division
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Washington, D.C. 20530