Draft 8/13/52
AS:ES

1. Market stabilization - August-September financing.

(a) Stabilization operations must be in accord with policy adopted by Executive Committee of Federal Open Market Committee at its meeting July 22, 1952.

"To effect a controlled release of reserve funds through open market operations while, at the same time, attempting to force the member banks to increase their dependence on the discount window in meeting their reserve needs." * * * "Making purchases of short term Government securities which could later be sold or allowed to run off if the situation warranted." * * * "In view of the relatively small size of this refunding (August 15-September 1), the System might advantageously experiment in its open market operations by making purchases of Treasury bills and short term certificates rather than concentrating all of its stabilization operations in 'rights' and 'when issued' securities." (Not to maintain a premium on rights) * * * "At one time the guide (to policy) might be interest rates and at another member bank borrowing; that during the actual refunding of the Treasury's maturing certificates, there should be reasonable stability in market rates. Once that operation is completed, however, the System might contemplate a further rise in member bank borrowing of say $500 million and a further firming of money rates." * * * "Try to moderate movements

but not attempt to hold rates after the forthcoming refunding operations were out of the way." * * * "the October refunding should be determined in the light of conditions at the time."

(b) After conversations Chairman and Secretary of Treasury, the word was that Secretary was accepting our suggestion (2% for not more than one year), in light of our credit policy, and we should "lean over backward" in helping make issue a success. Success initially is measured in terms of attrition. (Attrition - Treasury $_____ or ____%. Federal Reserve Banks bought $180.4 million "rights" and sold, on swaps, $170.5 million certificates - October, February, June)

(c) Market was supported - stabilized - fromtime of Treasury's announcement of financing on July 30th to closing of the books on August 7th, by purchases of bills, certificates and bonds (2% bonds of 1953), and by swaps of other securities (mostly October certificates) for "rights". Taking account of all System purchases the total gross support given the market was about $430 million. Net of swap sales and dealers sales contracts about $325 million of reserves were supplied to the banks by open market operations. Funds were furnished freely to dealers to enable them to carry short term positions without loss; they reduced their sales contracts as funds became available to the market. Similarly member banks reduced their borrowing through the discount window by about $650 million (from about $1,400 million to $750 million). There was no attempt to maintain a premium - rights value - on the maturing issues, which were bought at net par to the seller (100 plus $75 commission) on outright transactions, and on swaps at 100 1/64 net and interest.

(d) Only argument (and that among ourselves) seems to have been whether we should engage in swaps for "rights" or only buy the maturing

obligations and let the market seek to fill the other side of the transaction, thus forcing up prices and forcing down yields in this area. (October certificates involved in swap transactions were sold at 1.81% to 1.82%.)

(e) This in turn involved a judgment as to whether the market would function in this way. There was the real possibility that the holder of maturing issues (or dealer acting for him) not finding a convenient and ready swap, would hold the August and September certificates and cash them at maturity, before making other investments. In the interest of promoting as large an exchange as possible ("leaning over backward") to facilitate an offering which was not being well received, it was decided to help out on swaps if they were preferred by the market. (We were ready to buy outright or on swaps.) This also may be claimed to have had the effect of helping the financing with a smaller net use of Federal Reserve funds than would otherwise have been possible. In view of the fact that the banking position was being eased considerably by our operations and other factors (in excess of what we would have wanted to do at this time in the absence of Treasury financing), this consideration was not without weight. On the other side, it was urged that, at best, we were only pushing over to October 1st the problem we were relieving on August 15th, by making these swaps, and at worst it might involve putting more money into the market rather than less. There is no final settlement date in these matters, however, and if the changing needs of investors

are met by pushing forward redemption dates, it can be a continuing process of market adjustment, which should require less rather than more reserve funds.

(f) When the books closed Thursday, August 7th, we considered the possibility of continuing our stabilization operations through the following week to the payment date, August 15th. The considerations were the fact that an issue which goes to a discount as soon as the books are closed and before payment date is less than a success, the market was quite bearish on the course of interest rates, and the October 1st financing loomed ahead. If the bearishness of the market was exaggerated, and if the use of a small amount of reserve funds could help to reduce this exaggerated bearishness, it might be constructive both in terms of credit policy and debt management. Otherwise the Treasury might be forced to place a higher coupon on its October financing than the real facts justified (that is higher than say 2 1/8% for one year), or we might be forced to put more funds into the market then, to support a closely priced issue, than we would have to put in now to give a little further help to the current financing. It has to be kept in mind that we are going to have to provide a large amount of reserves to the member banks during the remainder of the year, some of it through open market operations in line with the policy adopted by the Executive Committee.

Purchases during the week beginning August 8 and ending August 15 would have consisted primarily of the "when issued" securities, which would have meant paying at least net parto the seller, either outright or through swaps.

On the other side it was urged that this would be getting back into the business of pegging prices, that it would mislead the market as to rates, perhaps lead to a mistake in pricing the October 1st refunding by the Treasury; and that it would provide the banks with additional reserves at a time when we had already relieved the pressure on their reserve position more than was consistent with System credit policy at this time.

It is dangerous to be dogmatic about these things. The more you are sure you are right the more you are likely to be wrong. There was no question of returning to a pegged market. The only question was whether the market should be stabilized (including support of the new issue) for another week - until payment date - or not. The market can be misled as to the future course of rates by lack of knowledge of our intention to help meet seasonal credit needs and this can exaggerate market bearishness (perhaps it has already done so). The Treasury can price its October refunding "on the market" instead of "on the rich side", and leave us with a difficult stabilization job, no matter what we do now. (If it does so, we can't repeat the actions of September-October 1950.)

It is true that the banking position was relieved somewhat by our open market operations, which supplemented other factors, during the week ending August 6th.

Gains from

Gold - Currency - Reserve Requirements	+90	
Treasury - Float - Other	+309	
Net open market purchases	+133	(on a commitment basis this would be +208)
	+532	

This enabled the member banks to reduce their borrowings from the Federal Reserve Banks from 1,403 million to 843 million, a decline of 560 million. Excess reserves of the member banks moved from 637 million to 609 million.

These are statistics. They don't tell the whole story. The hopes and fears of the market enter in, as do our intentions. No one can say, I suggest, that an additional 25 or 50 million of Federal Reserve net purchases of the "when issued" August 15th certificates would have changed this picture materially. Yet that is all that might have been needed (there was little reason to believe that many holders of "when issued" certificates, having passed up their chance to swap or redeem, would now rush to sell at par), if we were dealing with exaggerated bearishness in the market, or with price markdowns on a limited volume of sales, in order to do a constructive job.

As it turned out the market was very quiet during the week preceding payment date, and while the new certificates were bid at a discount (2.02) little business was done. At the end of the week there were reports of transactions at par. It may be that if we had shown a willingness to buy at par, or better, a considerable amount of certificates would have been thrown at us (the dealers tried us out with offerings when the market opened Monday, August 11), or it may be that the reassurance of our buying would have contented possible sellers, the quotation would not have gone to a discount before payment date, and our purchases would have been negligible.

We were taking a risk. Discussion in the market of private and public demands for credit during the fall, and of our policy which was looked upon as

a "tight money" policy, and of the effect of monetary measures on Government security prices abroad, particularly in Great Britain, had led to fears of substantial increases in interest rates and substantial declines in security prices. At least temporarily, the morale of the market was distinctly low.