



Atlanta, Georgia
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Monthly Review

Managing the System Open Market Account

The securities portfolio of the Federal Reserve System is called the Open Market Account. Composed almost entirely of U. S. marketable securities, the Account's resources exceeded \$26 billion as of late April of this year. This makes the Account roughly two and one-half times greater than the total resources of the nation's largest commercial bank, and over 50 percent greater than the assets of the biggest insurance company.

The System's securities portfolio is composed largely of issues maturing in less than one year. As of late April, these comprised about 55 percent of the total portfolio. Issues maturing between one and five years made up another 35 percent, and those maturing in more than five years, the remaining 10 percent.

Only about one-tenth of the preponderant short-term issues, however, are the very shortest type: Treasury bills. The great bulk—over 80 percent—are certificates and notes. The System acquired a large amount of these two types of securities during the Korean War, and as the original issues have matured, it has exchanged them for other certificates and notes.

Today, the System's holdings of certificates are nearly as large as those of all other investors combined. Of bills, notes, and bonds, the System holds considerably less than the totals owned by other investors.

Also in this issue:

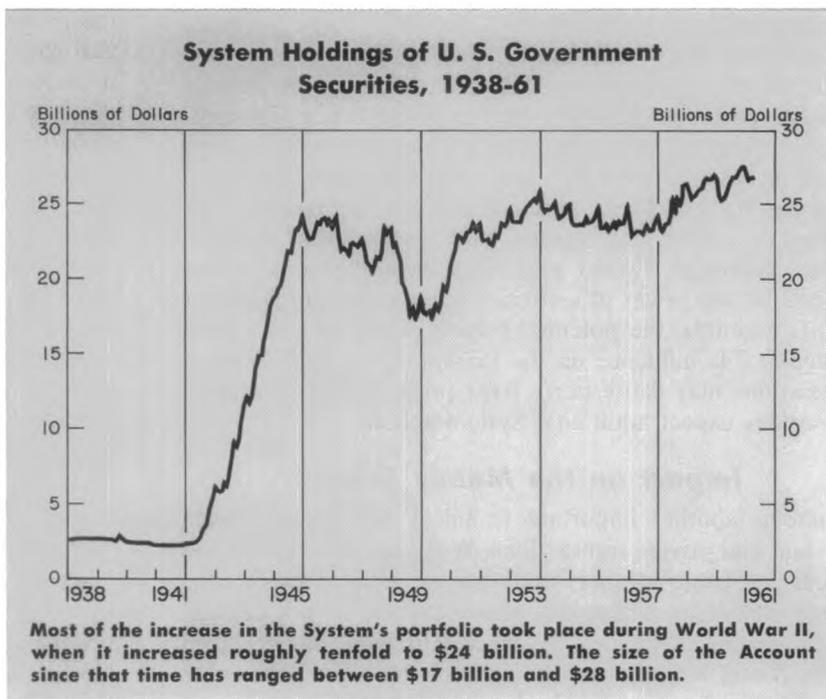
**WILL WARM
WEATHER THAW
GEORGIA'S
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System Holdings of U. S. Government Securities
Daily Average for Week Ended April 26, 1961

Type	Amounts (\$Millions)	Percent of Total	Maturity	Amounts (\$Millions)	Percent of Total
Bills	1,974	7.5	1 year or less	14,646	55.8
Certificates	5,001	19.1	1 to 5 years	9,578	36.5
Notes	16,418	62.6	5 to 10 years	1,853	7.1
Bonds	2,835	10.8	Over 10 years	151	0.6
Total	26,228	100.0	Total	26,228	100.0

But, altogether, the System holds nearly one-seventh of the marketable Government debt. Obviously, changes in any investment account of this size must have an important influence on the prices of Government securities.

Influence on Prices

An influence on the prices of Government securities, and in turn on the current interest rate, as measured by the yield, is not confined to the Federal Reserve System. The actions of any large institution, whether it be public or private, have a somewhat similar influence on the price of the commodity (in this case, Government securities) that it buys and sells. Buying increases the demand for the securities in the market and tends to raise their price, thus lowering the yield. Selling, on the other hand, adds to the total volume of securities in the market and tends to reduce the price and raise the yield.

The importance of System transactions in the Government securities market cannot be attributed solely to the size of its portfolio. Commercial banks hold about twice as many Government securities, and the net change in holdings often exceeds that of the Reserve System holdings.

One unique thing about System transactions, however, is the size of operations of the System on a day when it is in the market. Transactions often exceed \$100 million in one day and several hundred million dollars in a week. In 1958 the System bought outright nearly \$7 billion of securities, sold or redeemed \$4 billion, and bought several billion dollars of additional securities under repurchase agreements.

Another thing that makes the System's role in the Government securities market different from the role of private participants is the greater resources at its command. Whereas others can buy only as long as they have cash or assets convertible into cash, the Federal Reserve can pay for its security purchases by creating money. This power is limited only by the gold reserves that it holds. Thus, although System purchases have the same direct effects on the prices of securities as do other purchases of equal amounts, the potential buying power of the System magnifies its influence on the market. Even small System operations may cause fairly large price changes if market observers expect additional System action.

Impact on the Money Supply

There is another important technical difference between System and private transactions. When one individual buys securities from another, total private bank deposits, the most important part of the money supply, do not change. Suppose the buyer pays by check. His bank balance then goes down, but the bank balance of the seller goes up as soon as he deposits the check with his bank.

Results are different when the Federal Reserve buys or sells securities. Any time the System enters the market, it changes reserves and contributes to changes in bank deposits. When the System buys securities, it pays by a check drawn on the Federal Reserve Bank. Purchases of securities by the System, therefore, result in an increase in the reserve balance of the commercial bank where the seller keeps his account, as well as in an increase in the seller's balance. Conversely, when the System sells securities, the result is a smaller bank balance for the purchaser and a corresponding decline in the reserve balance of his bank.

The economic effects of the flow of reserves into and out of the banking system as the result of open market operations (that is, the buying and selling of Government securities) are far broader than the immediate effects of the transactions on the securities market. Additional reserves supplied the commercial banks through Federal Reserve purchases of securities can encourage credit expansion by the commercial banks amounting to several times the amount of reserves supplied. On the other hand, when the System sells securities, the withdrawal of reserves from the banking system can result in a contraction of bank credit far greater than the amount of securities sold. The potential effect on total borrowing and on spending in the economy thus can be very great. Moreover, if in expanding credit the commercial banks buy Government securities, the impact of their purchases on the prices and yields may be far greater than the direct impact of Federal Reserve purchases.

Economic Goals

The economic effects of the increases or decreases in reserves on the money supply and on interest rates are obviously more far-reaching than the direct effects of System transactions on the prices of Government securities. Therefore, the System's motive for buying and selling must be different from that of private investors if the System is to carry out its major responsibility of helping bring about high level production, maximum employment, and stable prices. While private investors generally deal in securities for maximum returns on their investments, those responsible for the System Account base their decisions primarily on expected economic results.

Like any private investment managers, those who manage the Account are constantly faced with decisions. Should the Account do any buying or selling at all? If so, how much, and what kind of securities? Securities mature from time to time. If the Treasury offers other securities in exchange for maturing issues, should the Account accept the offer; and if there is a choice of several, which security should it accept? Or, if the Treasury pays off the maturing securities in cash, should the System re-invest the proceeds; and if so, in what maturities?

Responsibility for the Account

The general policy for System open market operations is made by the twelve-man Federal Open Market Committee. The permanent members of this Committee are the seven members of the Board of Governors and the New York Reserve Bank president. The presidents of the other Reserve Banks take turns filling the remaining four posi-

tions. But all of them usually attend the policy meetings, which are held in Washington about every three weeks.

The policies laid down by the Open Market Committee are carried out by the Federal Reserve Bank of New York. This Bank—chosen because it is located in the nation's financial center—has been the agent of the System since 1923. At each meeting, the Committee gives instructions to the Manager of the Account, who is a senior officer of the Federal Reserve Bank of New York.

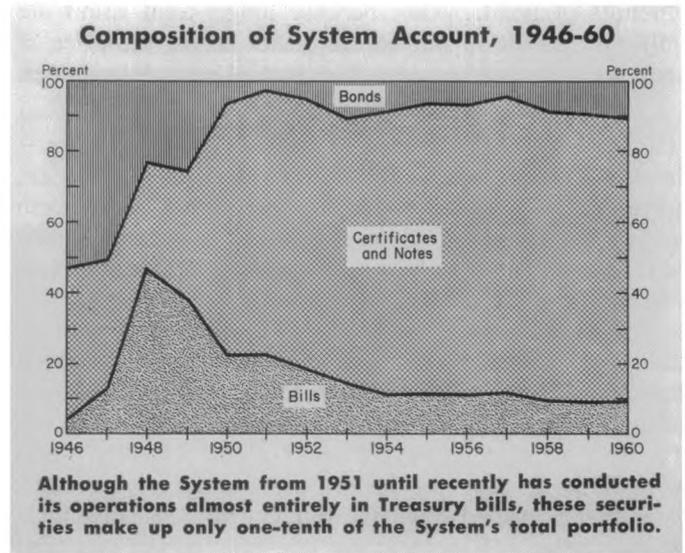
The decisions the Account Manager makes in executing the instructions are influenced to some extent by day-to-day events in the money and securities markets. Suppose bad weather delays checks in transit between banks? Bank reserves would pile up because the Reserve Banks, following a certain schedule, give credit to member banks before physical collection is completed. A sharp increase in reserves resulting from this sort of condition may encourage banks to buy securities in large volume and temporarily make credit easier than the economic situation warrants. If it is deemed desirable to offset some or all of these reserves, the Manager usually sells securities.

Government securities dealers are the source of securities purchased and sold for the System. These dealers, numbering less than twenty, are specialists in Government securities. The total dollar volume of business they do is several times larger than that done on the New York stock exchange.

Technical Considerations

The composition and maturity structure of the public debt, preferences various investors show for certain securities, and other technical considerations influence decisions to conduct operations in certain types of securities. For one thing, a large part of the Federal Government debt is short-term. The average length of the debt is about four and one-half years; about two-fifths matures within one year. So long as such a structure exists, the Treasury is more frequently in the market to sell or redeem short-term issues than those with longer maturities. Less frequently it sells or refunds longer-term securities, either to keep the length of the debt from shrinking or to increase it. Because Federal Reserve operations are large and purchases are frequently followed rather quickly by sales, the System portfolio must consist of securities that can be sold or redeemed readily without upsetting the securities market.

Dealing in short-term securities has other technical advantages to the Reserve System. Short-term securities,



especially the very shortest (Treasury bills), can easily be held until maturity and are easily sold because banks use them to adjust their positions and corporations like to invest their idle money in them.

Of these short-term securities, Treasury bills are a favorite and are traded more than any other. Commercial banks and corporations own about one-third of the total bills outstanding. A recent study made for the Joint Economic Committee shows that, even though bills have accounted for less than one-fifth of the marketable debt, trading in bills has for many years been greater than trading in all other securities combined. Maturities exceeding five years have been traded in much smaller volume, accounting for around 10 percent of the total trading.

Whereas dealers carry large inventories of short-term securities (especially bills), their holdings of intermediate- and long-term bonds are very small. In the week ending April 5, 1961, dealers held only \$135 million of securities due after five years, but they held about \$1.6 billion of securities maturing in one year or less and more than \$200 million in one- to five-year maturities. Most dealers, therefore, cannot handle a large order for long- or even intermediate-term bonds at the prices they quote. They try to obtain them from insurance companies, savings banks, and other institutional investors that own the bonds. Since many of these institutions consider their bonds to be permanent investments, a sizable price change is usually necessary to induce them to sell large

Total Marketable U.S. Government Debt

December 31, 1960

	Total Marketable Debt (\$ Millions)	Composition of Portfolio for Each Major Investor Group (Percent)				Percent of Outstanding Marketable Debt Held by Each Major Investor Group				
		Bills	Certificates	Notes	Bonds	Total Securities	Bills	Certificates	Notes	Bonds
Commercial Banks	54,259	12.9	4.7	31.2	51.2	28.7	17.7	14.0	33.0	34.8
Federal Reserve Banks	27,384	11.7	33.2	45.7	9.4	14.5	8.2	49.2	24.4	3.2
Nonfinancial Corporations	10,741	52.1	12.4	15.9	19.6	5.7	14.2	7.2	3.3	2.6
Insurance Companies	9,000	3.8	1.6	15.3	79.3	4.8	0.9	0.8	2.7	8.9
U.S. Government Agencies and Trust Funds	8,117	7.3	5.7	21.8	65.2	4.3	1.5	2.5	3.5	6.6
Mutual Savings Banks	5,943	2.4	2.4	20.0	75.2	3.1	0.4	0.8	2.3	5.6
Savings and Loan Associations	2,454	6.6	2.3	20.8	70.3	1.3	0.4	0.3	1.0	2.2
All Others	71,115	31.5	6.5	21.5	40.5	37.6	56.7	25.2	29.8	36.1
Total	189,015	20.9	9.8	27.1	42.2	100.0	100.0	100.0	100.0	100.0

amounts of bonds. Also, because longer-term issues are only redeemable at par several years hence, the price of such securities varies more than that of short-term issues.

Pegging the Market

In addition to these technical considerations, there are economic factors influencing the decisions of the System to buy or sell and to choose short- or long-term securities. Should decisions be based primarily on the effect on reserves or on the direct effect on prices and interest rates?

The experiences in World War II and postwar years until 1951 demonstrated some of the difficulties a central bank can get into when decisions to buy and sell are based primarily on maintaining a given pattern of interest rates. The System agreed to buy all issues offered it during World War II at or near the historically low level of interest rates that prevailed when the war began: 3/8 percent on 91-day bills, 7/8 percent on one-year certificates, and 2-1/2 percent on long-term bonds.

After the war ended, the System continued this policy of buying at the established rate (or price) any securities that investors wished to sell. With few exceptions, these rates were identical to those established during the war. Insurance companies and other lenders knew they could get higher rates on their loans than they could earn on the Government securities, so they sold large amounts of bonds. Most of the bonds in the System portfolio today were acquired during that period. By making these purchases, the System added to bank reserves at a time when bank credit already was ample and prices of goods and services were rising.

On the other hand, decisions to buy or sell since 1951 have been based primarily upon the effect such operations would have on member bank reserves. This policy, it was thought, could best be carried out by buying and selling short-term securities.

There have been some exceptions to this general policy. In the summer of 1958, conditions in the Government securities market became disorderly, and the Open Market Committee then felt obliged to buy some long-term securities and support a Treasury financing that had been threatened with failure.

The 1960 Record

The 1960 record, which was published as part of the Annual Report of the Board of Governors for 1960, illustrates the factors taken into consideration in making decisions to buy and sell.

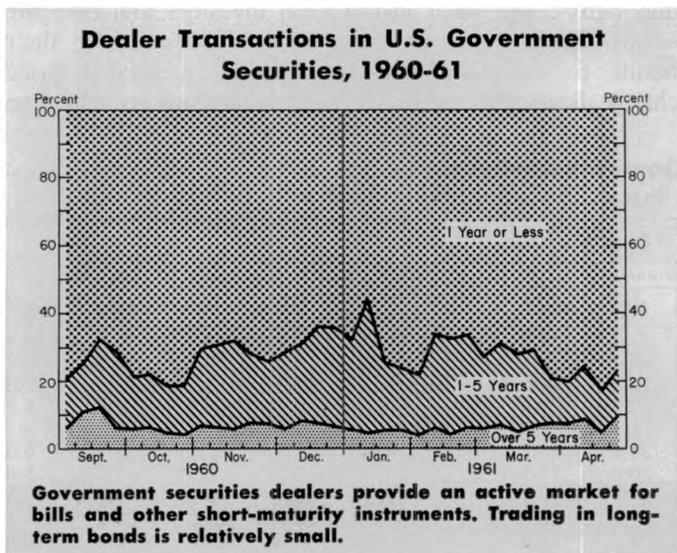
At the January 12 meeting of last year, the Committee reaffirmed the previously existing policy directive calling for operations with a view to "restraining inflationary credit expansion in order to further sustainable economic growth and expanding employment opportunities." As soon as it became apparent that credit demands had diminished and that economic expansion had slowed down, policy shifted. Thus, the directive adopted at the March 1 meeting provided that operations should be conducted toward "fostering sustainable growth in economic activity and employment while guarding against excessive credit expansion." Translated into actual operations, this resulted in buying securities and adding to available reserves.

As business slackened further, open market policy became increasingly directed toward stimulating credit. Accordingly, the Committee on May 24 changed the policy directive to "fostering sustainable growth in economic activity and employment by providing reserves needed for moderate bank credit expansion." Open market buying was subsequently stepped up, and on August 16, the instructions were changed to "encouraging monetary expansion for the purpose of fostering sustainable growth in economic activity and employment." The last change in the directive during 1960 was made on October 25. The Committee then decided in favor of operations that would continue to supply reserves necessary for stimulating the domestic economy "while taking into consideration current international developments."

Change in Policy

International developments have recently caused the System to change its normal conduct of operations in the hope that purchases and sales of different maturities would assist the United States in solving its balance of payments problem. This problem was being aggravated by the movement out of the U. S. of short-term capital funds that were attracted by the higher short-term rates abroad. On February 20, the System announced that it would buy notes and bonds, some of which had a maturity exceeding five years. For the System to have concentrated purchases entirely on Treasury bills or other short-term securities would have placed the full impact of System buying on these securities, and rates on them would probably have declined. This might have encouraged a further outflow of funds to foreign countries. In the nine weeks ending April 26, the System added \$427 million of notes and \$293 million of bonds to its portfolio. At this point, it is too early to evaluate these operations, but they illustrate the problem inherent in deciding how the Account is to be managed.

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Additional copies of this article are available upon request to the Research Department, Federal Reserve Bank of Atlanta, Atlanta 3, Georgia.