FEDERAL RESERVE BANK

OF NEW YORK

NEW YORK 45, N.Y.

September 2, 1949

Hon. Marriner S. Eccles,
Board of Governors of the
Federal Reserve System,
Washington 25, D. C.

Dear Marriner:

In the light of discussions at recent meetings of the Federal Open Market Committee concerning a 'free market' for Treasury bills, some of my associates, and I, have prepared a memorandum on this proposal, a copy of which is enclosed. I think you may find it interesting and that its preparation should lead to more informative discussions of this proposal, if it comes up in the future.

Yours faithfully,

Allan Sproul,
Vice Chairman, Federal Open Market Committee

Enclosure

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A PROPOSED FREE MARKET IN BILLS

At recent meetings of the Federal Open Market Committee, and of its Executive Committee, there have been discussions of a "free market in Treasury bills", and this has been the subject of one memorandum and an underlying theme in another memorandum prepared by the staff of the Board of Governors and submitted to the Committee.[1] In a manner described further below, this proposal would abandon System leadership in the determination of Treasury bill rates, permitting these rates "to fluctuate fully below the System's established bill purchase rates," while the purchase rates themselves would be kept 1/8 to 1/4 of 1 per cent above the market. As a result, the proposal is expected to bring about a market determination of interest rates characterized by relatively greater fluctuations in short rates than in the rates of medium or long-term issues. With the interest rate structure exposed to natural market forces as revealed by fluctuations in the bill rate, it is argued, System operations could be concerned more largely with changes in the quantity of bank reserves.

The present memorandum opposes the free bill market proposal on three grounds. First, the theory of credit policy on which it is based is questioned; certainly it has not been reviewed nor accepted by the Open Market Committee. Second, as a practical matter, the "freedom" given the market by the proposal is likely to prove to be fictitious; and the suggested complete redemption of System bill holdings (apart from back-stop acquisitions) to be impossible. Third, it is argued that the proposal's insistence upon formal freedom of the bill market would eventually force the System to rely upon roundabout methods to achieve that guided flexibility in bill rates which is essential to effective credit control in a highly liquid economy.

I. The Doubtful New Theory

The assumption upon which the case for a free bill market rests has been stated, but not analytically defended, in the memoranda referred to above.[2] It is believed, apparently, that credit policy rests on System control over the volume of Federal Reserve credit outstanding; that it need not be directly concerned with determining the level or structure of interest rates. It is implied that this

1. Messrs. Riefler, Young and Youngdahl, "Management of the Bill Market..." (6-27-49); and same authors plus Mr. Thomas, "Framework for System Credit Operations under Peacetime Conditions" (8-4-49).
2. Cf. the memorandum of June 27th, p. 1: "...some modified procedures must be developed...so that the initiative for the volume of Federal Reserve credit outstanding will be with the System, while the initiative for determining yields and prices on Government securities will be with the market..."

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premise is intuitively obvious, although in fact it represents an abrupt departure from the traditional lines of development in modern central banking -- a development which had its origins in reliance upon the discount rate as the instrument for adjusting interest rates to levels consistent with whatever quantitative changes were being attempted in the reserve base.

In subsequent stages of central banking development there has, at times, been an undue emphasis upon interest rates as a direct influence upon general economic activity, but never a deviation from the principle that some degree of control over interest rates themselves, at least the shorter-term rates, was essential to the primary objective of influencing the availability of credit. And conversely, when the wartime pegging commitments prevented System guidance of interest rates to levels consistent with the postwar phase of credit policy, it soon became apparent that all other instruments of monetary control were relatively useless. Certainly rate policy and the determination of bank reserves have always been opposite sides of the same shield; one invariably implies, and depends upon, the other. One major step in spelling out any general credit policy must be to state explicitly its rate implications; and in effectively implementing that policy, every opportunity must be taken to achieve those rates, within a reasonable range. While short run factors originating in the market must set the precise decimal points on rates each day, and are doing so now, the System by its general credit policy must inevitably determine the significant characteristics of the rate structure. The System cannot pursue a policy divorced from rates.

The premise introduced by the Board writers represents, indeed, a fundamental change in the theoretical underpinnings of credit control. If their premise is correct, a thoroughgoing reformulation of nearly all aspects of System policy will be necessary. Certainly the free bill market proposal, which depends entirely upon acceptance of this premise, should be deferred until the Open Market Committee has decided the major questions:

(1) Is the conscious influencing of interest rates an essential part of a coherent and effective monetary policy; and

(2) Can any rates (particularly those for bills, one of the closest "money substitutes") be determined independently by "the market" so long as purposeful monetary control exists?

II. The Actual Operation of a "Free Bill Market"

The free bill market proposal itself is relatively unimportant alongside these fundamental questions. In practice it seems likely to prove an empty formality. To discover why -- and incidentally to cast further light on the doubtful nature of the premise that rates and reserve policy can be segregated into separate compartments -- the specifications which have been given for such a market will be re-stated, and an attempt made to trace them through in actual operation.

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A. The Technical Details

In the formulation in the memorandum of August 4th, it is suggested:

(1) Direct purchase of new Treasury bill issues by the System shall be limited to "back-stop" acquisitions to assure placement of total offerings, at bids substantially above the market.

(2) Market purchases of outstanding bills will be made only at a penalty rate of 1/8 to 1/4 of 1 per cent above the market. This penalty rate will, in turn, be 1/8 to 7/8 per cent below the rediscount rate.

(3) Maturing bills held by the System will generally be allowed to run off without replacement.

(4) Sales of bills by the System "would be confined principally to switches for purposes of proper maturity distribution and to selloffs of holdings acquired through auction bidding, if any."

Presumably the suitable permanent volume of System bill holdings would be a relatively nominal amount, possibly in the neighborhood of $1 billion, although no amount is stated. Nor is there a definition of "proper maturity distribution," although a preference for approximately equal holdings of all outstanding issues may perhaps be implied.

In order to accomplish the transitional reduction in the System's bill portfolio "to a relatively low working level," a series of releases of excess reserves through lowering reserve requirements is suggested. Present System holdings would be sold off at a discount rate of, "say, ... 0.90 to 1.00 per annum." No criteria for setting selling rates after the transition period are specified. The problems raised by additional bill issues (such as are now being issued as part of the current deficit financing of the Treasury) are not discussed.

B. Actual Operation

There seems, at best, only a tenuous connection between the intentions expressed by the memorandum and the detailed plan which it presents. A freely moving bill rate, uninfluenced by the System, is projected, but what is contrived is an awkward device for imposing System control over the bill rate, under terms which are likely to exert more or less continuous upward pressure on that rate, whatever the current phase of credit policy may be. The recent August experience in letting maturing bills run off and placing only "back-stop" bids for new bill issues -- at a time when reserve requirements were being lowered -- provides some evidence on this score.

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1. Fictitious freedom

So long as the System must enter back-stop bids at prices "below the market," (yields above the market) and must maintain correspondingly low market buying prices, it is difficult to see how the bill market can avoid moving toward the back-stop (or bill-buying) level. The back-stop rate or the buying rate will, in fact, become a medium through which the System will continue to determine the general level of bill rates. Insistence upon the new rules will mean, moreover, that the bill rate thus set by the System may, at times, be inconsistent with prevailing credit policy, because of the upward bias in the control method.

The transitional unloading of System holdings would pose acute problems in itself, since there is no reason to assume that all reserves released by lowered requirements would be employed in buying bills (short of unwanted increases in rates). The banks whose reserves are released may (and frequently do) prefer other securities. But if the transitional unloading can be accomplished without first completely flooding the banks with reserves, and without carrying easy money to extremes in the process, there will still be grave difficulties in the longer run operation of the scheme.

For example, when rates are moving downward under a System policy directed toward increasing the availability of credit, steadfast pursuance of the "technical details" described above will lead to spasmodic stiffening in the bill rate. Although no set of influences works itself out in isolation, and offsetting forces may sometime conceal these stiffening factors in concrete situations, they will nonetheless be at work tending to pull bill rates to higher levels. One illustrative case is that in which investors, confronted with the prospect of declining yields, characteristically reach out for longer certificates or notes (to protect their earnings), and neglect bills. In that event, the back-stop bid must become the effective placement price for part of the Treasury issue; and the System will in turn set the market price for this outstanding issue when it is forced by the new rules to unload its acquisitions. ("Selloffs of holdings acquired through auction bidding, if any.") Should the System attempt to make a market for these bills by pumping out funds through other open market purchases, one control would have been replaced by another in order to keep bill rates where the System thought they ought to be.

A second illustrative case would be that in which the normal ebb and flow of funds produced a short period of tightness in the money market, such as normally occurs from time to time regardless of the prevailing trend in overall credit policy. In such circumstances, the penalty bill-buying rate would become effective, with the market compelled either to borrow from or to sell bills to the Federal Reserve Banks. Almost by definition, the new weekly bill issue auctioned by the Treasury, during this brief period, would not be bid for, in volume, at rates below those at which penalty sales of bills were being made to the Federal Reserve Banks. Since by the terms of the new plan the System must maintain a differential between its bill-buying rate and the market, there must then be a further rise in the System's buying rate. This rise could lead, by the same process, to further upward ratcheting of the market rate for bills. And the upward chase could continue, barring the appearance of new elements in the market, until the System decided that the rise had gone far enough, and gave up the attempt to maintain an arbitrary differential above the market rate.

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Thus in at least these two cases characteristic of an easy money, or neutral, phase of credit policy, the market rate is likely to be set, perversely, by the System's penalty rate. Whenever the System aims at tighter money, of course, the commercial banks will be "forced into" the Federal Reserve Banks and the penalty rate will set the market rate on bills. The mechanical maintenance of a differential will probably, however, cause a steeper rise in the bill rate than would normally be desirable.

It is submitted that, despite the free market objective of these proposals, direct System influence would continue to dominate the determination of bill rates, but with a consistently upward pull on these rates regardless of the current phase of overall credit policy.

2. The August experience

Beginning with a decision reached by the Open Market Committee on August 5th, the System initiated what was, in effect, an experimental trial of some features of the free bill market proposal. Over the ensuing four weeks the System was to permit all of its maturing bills to run off (roughly 1.4 billion), while staggered reductions in reserve requirements would furnish $1.8 billion in new reserves to the market. Net additions to Treasury bill issues over this period were to absorb any freed reserves in excess of the 1.4 billion used to acquire the bills replacing those which the System had allowed to run off. In its trading in outstanding bills, the System was to be a reluctant buyer at rates slightly above the market, becoming an active buyer only at or close to a "ceiling rate", and to sell freely in increasing amounts if rates edged downward. The System also entered regular back-stop bids for the new Treasury bill issues at 1 to 4 basis points above the market.

What happened was that the market, after some initial uncertainty, began to resist the larger volume of bills being unloaded upon it, and concurrently made substantial purchases of long certificates which the System had to supply to keep certificate yields from going too low. Dealer portfolios of bills grew to unwieldly proportions, and had to be carried at times at penalty borrowing rates destined to discourage the performance of the dealers' necessary wholesaling function. The consequent unusual phenomenon of rising bill rates, in a period when policy was directed toward continued easy money, forced the System to make substantial purchases of outstanding bills in the market. Notwithstanding these purchases, the average rate on new Treasury issues rose (or was raised by System action) from 1.007 for the issue dated August 11th to 1.054 on the September 1st issue. Data summarizing these developments are presented in the accompanying table.

At the same time the System had to make substantial sales of certificates, which were preferred by large sectors of the market in utilizing released reserves, in order to assure the choice of a 1 1/8 per cent rate for the next Treasury certificate issue. The System could not, without abandoning its general policy aims, follow the prescription of the August 4th memorandum and allow certificate yields to be determined "by market arbitrage."

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By August 29th, when tenders were received for the new bill issue to be dated September 1st, the System gave up its rigid insistence on cash redemption of its entire maturity and entered a split bid, part of it at rates below the "back-stop" level (which had throughout been kept much closer to the market than the "free bill market" proposal would suggest). With potential run-offs of about 415 million, the System found its tenders accepted for 348 million of the new issue, which carried an overall average rate of 1.054 per cent (and would have gone higher, of course, if the System had not re-entered the active bidding). Purchases of 209 million in outstanding bills during the week preceding September 1st, and repurchase agreements with dealers for a net of 103 million in addition, more than offset the cash redemption of 67 million (415 less 348). Thus by the fourth week of a trial run, the plan had failed, in that the System had to make net additions to its bill portfolio, in the face of further reductions in reserve requirements. The System had no choice in this course if it was to exercise its responsibility for general credit policy, and the rate levels inextricably associated with that policy.

C O N F I D E N T I A L

Significant Factors in the Money Market as of Selected Dates, August 4 - September 1, 1949
(in millions of dollars)

	August 4	August 11	August 18	August 25	September 1
Estimated reductions in reserve requirements[1]	a	650	655	259	259
Scheduled System bill redemptions	-	269	329	389	415
Accepted tenders in N.Y. District on issues dated as above:					
System account	239	-	-	-	348
Banks	83	174	127	115	50
Dealers and brokers	269	386	412	412	200
Others	99	98	85	99	145
Total[2]	691	658	624	626	743
Average rate for total Treasury bill issue	1.032%	1.007%	1.017%	1.031%	1.054%
Net System account Purchases(+) or Sales(-)[3]:					
Bills	a	+ 69	+ 66	+153	+209
Certificates	a	-315	- 86	-268	- 69

a. Only limited August 4th data are presented here for comparative purposes.
1. Reserve reductions in country banks retroactive to August 1st are included with those of August 11th; reductions effective August 16th are included with those of the 18th.
2. Owing to rounding, details do not necessarily add to totals.
3. Purchases and sales recorded on a delivery date basis for the week preceding the date shown at the head of each column.

Source: Weekly Board Letters and Confidential Files.

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III. The Necessity for System Guidance of Bill Rates if Monetary Policy is to be Effective in a Highly Liquid Economy

The proposed "free market in bills" should not be rejected, of course, solely because it is held to be unworkable in its present form. If the expressed goal of the proposal is a desirable one, an effort should be made to find practicable techniques for achieving it -- difficult as that may be. The answer of this memorandum to that approach, however, is negative. The nature of the debt structure and the relative importance of various types of debt instruments have changed radically over the past thirty-five years. And one concomitant of those changes is an increased necessity for the System to determine the range within which market movement of interest rates can take place -- if control over the availability of credit is to be effective. Whatever may be said for or against interest rate control as an influence upon borrowers, that control has become increasingly important for its influence upon lenders, i.e., upon the availability of credit.

It appears that consideration of the "free bill market" proposal was prompted, at least in part, by a study of prewar money market rates, and such data as those shown in charts 2 and 3 of the August 4th memorandum. It is certainly true for the period before 1929, and to some extent for the decade thereafter, that short rates were subject to much greater fluctuation than intermediate and longer term rates -- the divergence was even greater before the Federal Reserve System became fully "operational" around 1920. But in those days the proportion of total debt subject to credit risk (i.e., private debt, and the debt of states and municipalities) was altogether different. In 1914, debt subject to some degree of credit risk was 99 per cent of the total. In 1948, following the great growth of the Federal debt, the credit risk segment had fallen to 47 per cent of the total debt. With this transformation in the debt structure had come an amazing growth in the liquidity of the economy. Apart from the more rapid growth in the money supply than in total debt, the proportion of short-term marketable Federal debt in the total debt structure had increased by 50 times from 1914 to 1948.[1]

The great rise in the proportion of liquid assets to the total debt structure, and the decreasing proportion of debt subject to credit risk, must inevitably have a dampening effect on fluctuations in short-term rates, and must increase the sensitivity of the market to small changes in these rates. Moreover, as shifts between "money" and other liquid assets become commonplace, with relatively large volumes of assets shifting onto the market at moderate changes in rates, it becomes imperative for an effective monetary policy to control those rates within relatively narrow limits, in keeping with its general control over the availability of credit.

It may not be an exaggeration to say that abandonment of direct System influence upon the primary short-term rate (that on Treasury bills) leads, in principle, to abandonment of purposive monetary control in a highly liquid economy.

1. The data mentioned in this paragraph are not generally available. They will soon be circulated in a significant study of *The Debt Structure in the United States, 1914 and 1948* which A.J.R. Smith is just completing as one of the Studies in Monetary and Credit Control being prepared in the Research Department of the Federal Reserve Bank of New York.

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The volume of reserves may, of course, be jiggled up and down to give an appearance of industrious "control"; but to what account if there is no interest rate policy to make that reserve variation effective at the margins -- to influence the disposition of those reserves between idle balances, Government securities, and other uses.

On the other hand, to recognize that the bill rate (and other rates) must be guided, though not precisely "set" by the System, does not imply that there is no need for rate flexibility. The mistake lies in assuming that "flexibility" is synonomous with "freedom." The System is actually in a better position than ever before (if there be Treasury cooperation) to accomplish a guided flexibility. The vast enlargement of the public debt has given the System, for the first time, a broad homogeneous market -- free of credit risks and extending to virtually all maturities -- through which it can directly exert its influence upon the basic monetary forces underlying the interest rate structure, as part of its overall credit policy. To reject this opportunity, even in part, in order to achieve a formal market freedom for bills would seem to be folly. To propose, instead, complete reliance upon quantitative changes in the aggregate reserve base would seem to be unrealistic. The System should be able to redeem or exchange maturing issues of Government securities, or to buy or to sell outstanding issues of all types and maturities, including Treasury bills, whenever such action will help to achieve that range of rates which is consistent with current policy. A dynamic economy requires a flexible monetary policy, adaptable to the market conditions prevailing at any given time, and the System should not arbitrarily deny itself the use of any important instrument which can assist in accomplishing that flexibility.

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