March 17, 1939.

The Federal Open Market Committee met on March 20 and considered the question of whether the System would be willing to participate with the Treasury in the sale of bonds for the purpose of checking a too rapid rise in the Government securities market.

It is the opinion of the Committee that the recent rise in the Government security market represented primarily an adjustment to a higher level of prices in view of fundamental changes in the market and was not a sudden spurt of a speculative nature likely to be followed in the near future by corresponding liquidation. The fundamental factors in the rise are the large and increasing volume of excess reserves available to banks and a growing belief that money rates are likely to stay at near the present low levels for some time. The advance has resulted to a large extent from purchases of bonds by New York City banks, which have large amounts of excess reserves and relatively small amounts of long-term obligations and which are under some pressure to increase their earnings. In the four weeks ending March 15 New York City banks increased their holdings of United States Government bonds by $390,000,000, while their holdings of notes and bills declined by $210,000,000. The rise has not been disorderly and a good two-way market has existed practically all the time.

Since there is no indication that the growth in bank reserves is likely to be reversed in the near future, either because of an outflow of gold or by action of monetary authorities, there seems to be no reason for attempting to check a rise in bond prices which is a normal result of that growth. It is entirely unlikely that there will be a sustained outward movement of gold which would have a substantial effect on the volume of bank reserves. On the contrary, a continuation of the gold flow to this country is more likely. In view of the fact that we have still not had the full measure of recovery in business that is needed and since there are no indications of excessive use of credit for speculative purposes but rather a need for encouraging greater volume of credit expansion, there would appear to be no occasion for a reversal of the current easy money policy followed by the Federal Reserve System.

Action by the Committee to sell small amounts of bonds from the System account would probably have only a temporary effect on the bond market and would not remove the fundamental causes of the advance in prices. These can be corrected only by dealing comprehensively with the problem of excess reserves and related problems. The Committee believes that the System should not use the limited resources of its present open-market portfolio for short-term market adjustments until it has obtained more adequate powers to deal with the situation from a long-time viewpoint. The need for such powers was discussed at some length in the Board's twenty-fifth annual report and does not require further comment by the Committee.

It is the Committee's opinion that purchases and sales of securities from the System's Open Market Account should be determined on the basis of reserve policy considerations or should represent adjustments to changing money-market conditions. At the present time, in view of the large volume of excess reserves, the System is out of touch with the money market, and, therefore, changes in its portfolio would have no significant effect on member bank reserves or on the money market, except as an indication of a reversal in policy. If the action were interpreted by the market as a reversal in System policy then it might be followed by a much larger liquidation of securities than would be desirable at this time. Banks might consider it as an indication that the long decline in interest rates has ended and consequently decide to sell some of their bond holdings. At the present time it is better to encourage banks to make more active use of available funds than to take action which would give them an excuse for holding funds idle until there should be a higher level of interest rates.

The Committee believes that action by the System purely for the purpose of influencing the level of Government bond prices might have a different effect upon the market than similar action taken by the Treasury. The Treasury can sell bonds from its various investment accounts and increase its cash holdings. This would be in effect simply anticipating future sales of new issues which will need to be made to provide for Treasury cash requirements. Sales by the Federal Reserve System, however, would mean using for temporary market purposes part of its portfolio that will be needed for more effective use at some later date and is required at the present time as a means of subsistence for the Reserve banks.