

A meeting of the executive committee of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington on Wednesday, October 20, 1954, at 10:45 a.m.

PRESENT: Mr. Martin, Chairman  
Mr. Sproul, Vice Chairman  
Mr. Robertson  
Mr. Szymczak  
Mr. Williams

Messrs. Balderston, Miller, Mills, and Vardaman,  
Members of the Federal Open Market Committee

Mr. Thurston, Assistant Secretary  
Mr. Solomon, Assistant General Counsel  
Mr. Thomas, Economist  
Mr. Young, Associate Economist  
Mr. Carpenter, Secretary, Board of Governors  
Mr. Sherman, Assistant Secretary, Board of Governors  
Mr. Youngdahl, Assistant Director, Division of Research and Statistics, Board of Governors  
Mr. D. C. Miller, Economist, Division of Research and Statistics, Board of Governors  
Mr. Roosa, Assistant Vice President, Federal Reserve Bank of New York  
Mr. Gaines, Securities Department, Federal Reserve Bank of New York

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meetings of the executive committee of the Federal Open Market Committee held on September 22 and October 5, 1954 were approved.

Before this meeting there had been sent to the members of the committee a report prepared at the Federal Reserve Bank of New York covering open market operations during the period October 5 to October 15, 1954, inclusive, and at this meeting a supplementary report covering commitments

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on October 18 and 19, 1954, was distributed. Copies of both reports have been placed in the files of the Federal Open Market Committee.

Mr. Robertson called attention to the manner in which the report of open market operations since the preceding meeting was listed on the agenda, noting that it was submitted with a view to having such transactions approved and ratified by the executive committee. He expressed some doubt as to whether it was necessary or desirable for the executive committee to approve the transactions that had been entered into, suggesting that it might be sufficient to have the report of transactions, as arranged by the Manager of the System Open Market Account, presented for review by the executive committee. Mr. Robertson stated that while he did not feel the matter was of great importance, he thought it might be preferable if the committee were not in the position of approving transactions that had already taken place when, as a practical matter, it would not be feasible for the committee to disapprove prior transactions even if it wished to do so.

Mr. Szymczak noted that the present procedure had been followed for a great many years. It was his view that any change in procedure would raise questions as to why the change was made, and an unexplained change in procedure would, therefore, be undesirable.

Mr. Vardaman mentioned that if he were Manager of the Account, he would wish the minutes to show "approval and ratification" for his own protection.

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After brief discussion, Chairman Martin suggested that Counsel be requested to consider the question raised by Mr. Robertson, in the light of the history of the use of the present words and the purpose of submitting reports of open market operations. This suggestion was approved with the understanding that the matter would be discussed at a subsequent meeting.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions during the period October 5-19, 1954, were approved, ratified, and confirmed.

Chairman Martin next called upon Mr. Young who made a statement with respect to the economic situation based upon the staff memorandum on this subject which had been sent to members of the committee under date of October 18, 1954. Mr. Young's statement, in summary, took the position that the general economic situation continued to be one of offsetting changes with the broad aggregates still showing few signs of moving upward or downward by significant amounts. Industrial production on a seasonally adjusted basis appeared to have remained at about its August and September level and underlying conditions seemed to be a bit stronger than a few weeks ago. Mr. Young also commented on views expressed by business economists who had visited Washington recently, the gist of such views, he said, having given the impression that at the moment there was a disposition to project activity for the near-term future on the up side.

During Mr. Young's statement, Mr. Thomas and Mr. D. C. Miller entered the meeting.

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Mr. Thomas reviewed the current credit and financial situation commenting along the lines of the statements contained in the staff memorandum of October 18, heretofore mentioned, with respect to capital market developments, the Treasury cash position, and commercial bank credit and reserves. Mr. Thomas also distributed a sheet containing projections of changes in reserves by weeks during the period October 13-November 24 which indicated that, without further operations for the System account, the outstanding amount of free reserves might be expected to average well above \$700 million during the rest of October, but somewhat below that volume during most of November, although at no time would the average be likely to go below \$500 million. It was Mr. Thomas' view that little or nothing in the way of operations for the System account would be required during the next two or three weeks but that some operations to increase the supply of reserves would be necessary during the month of November.

Following a discussion of the comments by Messrs. Young and Thomas, Chairman Martin called upon Mr. Sproul for a statement with respect to open market operations during the period between now and the next meeting of the executive committee.

Mr. Sproul said that the situation continued to be one in which decline in Government spending and private capital expenditures had been offset by higher consumer spending and large outlays for new construction, with remarkable stability in aggregate economic activity. He agreed with staff comments that underlying conditions seemed just a little bit stronger

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than a few weeks ago; he emphasized that a sidewise movement persisted through October even while the automobile industry was going through the declining production phase of model changeovers, and that with resumption of automobile production on new models, there might be a pick-up. Mr. Sproul felt that from the standpoint of the economy it was significant that Treasury expenditures were now apparently running at an annual rate of \$44 to \$45 billion compared with \$41 billion in September, that these expenditures were resulting in a cash deficit, and that the money was being obtained largely through the banking system, all of which should have some stimulating effect. In commenting on bank credit and bank reserves, Mr. Sproul felt that, on the whole, the System had successfully met the needs of the economic situation, including Treasury needs: the policy of maintaining an easy reserve position, moderating but not trying to offset, in amount or timing, the wider swings in reserve positions, had worked. He thought that a continuance of that policy was indicated--encouraging the possible revival of business with readily available funds but not trying to force reserves on the market which would not facilitate productive uses of credit or capital, but merely drive down rates on money market instruments. There would be a run-off of \$75 million of bills from the System account tomorrow, Mr. Sproul said, but beyond that, it did not appear that additional open market operations would be called for during the next two statement weeks in order to continue existing policy.

Mr. Szymczak stated that he had been impressed by informal comments made by Mr. Mills earlier this week with respect to open market operations and with Mr. Mills' suggestion that it might be desirable to permit "natural"

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factors such as float and Treasury operations to have the effect of increasing the volume of excess reserves in the market during parts of each month, if it appeared that those additional reserves would be needed to meet seasonal and growth factors later during the current calendar year. It was Mr. Szymczak's thought that frequent purchases and sales of securities for the System account might unnecessarily raise questions regarding System policy in the minds of persons operating in the market, and that accordingly it would be preferable to refrain from sales of securities or from taking other actions designed to reduce for a few days the volume of excess reserves, so long as it appeared that current policy and projections of reserve needs would call for most of those funds being made available shortly. Mr. Szymczak also said that he felt the committee should avoid giving the impression that it was trying to "peg" the level of free reserves.

Mr. Robertson felt that there was no evidence of confusion having been caused by recent operations for the System account and he could see nothing which would warrant any fundamental change in either the policy that had been followed or in the procedure that had been adopted for carrying out open market policy. He thought it possible that the System would have to put in more reserves within the next six weeks or so and that, depending on the then state of the economy, it might be that the executive committee would wish to raise its sights from a target of \$400-700 million of free reserves to something like \$600-900 million.

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Mr. Williams said that the projections which Mr. Thomas had presented indicated that little decline in free reserves would occur until mid-November, and it was his view that for the present the committee might well continue the procedure which it had been following with the thought that at the time of its next meeting it would take another look at the questions raised.

Mr. Mills stated that he felt there was a possibility of smoothing out open market operations in a way that would avoid rapid injections and withdrawals of reserves. This could be done, he felt, by taking advantage of the changes in the natural short-run factors which would affect reserves each month, such as recurring changes in float and Treasury balances, and relating such changes to the longer-run factors which could be expected to continue with the season, such as growth in bank investments and outflow of currency. The idea, Mr. Mills said, would be to allow the increase in float that would take place in a certain period each month to finance the normal seasonal expansion and when the time of the month was reached when float would contract sharply, to reappraise the factors then operating in the market with the thought of acquiring Treasury bills in whatever amount seemed reasonable to cover the expansion in need for reserves. This would mean an ascending level of Treasury bill purchases between now and the turn of the year, after which there would be a return flow of currency and a reduction in bank loans which would be accompanied by actions to accelerate a reversal of the expansion in reserves that would take place this fall.

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Mr. Sproul said that he did not think there had been any real confusion in the market as to the System's policy during recent operations. With respect to Mr. Szymczak's reference to the pegging of a level of free reserves, Mr. Sproul did not think there had been any such pegging, that free reserves had moved within a range, and that the range generally had been on the high side of the target at which the committee was shooting, in keeping with the general idea that doubts should be resolved on the side of ease. Recently there had been no selling in the market, Mr. Sproul said, although some Treasury bills had been redeemed. Thus, he did not think that operations had been such as to raise a question whether the System account was intervening in the market too much and interfering with the market's freedom of action. It was Mr. Sproul's view that to try to maintain a larger volume of excess and free reserves by anticipating a further need for reserves and by never selling from the System account but always buying when free reserves fell below some given level would mean a procedure which was likely to become a one-way escalator going up. The System would find itself more or less continuously putting in reserves which would flow to the money centers and cause money market banks to bid Treasury bills away from nonbank holders and others, thus driving down sensitive short-term rates still further without promoting the kind of borrowing and lending which facilitates economic recovery. Mr. Sproul thought it fair to say that banks are avid for loans and feel no restraint so far as their reserve position is concerned that could be removed by trying to maintain free reserves \$200 or \$300 million higher.



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Mr. Thomas said some attempt had been made to project reserves needed during the next few weeks and that if the System were to follow a program during this period of not making any sales from the account or permitting any bills to run off and if it made such purchases as were necessary to maintain a minimum of \$700 million of free reserves at all times, it appeared that at no time between now and the end of the year would there be more than \$800 million of free reserves for any week, computed on a weekly average basis.

Mr. Mills stated that operations along lines indicated in Mr. Thomas' statement would be in accord with his general thinking except that he would not have in mind any specific level of free reserves to be maintained. Rather, the purpose would be to meet the loan demand that might be expected this fall.

Mr. Robertson felt this was equivalent to moving up from a target range of \$400-700 million to a range having a minimum of \$700 million with no upper limitation.

Mr. Mills did not agree with this statement, feeling that purchases of bills could be moderated so as to keep free reserves from rising to an inappropriate level. Such a procedure would, on the other hand, eliminate the confusion that Mr. Mills felt had resulted from buying and selling operations for the System account.

Mr. Williams inquired of Mr. Roosa whether he felt there had been confusion as to System policy in the market.

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Mr. Roosa stated that there had been some comment by dealers who were trying to think through why the System had done what it had done. Dealers realized that an attempt was being made to control the aggregate volume of reserves so that it did not run away without limitation, but for reasons which he stated, Mr. Roosa did not feel that day-to-day trading had been affected by uncertainties as to System policy.

Mr. Sproul said that as a practical matter there probably would be little occasion to consider sales of bills during the next several weeks. However, he felt it undesirable for the committee to commit itself to a policy of maintaining a volume of reserves on an automatic formula such as was implied in Mr. Mills' suggestion.

Chairman Martin said that the discussion dealt with one of the most difficult problems before the committee, that is, with "tone" in the market. In Chairman Martin's view it was necessary for the committee to depend on the judgment of the Manager of the Account for the feel of the market at any given time. He stated that he had been impressed recently with the fact that the Manager of the Account had at times been operating on the basis of his "feel" of the market and that in his (Chairman Martin's) judgment this had resulted in better handling of the System's operations than when there was an attempt to adhere closely to projections of various figures affecting reserves in carrying on operations of the System account. Chairman Martin felt that at this point there was no immediate problem because of the likelihood that the System would have no occasion to sell securities during the next few weeks. However, it was his view that the

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committee should continue to wrestle with the problem of tone and the technique for carrying out operations for the account.

Chairman Martin then inquired whether any of the members of the committee felt there should be any modification of the policy of active ease as authorized by the full Committee, or of the general program for operating the account in order to carry out that policy. None of the members of the committee suggested any change and Chairman Martin stated that it would be understood that operations would continue on the same basis as was agreed upon at the last meeting, with the further understanding that the management of the System open market account would bear in mind the views expressed at this meeting.

There was agreement with this statement.

Mr. Robertson then made a statement with respect to the use of repurchase agreements, discussed briefly at the two preceding meetings of the executive committee, substantially as follows:

In view of the action of the Executive Committee on September 22, 1954, in authorizing the use of repurchase agreements, at rates below the discount rate, and the transactions entered into under that authorization, I feel obligated to make the following comments.

Sections 12A and 14 of the Federal Reserve Act relate to "open-market operations" -- buying and selling in the open market. The general understanding of dealings in the open market is that they are based on freedom of access by any willing participants who buy at the lowest available price and sell at the highest price offered.

Repurchase agreements, as they have been used in our open-market operations, do not meet these standards. "Buying" and "selling" imply price, and there is no bona fide price in our repurchase agreements. A dealer purports to "sell" to the Federal Reserve Bank government

obligations with a present market value of \$10,200,000 or more at a "price" of \$10,000,000. On its face this is absurd, and all persons involved in this transaction are aware that the price is a fiction and that the rate is the significant figure. Our Repurchase Agreement form itself speaks of "interest...at the rate of \_\_\_per cent per annum". But there is no rate of interest in a true purchase and sale transaction; such a rate is one of the major characteristics of a loan. In all honesty, we know that repurchase agreements, whatever their purpose, in substance are loans. Dealers in government securities are also aware of this; within recent weeks two dealers have told me that they regard repurchase agreements with the Federal Reserve Bank as loans collateralized by government securities, exactly as if they borrowed the same amount of money from a commercial bank upon identical security.

The departure of our practice from true open-market operations becomes even more apparent when we enter into repurchase agreements at an interest rate below the current discount rate. In a true open market, business is transacted with the highest bidder. Under our arrangements, however, when the discount rate is 1-1/2 per cent and the repurchase rate is 1-1/4 per cent, we will "buy" from and "sell" to (I have to use the words buy and sell in quotes because in reality we are lending) a nonbank dealer at 1-1/4 per cent despite the fact that a competing bank dealer, in need of Federal Reserve credit, is eager to enter into identical transactions with us at a higher "price" -- e.g., 1-3/8 per cent. It is difficult to believe that Congress intended the Federal Reserve System, in its open-market operations, to give preferential treatment in identical transactions to nonbank dealers over bank dealers.

If the Open Market Committee may enter into repurchase agreements with nonbank dealers, it may also enter into such agreements with member banks, nonmember banks, corporations, and individuals. It may enter into such agreements not only with respect to government obligations, but with respect to any other class of paper described in Section 14. In other words the Open Market Committee would have power through this device, to make advances on various classes of securities, and at rates below the current discount rates. To defend this result requires that we interpret the Federal Reserve Act to mean that the Congress intended to authorize the Open Market Committee not

only to buy and sell in the usual sense of these words, but also to make advances of the types that may be made by Federal Reserve Banks under Section 13. I hope it is not necessary to convince anyone here that this was not the Congressional intent. Congress separated the two functions -- credit through loan transactions was to be extended under Section 13, and under Sections 12A and 14 the Federal Reserve Banks, under the direction of the Open Market Committee, were to buy and sell (as those words are ordinarily understood). Nowhere did Congress indicate an intent that open-market operations should include the extension of credit at specified rates of interest on the security of collateral with a market value in excess of the "price" paid.

These are my personal views regarding the proper interpretation of Sections 12A and 14. However, the Committee's general counsel, for whose legal ability and integrity all of us have the greatest respect, has expressed the opinion that the use of repurchase agreements is within the legal authority conferred by Section 14. In view of this opinion and the use of repurchase agreements at various times over a period of more than thirty years, I am not prepared to contend that the use of repurchase agreements should be discontinued on the ground that it is ultra vires. Nevertheless, it seems to me that the doubtfulness of our legal position is a strong additional reason for minimizing the use of repurchase agreements, unless the affirmative reasons for their use are so strong as to outweigh all contrary considerations.

I should like to request those who favor the use of repurchase agreements -- particularly at interest rates below the discount rate -- to justify this practice. Admittedly it is a departure from the dictionary meaning of the words of the law under which we operate. It cannot be denied that the use of repurchase agreements of this type adds to the complexity of our operations. Even more important, it takes out of our hands, to some extent, the initiative in open-market operations, and transfers that initiative to dealers in governments. Furthermore, when nonbank dealers can borrow from the Federal Reserve through repurchase agreements at 1-1/4 per cent, and member-bank dealers can borrow from the Federal Reserve at no better rate than 1-1/2 per cent, it seems clear to me that the Federal Reserve System is giving to nonbank dealers a competitive advantage that is most difficult to justify.

As I said before, the advocates of this procedure bear the burden of establishing firmly that it is a sound procedure.

It has generally been described as simply performing a subordinate and supplementary role to outright purchases and sales -- a means of getting funds into the market quickly on a temporary basis, to be used only when outright purchases and sales cannot serve the purpose. However, this argument for using repurchase agreements lost most, if not all, of its validity when we found feasible the cash-basis technique, which enables us to supply and withdraw reserves immediately without resort to repurchase agreements.

It is sometimes suggested that repurchase agreements, with a rate somewhat below the discount rate, operate as a sensitive automatic control over the supply and withdrawal of reserves -- a mechanical device that operates in some mysterious way more precisely than the judgment of the executive committee or the Manager of the Account. A couple of weeks ago we entered into repurchase agreements to the extent of \$37,000,000 at a 1-1/4 per cent rate when the need for supplying reserves was not evident to me, and I am unable to satisfy myself that such addition to excess reserves was not simply arbitrary and at the will and judgment of the dealers concerned. With respect to the repeat performances since then, I have the same difficulty.

It has been contended that the repurchase-agreement device serves as a sensitive valve through which the needs of the market can be met semi-automatically. Congress thought of the need for such a valve, and provided it in the form of the discount privilege of member banks, but put the operation of it in the hands of the Federal Reserve Banks and the Board of Governors -- not the Open Market Committee. The power to make loans and discounts to member banks is specifically vested in the Federal Reserve Banks and the Board of Governors. This is true also under Section 13 of the Federal Reserve Act with respect to advances to nonbank borrowers. The power was not given to the Federal Open Market Committee. We should not continue to deviate, on the basis of subtle and perhaps disingenuous reasoning, from the procedure Congress specifically adopted unless we are quite certain of what we are doing and why we are doing it.

The repurchase device does not improve the ability of the Manager of the Account to operate on the basis of the "feel of the market". Quite the contrary -- it enables him to operate, to some extent, without a "feel of the market", on the basis of the judgment and profit motives of dealers rather than the judgment of men charged with the duty of maintaining the appropriate volume of reserves. The Manager has access to all the information that the dealers have, and

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more. Therefore, the Manager should be in as good a position as any dealer or group of dealers to know the needs of the market, and therefore ought to be able to act positively through actual purchases and sales rather than passively through repurchase transactions.

Needless to say, I am more than willing to consider any and all arguments in favor of the use of repurchase agreements, and particularly the use of agreements at interest rates below the discount rate. To my mind, any such arguments should make clear what is expected to be achieved through repurchase agreements that cannot be achieved by buying and selling, on a cash basis whenever necessary. My own tentative position is that unless it is clear that repurchase agreements can accomplish something which cannot be accomplished in any other way, their use should be discontinued, in view of; (1) the uncertainty as to their legal status; (2) the possibility that the Open Market Committee is usurping the authority of the Federal Reserve Banks and the Board of Governors, and thus deviating from the procedure adopted by the Congress in separating the discount function from the open-market functions; (3) their patent inequity as between nonbank dealers and bank dealers; (4) the unnecessary complexity of our operations as a result of their use; and (5) the fact that the use of repurchase agreements takes the initiative away from the Reserve authorities to some extent, and places it in the hands of dealers to whom the repurchase agreement is simply a beneficial alternative to commercial bank loans.

Chairman Martin stated that Mr. Robertson had presented a stimulating and provocative paper on the question of repurchase agreements, and he suggested that copies be circulated to the members of the committee for study and consideration at a later meeting, with the understanding that further discussion of the memorandum would be deferred until that time.

There was agreement with  
this suggestion.

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In this connection it was understood and agreed that the authorization for the Federal Reserve Banks to enter into repurchase agreements at a range of rates of  $1-1/4$  -  $1-1/2$  per cent, subject to the other terms and conditions of the authorization issued on June 24, 1954, was continued until the close of the day of the next meeting of the executive committee (tentatively scheduled for Tuesday, November 9, 1954, at 10:45 a.m.).

Mr. Sproul stated in response to Chairman Martin's inquiry that he had no suggestions for change in the directive to be issued to the Federal Reserve Bank of New York.

Thereupon, upon motion duly made and seconded, the executive committee voted unanimously to direct the Federal Reserve Bank of New York until otherwise directed by the executive committee:

(1) To make such purchases, sales, or exchanges (including replacement of maturing securities and allowing maturities to run off without replacement) for the System account in the open market or, in the case of maturing securities, by direct exchange with the Treasury, as may be necessary in the light of current and prospective economic conditions and the general credit situation of the country, with a view (a) to relating the supply of funds in the market to the needs of commerce and business, (b) to promoting growth and stability in the economy by actively maintaining a condition of ease in the money market, and (c) to the practical administration of the account; provided that the total amount of securities in the System account (including commitments for the purchase or sale of securities for the account) at the close of this date shall not be increased or decreased by more than \$750 million;

(2) To purchase direct from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time



to time for the temporary accommodation of the Treasury; provided that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed in the aggregate \$500 million;

(3) To sell direct to the Treasury from the System account for gold certificates such amounts of Treasury securities maturing within one year as may be necessary from time to time for the accommodation of the Treasury; provided that the total amount of such securities so sold shall not exceed in the aggregate \$500 million face amount, and such sales shall be made as nearly as may be practicable at the prices currently quoted in the open market.

At this point Mr. Sproul read a statement as follows:

I would like to inform the Committee of a situation which does not call for action by this body but which bears some relation to our open market operations. This is a situation related to the question of reserves and their distribution and maintenance which we are going to have to bring to the attention of the Board of Governors. It is the practice of a few banks in New York City - and the same situation may prevail in Chicago or elsewhere - which we believe constitutes an abuse of the privilege of carrying reserve deficiencies within a statement week, and from one statement week to the next, without penalty. This creates problems with respect to Federal Reserve policy and with respect to the Government security market, particularly the market for Treasury bills.

These banks appear to have adopted practices which result in their frequently carrying large daily and accumulated reserve deficiencies within computation periods, and these practices seem to smack of playing the intra-monthly pattern of reserve changes rather than meeting the unavoidable swings in the money positions of individual institutions.

The policy or practice makes these banks quite vulnerable to unexpected losses of funds, and this vulnerability leads to recurring intensified pressures on the money market as the banks involved make strenuous last minute attempts to get the funds they need. It often creates an appearance of tightness in the New York market, even though there are ample reserve funds in the whole banking system and not a serious dearth of funds in the New York money market. At such times it drives the rate on Federal funds to the ceiling, it causes the rate on loans to Government security dealers to advance sharply, and it adversely affects the Government security market.

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We are hopeful that we can propose some modification of the present method of computing reserves and waiving penalties for deficiencies on reserves which will curb this practice.

Thereupon the meeting adjourned.

  
Assistant Secretary