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FILES SECTION
MAY 23 1955

May 20, 1955

TO: Members of the Federal Open Market Committee

Attached is a rough draft of a staff memorandum that is being distributed in advance of next Tuesday's meeting of the executive committee, to serve as a basis for discussion.

Winfield W. Riefler, Secretary,
Federal Open Market Committee.

Attachment

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ROLE AND STATUS OF SHORT-TERM DEBT
IN TREASURY DEBT MANAGEMENT

Two important objectives of Federal debt management over the past two years have been (a) to lengthen the average maturity of the funded, marketable debt and (b) to achieve a better balanced maturity distribution within the lengthening process. Efforts to attain these objectives have met with much success. They have had a pronounced effect, however, on the volume of and role played by very short-term issues, i.e., by the floating and the liquid debt.

Floating vs Funded Debt

Classical debt management discussion distinguished between floating debt and funded debt. Originally, floating debt appears to have been a term applied exclusively to nonnegotiable claims against and accounts payable by the Government, while funded debt was a term applied to instruments bearing prima facie evidence of Government indebtedness. Later as governments came to operate more and more on a current payment basis, the term floating debt came to be used to apply to that part of the public debt which had a short maturity--say under one year and was sold at auction. In more recent times, the criterion for floating debt of sale at auction has tended to be dropped, so that the contemporary distinction is between debt of long original maturity and debt of short original maturity. Even this distinction cannot be held too rigidly, since some short-term notes with maturities just over a year, as well as longer-term paper approaching the date of maturity take on some of the character of floating debt.

Table I shows the composition in recent years of this country's floating debt as defined above--Treasury bills, certificates, tax anticipation

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issues, and savings notes. Also included in the table are other marketable securities within one year of maturity. The sum of these two categories is referred to in this memorandum as the supply of total Government liquidity instruments. The bottom of the table notes the ratios of this debt and also of floating debt to total marketable debt plus savings notes.

The classical view of floating debt was that its volume as a matter of prudence should generally be held to a minimum, and that following periods of its rapid expansion, such as war, debt management policy should focus on funding floating debt as speedily as possible. In recent decades, the debt management task resulting from the financing of two world wars has occasioned reconsideration of the classical view. More and more attention has been given by debt management students to the liquidity role in financial markets of short-term Government debt instruments, particularly in facilitating the financial adaptations of banks, financial institutions, business corporations, and others. In view of this changed orientation of debt management principles, the orthodox debt management view today can be said to be that:

(a) There is continuing need for a large volume of floating debt to meet the basic liquidity demands of the money market;

(b) From a business cycle standpoint, the functioning of money markets will be more responsive to stabilizing credit and monetary policy if the volume of floating debt is increased in depression and contracted in prosperity; and

(c) From the standpoint of economic growth, attention needs to be paid to pressures for enlargement of the supply of liquidity instruments in the market along with growth in the money supply.

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Debt Management Procedures

In the past two years the Treasury has engaged in financing operations totaling over 300 billion dollars--more than the total outstanding public debt. In order to reduce its trips to the market, the Treasury has consolidated several financings and spaced out debt maturities. The net effect of this program has been to extend the average maturity of the funded debt from 7.1 years to 7.6 years.

In 1953 there were seven financing ventures plus tax anticipation issues and increases in weekly bill offerings. In 1954, not only were issues maturing in different months combined into one offering, but also a refunding and cash offering were combined. In addition to offerings of tax anticipation securities, the Treasury came to the market five times.

Debt management operations in the past two years have included offerings of:

> Bonds with maturities of 30 years or more, totaling approximately 3.5 billion dollars;
>
> Bonds with maturities between 5 and 10 years, totaling nearly 26 billion; and
>
> Notes with maturities of roughly 2 to 4 years, totaling over 16 billion.

Approximately one-fourth of the securities involved in these operations were sold for cash. The other three-fourths were subscribed to in refundings of maturing issues.

One result of these financing operations has been to reduce the supply of Government liquidity instruments available to the market below the levels prevailing at the time of the accord (from 55 billion dollars on June 30, 1951 to 34 billion on June 30, 1955). This is true both in absolute volume as well as in proportion to the total debt and the total financial

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position. One of the chief points of discussion during the negotiations that led up to the accord was the effect of unpegging on the market demand for liquidity instruments. It was pointed out at that time that banks and other investors, once long-term security prices were unpegged, would have to pay attention to problems of liquidity and would need consequently a much larger volume of short-term investments. These prognostications have been borne out by a subsequent experience. Since the accord, there has been a sharp increase in the desire of investors for liquidity instruments for the employment of temporary funds.

Market Repercussions

The market changes in the maturity distribution of the debt have been reflected in market factors which suggest some strain on the supply of Government liquidity instruments. One evidence of such strain is the very steep slope of the curve of market yields on shorter-term Government securities, indicating strong demand relative to supply at the short end of the market.

The relative shortage of short-term Governments has also contributed to the pressure to develop a supply of private money market instruments as a supplement to the supply of Government liquidity instruments. Recently there has been an expansion in volume and in activity in commercial paper markets as well as in bankers' acceptances.

These developments raise the question of whether debt management operations had not removed too much liquidity from the money market. One purpose of this memorandum is to explore this question.

Absolute Short-term Debt Changes

Extension of the average maturity of the Federal debt has resulted in a substantial decline in the market supply of short-term Government securities. The market supply of Federal liquidity

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instruments, issues maturing within one year plus Treasury savings notes outside the Reserve System, dropped over one-third from June 1953 to June 1955, while the available supply of floating debt instruments fell almost one-fourth.

Although total marketable debt plus savings notes rose by nearly 5.5 billion dollars in this period, Table 1 shows that the amount of short-term liquidity instruments outside the Federal Reserve actually declined almost 20 billion dollars, and the floating debt about 8 billion. These shorter-term issues have been replaced for the most part by marketable securities maturing between 5 and 10 years.

It should be noted that the principal factor accounting for the decline in the market supply of total Government liquidity issues over the past two years was a decline in short-term bonds. Nevertheless, there was a substantial decline in the floating debt as well. At the present time, except for a very small amount of Postal Savings Bonds, there are no bonds maturing within one year.

Changes Relative to Other Economic Factors

Much the same results as shown by the absolute data are obtained concerning the role of Government liquidity instruments if ratios of these issues to other important economic variables are computed. Since early 1953 the ratios of market supplies of total liquidity instruments and floating debt to such factors as Gross National Product, total net public and private debt, total Federal debt, total commercial bank deposits, and total loans and investments of commercial banks all have shown a decline. For example, the ratio of total Government liquidity instruments outside the Federal Reserve to total loans and investments of commercial banks will probably drop almost in half from about 40 to around 20 per cent from June 1953 to June 1955. Thus as the economy has grown Government liquidity

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instruments have failed to keep pace with other economic factors.

Repercussions on Major Investor Groups

Changes in the maturity composition of Government debt have been accompanied by pronounced shifts in the ownership distribution of liquidity instruments. The marked ownership shifts among investor groups, of course, reflect many factors besides changes in the maturity distribution of the debt. Some of these shifts, as well as some estimates of the future role of these investors in the short-term Government security market, are noted below. The ownership at the end of March in 1953, 1954, and 1955 is shown in Table II. The end of March 1955 is the latest available date for these figures; hence, this date is also used for the other two years.

Commercial banks

Commercial bank holdings of Government floating debt have fallen almost 40 per cent since early 1953, compared to a decline of about 12 per cent in the total supply of these securities outside the Federal Reserve. In recent months the decline in bank holdings of these instruments has been especially sharp. From early 1954 to early 1955 the drop was almost 5 billion dollars.

This was a rapid reduction in the liquidity position of commercial banks and has occasioned some concern over the basic liquidity level of these institutions. Just as it is desirable that the banking system not be flooded with liquidity as it has been at times in the past, it is also desirable that its need for an ample liquidity position be recognized.

Nonfinancial corporations

In recent months nonfinancial corporations have been the primary buyers of the large amount of floating debt instruments sold by commercial banks. Although corporate demands for these issues are of a different

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character than that of banks, they are very strong when large volumes of internal funds are being generated and short-term rates are favorable. Under these circumstances, corporate actions will be such as to bid away the available supply from other investors.

At various periods, a large part of the floating debt has been in the hands of nonfinancial corporations. Although no detailed ownership data for these investors are directly available and thus are not shown in the tables, it is estimated that they held almost 20 billion dollars of Government securities of all kinds at the end of March 1955. It is believed that, in view of corporate financial practices, the bulk of these securities were floating debt instruments.

A study of the largest nonfinancial corporations indicates that in recent years perhaps 90 per cent of their total Government holdings are concentrated in Treasury bills, certificates, and savings notes. Discontinuance of the sale of Treasury savings notes and their almost complete retirement by the middle of 1955 has tended to increase corporate demand for Treasury bills and certificates and thus put additional pressure on the supply of these securities available to others.

State and local Governments

State and local Government authorities such as those with highway, bridge, and power jurisdictions, frequently have funds temporarily available between the receipt of the proceeds of long-term financing and the date such funds are actually needed for expenditure. State and local financing has been running at record levels and funds awaiting expenditure have been largely placed in floating debt instruments. The volume of such funds seeking a temporary liquid investment has been large.

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Foreign investors

In the last few years there has been a marked increase in foreign holdings of short-term dollar assets in the United States. There has been a shift in the investment preferences of foreign monetary authorities and they have tended to acquire large amounts of Treasury bills and certificates in preference to other forms in which dollars might be held. Such holdings now total about 3.6 billion dollars.

Federal Reserve System

Federal Reserve holdings of U. S. Government securities reflect the cumulative results of System open market operations. Since March 1953, System policy has restricted all such operations to securities maturing within one year, almost exclusively Treasury bills.

Future Demand

For the remainder of this year, commercial banks will be faced with an extensive loan demand and at times many banks will be under pressure to liquidate Government securities. While some banks may have funds available for adding Government securities to their portfolios, banks generally will want to keep liquid in order to meet loan demands. In view of this situation and presently reduced liquidity positions, any bank demand for Government securities will probably be concentrated on short-term issues.

Nonfinancial corporations over these months will be active competitors for the available supply of floating debt. About 3 billion dollars of Treasury savings notes will be retired, so a corporate demand for Treasury bills and certificates as a replacement for these notes is likely to appear in addition to the regular seasonal demand resulting from the second half-year accrual of reserves for tax purposes and dividend payments.

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Similarly, State and local Governments should be net buyers of Government liquidity instruments over the remainder of the year as many large financing projects are scheduled, and temporary investment outlets will be needed for accruing funds.

Foreign countries are expected to develop over-all balance of payment surpluses with the United States during the remainder of this year, and a portion of these net dollar earnings are likely to be invested in short-term Government securities. Therefore, further pressure on the available supply of such securities will also probably appear from this source. Federal Reserve open market activities over the remainder of this year will probably result in absorption of Treasury bills. Seasonal and growth demands for credit during the remainder of 1955 indicate that a sizable expansion in member bank reserves through open market operations will be needed. In addition, in view of the wide daily, weekly, and monthly variations in reserve needs, a substantial portfolio of bills distributed among all maturities is essential for operation of a flexible monetary policy.

Over the longer-run, demands for Government liquidity instruments from each of these sources seem certain to grow. Demands of the banking system--commercial banks and Federal Reserve Banks--can be expected to show relatively steady year-to-year increases to meet the credit and monetary needs of a growing economy and, in the case of commercial banks, to maintain an ample liquidity cushion. With respect to the Federal Reserve credit, the System may need to increase its holdings of securities by a billion dollars or more each year to meet growing demands for bank reserves. As a result, therefore, of growing needs and the maturing of long-term issues bought in earlier years, there will be a substantial accretion in Federal Reserve need for Treasury bills.

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Among the other demands, one of the most persistent is likely to be by nonfinancial business corporations. If corporations maintain about the same relationship of holdings of Governments to sales, liquid assets and current liabilities as they have in recent years, their holdings could rise by over 5 billion dollars by 1960.

In summary, total demands for floating debt and other Government liquidity instruments appear to be substantial for the remainder of this year and, for most investor groups, for the longer-run period ahead. Under these conditions, the pressure on the existing supply is likely to continue to be not only pronounced but also increasing. Thus, since most of the major investors in short-term Government securities are likely to wish to be net buyers of these issues, the only source would be an increase in the total supply.

Future Supply

Table 3 provides a projection of the total supply of Government liquidity instruments through 1960 on the basis of certain assumptions. If only the present outstanding issues are taken into account and if it is assumed that the existing marketable floating debt is rolled over at maturity into similar issues, the total supply of Government liquidity instruments would decline still further in the next few years. Under these assumptions Government liquidity instruments outside the Federal Reserve would fluctuate around the current level of 35 billion dollars for a few years and then drop to under 30 billion.

In the last half of 1955 about 7.5 billion dollars will be removed from the total supply of Government liquidity instruments solely as the result of the passage of time. The supply available outside the Federal Reserve will be reduced further as a result of anticipated open market operations.

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In order to maintain the total outstanding volume of Government liquidity instruments, the supply of floating debt would have to be increased. This could be done in one of two ways: part of the maturing 6.9 billion dollars, 1-3/4 per cent note could be refunded into a short-term issue; or part of the Treasury's new cash borrowing requirements, estimated at around 9 billion dollars for the remainder of this year, could be met with new issues of Treasury bills or certificates.

Similar opportunities for increasing the supply of Government liquidity instruments would arise in following years. If some of these opportunities are not seized, there would be a further decline in the total volume of Government liquidity issues outstanding. In such a case some needs for these issues might go unsatisfied. In a period of increasing business prosperity a moderate program of debt lengthening is called for, but this must be carried out with due recognition being given to adequacy of the existing supply of short-term issues.

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Table I

FLOATING DEBT AND OTHER MARKETABLE SECURITIES MATURING WITHIN ONE YEAR
(In billions of dollars)

	Total				Outside Federal Reserve System			
	June 1951	June 1953	June 1954	June 1955	June 1951	June 1953	June 1954	June 1955
Floating Debt: Total	31.0	40.1	43.0	35.4	27.2	33.7	34.1	25.9
Bills	13.6	18.9	19.5	19.5	13.1	17.5	17.2	18.2 1/
Certificates	9.5	15.9	18.4	13.8	6.3	10.9	11.8	5.6
Tax Anticipation Certificates	—	.8	—	—	—	.8	—	—
Savings Notes	7.8	4.5	5.1	2.1	7.8	4.5	5.1	2.1
Other Marketable Securities Maturing Within One Year: Total	37.7	29.0	22.2	16.3	27.5	20.0	14.9	8.0
Notes	18.9	15.2	13.5	16.3	10.0	7.5	6.5	8.0
Bonds	18.8 2/	13.8	8.7	—	17.5 2/	12.5	8.4	—
Grand Total: Government Liquidity Instruments	68.7	69.1	65.2	51.7	54.7	53.7	49.0	33.9
	(Ratio)							
Ratio of Floating Debt to Total Marketable Debt and Savings Notes	21.2	26.4	27.7	22.5	18.7	22.2	21.9	16.5
Ratio of Total Government Liquidity Instruments to Total Marketable Debt and Savings Notes	47.1	45.5	41.9	32.9	37.5	35.4	31.5	21.6

1/ Assumes outright System purchases of $400 million, May - June 1955.
2/ Callable within one year.

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Table II

OWNERSHIP OF FLOATING DEBT AND OTHER MARKETABLE SECURITIES MATURING WITHIN ONE YEAR
(In billions of dollars)

Investor Classes	Total Government Liquidity Instruments	Floating Debt					Other marketable securities maturing within 1 year		
		Bills	Certificates	Tax anticipation Issues	Savings Notes	Total	Notes	Bonds	Total
				(End of March 1953)					
Federal Reserve Banks	14.1	.5	5.0	--	--	5.5	7.7	.9	8.6
Commercial Banks	18.9	4.2	5.0	.5	*	9.8	4.2	4.9	9.1
Savings Institutions	1.9	.6	.5	*	*	1.2	.3	.4	.7
Other Investors	29.0	11.9	5.5	1.4	4.8	23.6	2.9	2.5	5.4
Total	64.0	17.2	16.0	2.0	4.9	40.1	15.2	8.7	23.9
				(End of March 1954)					
Federal Reserve Banks	15.9	1.9	6.1	--	--	8.0	7.1	.8	7.9
Commercial Banks	21.3	4.3	6.2	.3	*	10.8	3.7	6.8	10.5
Savings Institutions	1.9	.8	.5	*	*	1.3	.2	.4	.6
Other Investors	31.3	12.5	6.6	1.2	5.5	25.8	2.5	3.0	5.5
Total	70.6	19.5	19.4	1.5	5.6	46.0	13.5	11.1	24.6
				(End of March 1955)					
Federal Reserve Banks	18.1	.9	10.0	--	--	10.9	7.2	--	7.2
Commercial Banks	9.7	3.6	2.4	--	*	6.0	3.7	*	3.7
Savings Institutions	1.1	.8	.1	--	*	.9	.2	--	.2
Other Investors	27.9	14.2	5.2	--	4.3	23.7	4.2	*	4.2
Total	56.8	19.5	17.7	--	4.3	41.5	15.3	*	15.3

* Less than 50 million dollars.

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Table III

VOLUME OF U. S. GOVERNMENT SECURITIES
DUE TO MATURE WITHIN ONE YEAR - END OF JUNE 1955 - 1960
BASED ON EXISTING MATURITY STRUCTURE OF THE MARKETABLE FEDERAL DEBT
(Billions of Dollars)

	Total Government Liquidity Instruments		Floating Debt as of 6/30/55 1/		Other Marketable Debt Maturing Within One Year					
					Total		Notes		Bonds 2/	
End of:	Total	Outside F.R.	Total	Outside F. R.	Total	Outside F. R.	Total	Outside F.R.	Total	Outside F.R.
June 1955	51.7	33.9	35.4	25.9	16.3	8.0	16.3	8.0	--	--
June 1956	48.2	36.0	33.3 3/	23.8 3/	14.9	12.2	13.9	11.2	1.0	1.0
June 1957	43.5	33.3	33.3	23.8	10.2	9.5	5.0	4.3	5.2	5.2
June 1958	41.0	31.5	33.3	23.8	7.7	7.7	5.3	5.3	2.4	2.4
June 1959	37.2	27.7	33.3	23.8	3.9	3.9	.1	.1	3.8	3.8
June 1960	38.6	29.1	33.3	23.8	5.3	5.3	--	--	5.3	5.3

1/ Marketable floating debt outstanding 6/30/55 is assumed to be rolled over at maturity into similar issues. Attrition during refunding is ignored.
2/ Includes partially tax-exempt issues at their first call date.
3/ Deduct 2.1 billion savings notes maturing in fiscal 1956.