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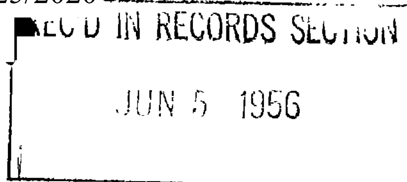

CONFIDENTIAL -- (F.R.)

To Federal Open Market Committee

From Securities Department,
Federal Reserve Bank of New York

June 4, 1956

Subject: Proposal to authorize swaps in Treasury bills

In a memorandum dated May 21, 1956, Governor Robertson has presented his views on the proposal advanced by Mr. Sproul to authorize the Account Management to make swaps in Treasury bills. The Department is in full agreement with Governor Robertson's conclusion that the proposal does not promise "substantial benefits"; it has been suggested only as a minor improvement in operating methods--as an aid in the routine work of the technicians on the trading desk rather than as a matter of serious policy significance. Since there is some reason to believe that the possible disadvantages Governor Robertson points to are unlikely to arise, and since the Committee could promptly discontinue the authorization if any such disadvantages did begin to emerge, a trial period to gain experience might provide the best answer at this stage. This memorandum considers several points raised by Governor Robertson on which comment may be appropriate from the operating level.

As Governor Robertson points out on pages 2 and 3 of his memorandum, one immediate aspect of the need for an authorization permitting swaps--to secure a better distribution of the very limited bill holdings in the System Account--probably has passed. At the time Mr. Sproul first broached the suggestion, the reserve projections indicated the need for a larger volume of selling during May than actually proved necessary. The authority to enter into swaps was suggested as a means of spreading the limited supply of Treasury bills in the System Account over a broader range of maturities so that the Trading Desk might be better able to meet dealer bids, at the time when action to absorb reserves became necessary, with securities available in the Account. Recent purchases for the System Account

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and the likelihood that for some time ahead the System will be on the buy side of the market have virtually eliminated this immediate potential need. However, Mr. Sproul's memorandum stressed that the immediate situation was only a case in point and that it was desirable to establish a continuing authority that would enable the Management of the System Account to rearrange the maturities of bills in the Account from time to time to improve its capabilities for meeting particular policy objectives.

Governor Robertson raises several questions with regard to the need for the authority to enter into swaps and on the effects that these operations might have in the market. On page 2, for example, he asks if there is any serious objection to the Account's purchasing bills of the maturities we need even though our concentration of purchases may drive up the prices and lower the yields of those maturities. There are several possible objections. One is that reserve considerations must always come first, and that outright acquisitions of wanted maturities will always have to be limited to those that happen to be available at the time purchases are made for reserve purposes. A second is that any clear notice to the market that the System intends, whenever reserves have to be provided, to concentrate its purchases in particular maturities, runs a grave risk at times not only of driving down the rates for these maturities, and producing rate distortions for which the Committee might not wish to take responsibility, but also of limiting the market's readiness to make those maturities available, of confusing the "retail" market, and of degenerating into dealer speculation for profit "against the Fed".

A third aspect is illustrated by the desirability, under present arrangements, to begin a half-year ahead in trying to provide for the System's January needs for bill redemptions. The difficulties are illustrated by the results of our recent operations. For example, total System purchases of

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Treasury bills on Wednesday and Thursday, May 23 and 24, amounted to $160.8 million, of which only $29.5 million were July maturities (in normal course these will eventually be rolled over into January maturities). These purchases represented all of the July bills offered by dealers in the "go-arounds" on the two days, and none were priced markedly out of line with the going market. A week later, on June 1, when purchases of $56 million Treasury bills were made, every offering of July bills was again taken, but the amounts were limited to $15 million out of a total of $141 million.

It is experience of this nature which suggests that, if the System Account is to accumulate sufficient January bills to provide for run-offs in lieu of outright sales during January, swaps in Treasury bills as initiated by the market itself from time to time provide the most reasonable and least disturbing method of securing the desired distribution in the portfolio. Of course, sales of later-maturity bills during January are always practicable in moderate volume, but in our opinion they generally prove move disturbing to the functioning of the market than run-offs of considerably larger size.

So far as outright acquisitions of desired bill maturities are concerned, it is somewhat easier to concentrate purchases upon a limited number of maturities when the aggregate volume of System purchases is small at the time of any given operation, or when the Management is able to spread a large operation over a period of several days. But, as already noted, the scale of an open market operation and its timing are determined by the reserve effect that is being sought. A reasonably precise control of reserve balances does not ordinarily allow much leeway in scheduling operations, particularly since reserve projections are not accurate enough to justify beginning an operation very much in advance of an anticipated change in reserve positions. Rather than completing a given day's open market operation in one go-around, the Trading Desk might

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request offers of bills in two or more go-arounds during a day, in each case picking off the July (or October or January) maturities offered by the dealers. However, it is likely that the market would find this procedure confusing and disturbing.

On page 4 of his memorandum, Governor Robertson asks if swapping by the System Account would interfere with the functioning of the market. He concludes that limited swaps confined to Treasury bills probably would not seriously interfere with the depth, breadth, and resiliency of the Government securities market, but that certain undesirable consequences might result. It is possible to argue, on the other hand, that in view of the organization and present practices in the Treasury bill market it is more likely that, if anything, the market might be slightly broadened and improved were the System Account to respond to some of the many swap propositions which originate with the market and are reflected to the Trading Desk.

In virtually all instances, market trading in Treasury bills originates with demand by an investor for a particular maturity or maturities to fill a particular investment requirement. Swapping of bills among dealers and between dealers and their customers is an important device by which dealers are able to satisfy their customers' desires for particular maturities. Dealers rely upon the weekly bill auction as the principal source of Treasury bills for their positions. After receiving their allotments of new bills, they attempt to find customers who either are interested in buying the new bills or who might be interested in swapping for the new bills an outstanding maturity that the dealer believes might be sold to another customer. In summary, the outright trading and the swapping in the Treasury bill market are directed toward distributing the supply of bills to investors, who generally are seeking particular maturities. The borrowing of

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bills to facilitate short sales is so difficult under present conditions that it seriously restricts the willingness of dealers to make short sales, and pure arbitrage operations, as such, almost never arise in Treasury bill trading.

Mr. Sproul's suggestion would be in the direction of broadening this market. As pointed out in his memorandum, the Trading Desk is informed almost daily of swaps that dealers are attempting to work out to provide for their customers' investment needs. If the Committee authorizes the Account Management to make swaps in Treasury bills, these swaps ordinarily would occur only occasionally and would originate with dealers and would represent transactions which the market was willing and anxious to do. With the System's holding of Treasury bills available from time to time for swaps, a new supply of certain bill maturities, and a market for other maturities, would be open to the dealers. Therefore, limited swaps for the System Account would serve the double purpose of enabling us to acquire without disturbance to the market the maturities that we want, while simultaneously broadening the Treasury bill market in the sense that bills taken into the System Account would remain a part of the market rather than being withdrawn from the market as they are now. Since all other investors employ swaps to acquire the bill maturities they want in exchange for bill maturities they do not need, it is extremely unlikely that the market would misunderstand System objectives if we were to adopt this standard market procedure; in fact, dealers have expressed surprise at times at our unwillingness to consider swap propositions.

Another question asked by Governor Robertson has to do with purchases or sales of Treasury bills directly between the System Open Market Account and foreign accounts. He agrees that a better balanced distribution of the Account would be helpful under present practices but raises a question as to the propriety of effecting foreign account orders through the System Account. In fact,

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the anticipated increase in System Account bill holdings during the next several months should largely correct the immediate problem, so that swaps as a means of balancing the bill maturities to facilitate transactions with foreign accounts may not be needed after the buying program has been underway for a few more weeks. On the broader question of the propriety of direct transactions between the System Account and foreign accounts, it should be stressed that all foreign account purchases or sales are handled in the market except when the execution of these orders would be contrary to System reserve objectives. An attempt is made to determine the source or disposition of the funds resulting from the transaction so as to identify the effect on reserves from day to day or week to week. The Trading Desk normally checks with the Foreign Department to determine whether given transactions will represent merely a shift of funds within the market or will affect reserve balances. Only when the latter is the case, and then only when the net effect runs counter to current policy objectives is consideration given to a direct transaction between System Account and foreign account. All foreign account orders could be placed in the market, but sometimes it is less confusing to the market and more in keeping with policy objectives to handle these orders directly through the System Account, particularly when such orders aggregate in the tens or twenties of millions of dollars over a short period.

It seems to us that occasionally there will be advantages to be derived from swaps in Treasury bills, and we do not think that any harmful effects are likely to result from these swaps. With reference to Governor Robertson's suggestion that Committee authorization of swaps in Treasury bills might be an opening wedge to swaps in longer maturities, or a first step away from a current policy principle, we can only suggest that the bill swap proposal be decided on its own merits.