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With the help of Messrs. Young and Eckert, I have attempted to design a capsule explanation of the reasons why dealing in short-term securities is preferable.

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THE WHY'S AND WHEREFORE'S OF BILLS PREFERABLY
(A "Capsule" Discussion)

The normal practice of the Open Market Committee is to conduct its buying and selling transactions in short-term securities. The reasons for this practice are primarily market place reasons rather than theoretical ones.

(1) The practice avoids "muddying the water" in day to day operations.

The chief activity of a central bank is to keep the appropriate volume of reserves in the commercial banking system. At times these operations involve the buying of Governments in order to put reserves into the money market; at other times, selling to take reserves out. Over short periods, the volume of these operations is usually too great to be accommodated in the long-term sector of the market without creating large, erratic price movements, and disturbing orderly market processes. Just as a person dipping buckets of water out of a small shallow stream will muddy the water less if he uses a deep hole, so the securities market will be less disturbed if dealings are in bills where the market has depth and breadth instead of in longer securities where the market is thin.

(2) Economic factors should guide private investor decision-making.

The needs and expectations of many lenders and borrowers are reflected in the structure of interest rates (i.e., a yield curve) that results from the workings of a free market. If the relation of short and long-term rates of interest is distorted by the Federal Reserve, investors must guess what "doctoring" of the yield curve the Federal Reserve may decide upon next. Moreover, without the guidance of market forces, the Federal Reserve has no valid basis for such "doctoring". No governmental agency can know what relationship of short, intermediate and long-term rates would be best for millions of individuals and business firms.

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(3) Dealing in long-term securities represents a one-way street.

Dealing in long-term as well as short-term maturities runs the risk that additions to System holdings would tend to be concentrated in long maturities and sales in short maturities. Suggestions to buy long-term bonds in order to stimulate investment through lower interest rates are strong and persistent, yet there are few occasions when the selling of such securities might seem appropriate. If such a practice were followed, the System's holdings of short-term securities would sooner or later reach the minimum needed for its day to day operations. At that point, further support to the long-term market would expand bank reserves, bank credit and money, and would be inflationary.

(4) If it is not to be an "engine of inflation" by creating inflationary pressures, the Federal Reserve does not have the power to maintain for long a level and structure of interest rates lower than market forces would create.

The long-run direct impact of the Federal Reserve System upon the market is small. Even though the totals of its seasonal purchases and sales may appear large, these largely offset each other. Thus the size of the Federal Reserve portfolio does not change significantly from year to year. For example, at the time of the Accord in 1951, the Federal Reserve portfolio was about $23 billion; in 1960, about $27 billion. Consequently, even if the central bank should wish to influence long-term rates, the volume of its operations is too insignificant in comparison with the total volume of the market.