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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON

CONFIDENTIAL (FR) July 8, 1966

To: PRESIDENTS OF ALL FEDERAL RESERVE BANKS

The following outlines a proposal by the Manager of the System Open Market Account to offset the large increase in float that is likely to result from the airline strike. Vice Chairman Hayes has called a telephone conference meeting of the voting members of the Federal Open Market Committee for 10:30 a.m., EDT, Monday, July 11, to discuss the proposal, with the understanding that no meeting will be required if a strike settlement is reached over the weekend.

The airline strike which began this morning threatens to produce a sudden and substantial bulge in float and thus in reserve availability. In order to maintain the firm money market conditions desired by the Committee, large scale open market operations may be required to absorb these reserves--operations which would likely have to be reversed within a short span of time. Under current operating practices, the only course open to the Desk to accomplish the desired objectives would be to engage in large scale outright sales of Treasury issues and subsequent purchases of roughly the same magnitude when the strike is terminated. Given current market conditions, such operations may be difficult to accomplish, heavily taxing the facilities of the market and possibly causing sudden, large, and undesirable rate fluctuations.

It is proposed, therefore, that the System utilize a new technique to accomplish the absorption and yet provide an automatic subsequent reprovision of reserves. The technique involves sale of securities combined with a simultaneous purchase of the same securities for delivery at a later date. This mechanism would make clear to the market the temporary nature of the reserve absorption and would eliminate the possibility that the intent of the operations would be misunderstood. It would also provide a broader base for operations since the dealers would be able to reverse the transactions with other investors, particularly banks which acquired reserves from the float bulge and would, therefore, be in a position to acquire such short-term investments.

There are a number of possible procedures which the Desk could utilize in undertaking such operations. The most clear-cut and simple approach would be an offer to dealers of short-term Treasury bills at the current market price together with a request that the dealers state the price at which they would be willing to resell the same issue for delivery at a fixed future date. This would provide a competitive criterion for determining the distribution of transactions among individual dealers and insure that transactions were executed on a best-price basis. The prices that would be established on the forward contracts would, of course, be influenced by the expected level of money rates over the intervening period.

Transactions of this type would be processed in the same manner as all other outright transactions, with the usual allocation among the Reserve Banks. No change in the continuing authority directive

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appears necessary to carry out the operations envisioned. The continuing authority directive authorizes the Federal Reserve Bank of New York "To buy or sell U.S. Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices. . ." Sales would be made for cash in the ordinary manner and the purchases for deferred delivery would be made under separate contracts. While there is no present established market price for deferred delivery contracts, a market price would, in effect, be established as the result of the competitive reofferings to the System envisioned in the proposal. No change in the authorization to increase or decrease the amount of securities held in the Open Market Account would be necessary, since the $1.5 billion leeway presently authorized is on a commitment basis, and no net change in the Open Market Account on that basis would be involved. Because of the unusual nature of these operations, however, the matter is being submitted to the Committee for expressions of views.

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