BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

June 20, 1969

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Holland

There is enclosed a copy of a memorandum from the Manager of the System Open Market Account dated today and entitled "Considerations against Federal Reserve Operations in Agency Issues at this time." It is contemplated that the enclosure, together with the Manager's memorandum of June 18, 1969, entitled "Experimental Open Market Operations in Federal Agency issues," will be considered by the Committee at its meeting on June 24, in connection with agenda item 8.

Robert C. Holland, Secretary,
Federal Open Market Committee.

Enclosure

CONFIDENTIAL (FR)

June 20, 1969

To: Federal Open Market Committee

From: Alan R. Holmes

Subject: Considerations against Federal Reserve operations in Agency issues at this time.

This memorandum, requested at the last meeting of the Federal Open Market Committee, sets forth considerations that argue against proceeding with System outright operations in Government Agency issues at the present time. It does not consider the technical problems of System operations, which have been amply covered elsewhere.

1. Unsettled status of Agency financing

One of the major problems facing the Administration and the credit markets over the next year is the expected growth of financing by Government agencies outside the Federal budget. Outstanding Government-guaranteed and Government-sponsored loans are scheduled to show a net increase of $20.9 billion in fiscal 1970 compared with $13.7 billion in fiscal 1969. The growth of Agency financing outside the budget raises serious questions about the total level of Government spending and casts doubts on the traditional use of the budget deficit or surplus as a measure of Federal fiscal stimulus or restraint.

In addition to more financing by old-line agencies a number of new agencies designed to finance social welfare programs are in various stages of formation. Areas involved include, among others, housing, urban redevelopment, urban transit, the supersonic jet, anti-pollution, and exports.

This proliferation of Agency financing outside the Federal budget--much of it on the basis of Government-guarantee of private financing--raises the risk of further fragmentation of the Agency market. The Treasury and the Budget Bureau are currently engaged in efforts to control both the volume and flow of this new financing, but many questions remained unresolved.

There are many arguments for, and some against, centralized financing of Government-sponsored financing programs, either directly by the Treasury or by a centralized financing agency. Federal Reserve operations in Agency issues would be facilitated by the consolidation of Agency debt operations, and it would appear unwise for the System to commence operations until the new Administration has formulated its own approach to Agency debt operations and worked out methods of control.

2. Problems of Agency operations in a period of monetary restraint

Starting Federal Reserve operations during a period of severe monetary restraint is almost certain to be interpreted as a move to channel funds into particular areas of the economy. The move would be expected by many in Congress and elsewhere to provide more in the way of support for housing or for exports than the cautious, objective approach outlined in Governor Robertson's memorandum and reflected in the suggested guidelines could deliver. It might, furthermore, be difficult to start operations in Agency issues without conveying the impression that the Federal Reserve was backing away from an over-all posture of restraint. Current marketing problems would whet the appetite of the financing Agencies for special access to Federal Reserve credit, and as new guarantee programs came into being local pressures for Federal Reserve support of individual projects would be bound to grow. All in all, current market conditions are not conducive to an objective experiment in operations in Government Agency issues.

3. Treasury financing and Agency operations

One of the arguments in favor of Federal Reserve operations in Government Agency issues is to provide an additional instrument for open market operations that would be useful in periods of temporary shortages of Treasury bills. With the Treasury about to move into a period of seasonal deficit financing, there is not apt to be any such shortage of Treasury bills. Dispersion of System open market operations over a broader range of instruments--particularly with the market uncertain as to how much System buying power would be shifted away from direct Treasury debt--could put added upward pressure on Treasury bill and other short rates at a time when seasonal pressures were already strong.

4. Decision to operate in Agencies probably not reversible

As noted earlier, the times are not conducive to an objective experiment in Agency operations. Once the System has announced its intention to operate in Agencies, it would appear extremely difficult to draw back, even if the experiment proves unsuccessful in the sense that System operations tended to have an exaggerated impact on the Agency market or had to be kept so small as to be insignificant. Thus the System would be under continual pressure from its critics to expand the scope of its operations in Agency issues in order to further certain social objectives, all of which might be desirable in themselves, but which might be incompatible with the over-all needs of monetary and economic policy. These expenditures might better be financed directly by the budget, where social priorities can be better ordered. There is a risk that System operations in Agency issues will tend to encourage extra-budgetary spending rather than encouraging the Congress and the Administration to establish desirable priorities for over-all Government spending.