



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

CONFIDENTIAL (FR)

October 23, 1969.

To: Federal Open Market Committee

From: Mr. Broida

At the October 7 meeting of the Committee Governor Maisel indicated that he planned to distribute certain comments on the subject of System operations in agency issues. The comments are attached.

A handwritten signature in cursive script that reads "Arthur L. Broida".

Arthur L. Broida,
Deputy Secretary,
Federal Open Market Committee.

Attachment.

October 22, 1969

TWO ADDITIONAL CONSIDERATIONS WITH RESPECT TO
FEDERAL RESERVE OPERATIONS IN AGENCY ISSUES

The present projections are for record-breaking levels of new issues of agency securities. The amount of new money which must be raised may create major problems both with respect to the market for Treasury bills and notes as well as for agencies. The FOMC should authorize purchases of agency securities in order to be prepared to aid somewhat the problems which these markets may face.

Prior discussion of Federal Reserve System purchases of agencies in the secondary market has been concerned primarily with helping to create broader and more viable markets. This would enable agencies to float new issues more readily and at relatively lower interest rates. Investors would recognize that the issues were more marketable if the Federal Reserve with its large resources were a buyer from time to time. Therefore, investors would be more receptive to the new issues which would become closer substitutes for the direct debt obligations of the U.S. Government.

Federal Reserve operations in secondary markets could also help in the process of market absorption of new agency issues since they could be a positive factor aiding in the smooth market distribution of agency issues, particularly in periods when such issues need to be crowded into the market in considerable volume. Limited experience with Federal Reserve transactions, in the form of repurchase agreements against Federal agency securities, suggests that this device

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also can be of considerable help in increasing the amount of private financing available for the secondary market for such issues.

Furthermore, if disorderly market conditions were to develop or threaten to develop in Federal agency debt markets, or if, as the result of an attempt to maintain the level of housing production, the price relationships between the agency and Treasury issues were widening markedly because of the increased demands made by the agencies on the market, the Federal Reserve should stand ready to buy those issues that were under exceptional pressures. This should be done as part of an effort to restore confidence in the market and to prevent disorderly conditions in one market from spilling over and affecting adversely the markets for other securities. While the criteria for measuring disorderly market conditions cannot be defined precisely in advance, the concept certainly would encompass cumulative downward movements in prices accompanied by persistent and aggressive efforts of investors and dealers to reduce or liquidate their holdings and by a failure of the agencies to obtain bids for new issues in any reasonable relationship to past spreads with the Treasury market for equivalent issues.

Where the Federal Reserve operates in the Federal agency markets, its responsibilities should be analogous to those in the U.S. Government securities market. At times in the past the System has had to purchase Treasury issues that were in, or coming to, the market under disorderly or near-disorderly conditions. At these times, the

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purchases have been aimed at steadying the market, avoiding sharp price declines in discontinuous markets, and halting sharp, cumulative interest rate increases, but since 1951 the Federal Reserve has avoided putting itself in a position where it has dominated specific markets except in short periods of unusual stress.

However, it seems desirable under normal circumstances for the borrowing costs of the agencies to continue to be determined in the market. Only in this manner could the true costs in these agency programs be accurately assessed. Such knowledge of costs is necessary if the Government is to know what results it is getting from its expenditures and in order that the Government be able to measure the costs and results through this channel in relation to other methods of improving housing.