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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Finance

of the

Committee on Banking and Currency

House of Representatives

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Mr. Chairman, I am here in response to your invitation to discuss Federal Reserve transactions in obligations issued by Federal agencies, and particularly the decision--announced September 16 by the Federal Open Market Committee--to broaden such transactions to include outright purchases and sales as well as repurchase agreements. For your convenience, a copy of the announcement is attached to my statement.

This Committee will recall that the System's authority to purchase agency issues was broadened in 1966. Up to that time we were authorized to purchase obligations "which are direct obligations of the United States or which are fully guaranteed by the United States." This authority covered some, but not all, agency issues. The principal issues in terms of aggregate size and market activity were ineligible for purchase by the System. These ineligible issues included Federal Intermediate Credit Bank debentures, Federal Home Loan Bank notes and bonds, Federal Land Bank bonds, Bank for Cooperatives debentures, and Federal National Mortgage Association debentures and certificates of participation.

In 1966, the Board recommended that the authority for System transactions in agency issues be amended to make all issues eligible.

In support of this recommendation, Vice Chairman Robertson testified that it "would increase the potential flexibility of open market transactions and could also serve to make these securities somewhat more attractive to investors." He also pointed out that "it might prove desirable to conduct such operations in the form of repurchase agreements" in order "to reduce the risk of undesired System market dominance associated with sizable outright transactions by the System."

Accordingly, the Congress added to section 14(b) of the Federal Reserve Act authority for the System "to buy and sell in the open market, under the direction and regulations of the Federal Open Market Committee, any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States."

In commenting on this amendment, the Senate Banking and Currency Committee report included the following statement, reflecting similar comments in Vice Chairman Robertson's testimony:

> "By authorizing System transactions in agency issues, the bill would place them on the same footing as direct obligations of the U.S. Government so far as System open market operations are concerned. As with direct Treasury debt, System decisions as to whether, when, and how much to buy or sell of

> agency issues would have to be made with a view to the need for supplying or absorbing reserves as indicated by the stance of monetary policy and in light of developments in the markets, including the need to cope with disorderly market conditions, should they emerge. In any event, it would be important, as at present, to avoid any semblance of 'rigging' the markets or 'pegging' the interest rates for any particular issues, for such actions would give rise to official dominance of the markets that would run counter to many of the broader objectives of Federal financial policies and might in fact harm rather than aid the propitious functioning of the market for such securities."

As you know, System open market operations are conducted to carry out the objectives of monetary policy by affecting the volume of bank reserves, money, bank credit, and conditions in credit markets. In December 1966 the System started transactions in agency issues with a view to fitting such transactions into its open market operations. In line with the Board's testimony on the 1966 amendment, it was then decided to confine these new transactions to repurchase agreements. From time to time, however, the Federal Open Market Committee has considered broadening operations in agency issues to include outright purchases and sales as well as repurchase agreements. After due deliberation, the Committee has now decided to take this step, as the announcement of September 16 indicates, in order to widen the base of System open market operations and at the same time to add breadth to the market for agency securities.

The recent decision to begin outright transactions reflects the fact that the market in agency issues, while less broad than that in Treasury issues, has grown substantially in recent years. The amount of Federal agency issues outstanding in the hands of private investors has risen from about $8 billion at the end of 1960 to $14.1 billion at the close of 1965 and to nearly $45 billion in early August of this year. The $45 billion of agency issues amounted to 28 per cent of the amount of Treasury issues outstanding at the time; at the end of 1960 the comparable figure was 5-1/2 per cent. Thus there is less risk that System purchases or sales could dominate the market.

Since the hope is that System operations will help to improve the market for these issues, we must be careful to avoid driving away other investors, as might happen if the System acquired a disproportionately large share of an issue and depressed its yield relative to other investment alternatives. To protect against this risk, the initial guidelines for System purchases include a provision limiting our holdings of any issue to 10 per cent of the amount outstanding.

We expect our portfolio of agency issues to grow modestly in the coming months, taking into account the amount of growth in bank reserves that is appropriate for monetary policy, the size of the market in agency issues, and the necessity of continuing operations in Treasury obligations as well. Transactions will be made in the market, at prices set by the market. We will seek quotations from dealers and buy or sell at the most favorable prices quoted. We will not buy any new issue until at least two weeks after it is issued, so as to provide an opportunity for establishing a fair price in the market for the issue without interference by the Federal Reserve.

You will notice that the initial guidelines at the end of my statement provide that our holdings of agency issues will be allowed to run off at maturity. This reflects a technical problem, in that the procedures by which agency issues are now marketed do not provide for exchange of maturing issues on the basis that the System now exchanges its holdings of maturing Treasury issues for new issues. Presumably such arrangements could be worked out for agency issues. This illustrates a point made in the announcement of September 16--that the initial guidelines will be subject to review and revision as operating experience is gained.

We plan to buy only taxable securities for which there is an active secondary market. The requirement of an active secondary market will help to insure that the System's portfolio remains liquid; it will also encourage issuing agencies and underwriters to develop secondary markets in their securities.

Under the initial guidelines, an issue will be eligible for purchase if at least $300 million is outstanding; for longer-term issues (over 5 years) the cut-off will be $200 million. In early August, when there were about $45 billion of agency issues outstanding, about $32 billion of these met the size test. A breakdown of these eligible issues is shown in the following table:

ISSUES ELIGIBLE FOR SYSTEM TRANSACTIONS UNDER INITIAL GUIDELINES[1/]

	Amounts in billions	Number of Issues
By Maturities		
0-5 years	$25.3	61
Over 5 years	6.8	21
Total	32.2	82
By Agencies		
Farm Credit Agencies	$10.8	25
FHLB	5.6	15
FNMA	10.1	28
GNMA	4.3	10
Export-Import Bank	1.5	4

1/ Minimum issue size is $300 million for issues maturing in 5 years cr less and $200 million for issues maturing in more than 5 6ears.

One cannot say with certainty what the results of our experimental transactions in agency issues will be. We hope they will be beneficial in terms of greater flexibility for System open market operations, broader markets for agency securities, and a narrower spread between such securities and Treasury obligations. If the borrowing costs of Federal agencies are reduced, however modestly, that result will be most welcome to the Federal Reserve as well as the issuing agencies and the public they serve.