

April 6, 1943

DEALERS IN THE GOVERNMENT SECURITY MARKET

Revised report of a special committee
of the Federal Open Market Committee*

Dealers in United States Government securities and their relationship to Treasury financing and to the open market operations of the Federal Reserve System have been under discussion in the System for a long time. In this report your committee has not undertaken to review or bring up to date material previously prepared on the subject. The basic report, which continues to be applicable to current conditions, is one prepared by the Federal Reserve Bank of New York in May 1940 entitled "The Place of the Dealer in the Government Security Market." Copies of this report have been distributed to all the members of the Federal Open Market Committee. Since this report was written, one of its recommendations--the formation of a voluntary Association of Government Security Dealers--has been adopted. Your committee suggested that a report on the Organization and Operations of this Association be prepared. Such a report by the chairman of the group is attached.

Your special committee decided that the question which has been referred to it can be viewed from two distinct points of view: (1) appraisal of the functions of dealers in a peace-time economy, and possible modifications in the regular machinery; and (2) review of the activities of dealers in relation to the financing of the war. Your committee decided to confine its report to the second subject since conditions are changing so rapidly and so radically that it is doubtful whether a study of the broader subject at this time would be profitable.

* For convenience of review the committee's recommendations have been underlined.

Dealers' services

In this war-time situation the dealers unquestionably serve an essential purpose. Through their widespread branch offices and their network of telegraphic and telephonic wires they cover the country and have numberless contacts with banks, corporations, and individuals on whom the Government must depend for absorbing its securities. The dealers handle the business; if they did not exist or were eliminated, the Federal Reserve System would be obliged to build up a similar mechanism, at great expense and with much costly delay. The cost to the System would probably be greater than the cost of operating through the dealers.

Dealers amenable to regulation

It should be emphasized that the dealers' long-term self-interest as well as their desire to cooperate in promoting a smooth financing of the war make them amenable to suggestions by Federal Reserve authorities. Their activities are, in practice, closely supervised and kept in line with System policy by constant contact with the management of the open-market account.

Possible criticisms

Your committee has considered the question as to what undesirable effects the activities of the dealers may be having at this time. The committee is of the opinion that the dealers do not increase the cost of borrowing to the Treasury, which is being done at rates that have been determined independently of them. They do reduce to a small extent the returns to investors in Government securities,

because commissions or the spread between buying and selling prices must come out of the investors' pockets. This cost of the dealers, however, does not appear to be larger than it should be in relation to the services that they perform.

Allotments

One complaint about the dealers has related to the marketing of Treasury certificates in February. The complaint was that the dealers as nonbank subscribers had no limits placed on their subscriptions and that the banks were allotted only 14 per cent of theirs. The banks felt, and possibly with some justification, that they did not get their fair share of this issue. One cause of the difficulty was that the offering appears to have been too small in view of a growing demand for certificates on the part of banks. There are, however, two moderating considerations: (1) the recognized dealers were permitted to subscribe to this issue no more than \$220,000,000, an amount equal to what they were asked to subscribe in October at the time that the current offerings needed support. It was felt that it would only be fair to let the dealers have as much of an issue that was going well as they were asked to take of issues that were not going well. And (2) the banks received considerably more than 14 per cent of what they really wanted because they did a great deal of oversubscribing. The percentage they received was between 40 and 50 per cent of what they wanted rather than 14 per cent. During the December

financing the dealers obtained about \$700,000,000 of the 7/8 per cent certificates and 1 3/4 per cent bonds, a substantial part of which was probably sold to banks.

Suggestion as to allotments

There probably should nevertheless be some modification in allotments made to the dealers. Subscriptions by dealers should not be permitted to circumvent the policy of regulating and limiting bank purchases of U. S. Government securities. In the April drive plans have been made to handle the matter by requesting banks not to buy during the drive securities that have been allotted to others. This procedure will no doubt be reviewed on the basis of the experience that will be acquired in April. For issues between drives the committee suggests that definite amounts be allotted to banks and that the dealers be included with nonbank subscribers, but that their total subscriptions be supervised by the Manager, in accordance with directions to be agreed upon between the Secretary of the Treasury and the Executive Committee of the Federal Open Market Committee.

Dealers' advice

Probably the least desirable thing that dealers do is one which it is difficult to control, namely, suggestions and advice that they pass on to their customers in conversations, on the telephone and otherwise. It is clearly to the financial interest of dealers that the market should be lively with movements of prices and with a large volume of operations. That dealers sometimes suggest sales or purchases for the purpose of stirring up the market and that they sometimes jiggle their quotations for that purpose, it would be very hard to establish, and yet it is

almost certainly done to some extent. Some dealers may also at times encourage customers to trade against the established pattern of rates. The committee has no remedy to offer for this situation other than watchfulness by the System and warnings to dealers when such practices come to its attention.

Consequences of the pattern of rates

Your committee is aware of the fact that undesirable practices exist in the Government security market today. Opportunities for these practices arise principally from the operation of the pattern of rates. This pattern has become much more crystalized than was intended when it was first adopted in principle. The thought was that it should govern primarily rates that the Treasury has to pay for borrowing money for different periods, and only indirectly and much less rigidly affect market yields and prices of outstanding securities. It is also true that the pattern itself, with its wide range of yields from short to long maturities, was better adapted to a condition when excess reserves were ample and demand for credit low than to the present situation when excess reserves are dwindling and the demand for credit is large and growing.

A fairly rigid pattern of rates going up more or less regularly from $3/8$ for 3 months' bills to $2\ 1/2$ for long bonds results in opportunities for what has become known as playing the pattern of rates.

Most of the playing of the pattern at present occurs in the certificate market. The game consists of buying certificates when they have a year to run, for example, carrying them for a period at the coupon rate, and then selling them at a premium. The premium arises from the fact that the paper would then be 3 months' paper, which in the market would carry only $3/8$ of 1 per cent, while the paper itself

would still be earning at a rate of $7/8$ per cent a year. To the extent that the pattern is rigid and a market at the rate is assured, an opportunity for speculative profits arises out of the establishment of the pattern.

It seems to your committee that the remedies for these situations are: (1) somewhat greater flexibility in rates, particularly for short paper of a year or less maturity, and (2) possible changes in the kind of short-term obligations that are offered. The committee understands that plans for such modifications are under consideration and is impressed by the importance of such plans. It is not prepared, however, to discuss the matter at this time.

Goldsmith's attack

A great deal of discussion of the dealers and of the general problem of open market practices of the System has been occasioned by two letters of the Goldsmith Washington Service, dated January 16 and February 6. The burden of Goldsmith's criticism has been: (1) that the Federal establishes minimum prices for the various issues of Government securities and does not permit sales below these prices. This sometimes results in creating considerable difficulty in disposing of Government securities and makes many purchasers, particularly the smaller banks, lose confidence in their ability to liquefy their securities at any time that they may wish. The committee has not been able to find evidence that the situation described by Goldsmith is widespread or that it has handicapped the Treasury financing program.

In a sense, minimum prices within fairly narrow limits are inherent in an assured pattern of rates. If prices were permitted to go down in accordance with market conditions without control, there would

be no pattern of rates. The problem under discussion is really a much narrower technical one as to the existence of some flexibility in price, within the general pattern. The Manager of the Account informs us positively that no rigid minimum prices are established or enforced. The situation appears to be that some holders of securities, who were in a hurry to sell and were willing to sell at a price that would in effect break the pattern of rates, found on occasion that they could not do so.

The other criticism that Goldsmith makes is: (2) that the Federal Reserve is reluctant to make swaps. This statement is correct. The reason for discouraging swaps is that they are not what we are after when we are selling Government securities. What we want is to find lodgment for additional securities represented by new issues, and if new issues are taken up on a swap basis to replace old issues sold to the Federal Reserve, then nothing has been accomplished. For that reason the System does not encourage such transactions, unless there are special reasons.

A memorandum of Mr. Piser's on the policies followed in the operation of the account is attached.

Federal Reserve Banks as dealers

One suggestion that has been made from time to time and has been considered by the committee is the desirability of having Federal Reserve Banks buy and sell securities for their own account up to a certain limited amount. This would be for the purpose of offering somewhat more direct facilities to banks and other investors outside of New York. It is the committee's understanding that all the Reserve banks now act as brokers for member banks, so that a bank can obtain securities

by calling up the Federal. The committee believes that at this time it would not be advisable to undertake the development of special machinery for buying and selling securities at Federal Reserve Banks, particularly in view of the shortage of personnel and the heavy volume of work at the Reserve Banks. This question may well be reopened for further consideration at a later time. In the meantime your committee suggests that each Federal Reserve Bank make a report to the Manager of the System Open Market Account at stated intervals or when important transactions take place or are contemplated covering the transactions in Government securities for account of member banks and others.

More complete information

The committee's final suggestion is that the Manager of the Account be asked to make somewhat more complete reports to the Federal Open Market Committee on his discussions and agreements with the dealers. Mr. Rouse is always willing to tell all that takes place, but at times he does not feel sure that there is sufficient interest on the part of the Committee in details of his conversations. Your committee believes that members of the Federal Open Market Committee, of its Executive Committee, and of the staff of the Committee would be in a better position to understand current developments in the market if they had more complete reports from the Manager. In particular, your committee feels that a general report of the principal developments at the Manager's weekly conference with the Executive Committee of the Dealers would be

helpful. We note that the weekly report for March 31, 1943 contains more detailed information on conditions in the market. This is in accordance with the suggestion in our preliminary report.

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