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SYSTEM POLICY AS IT CONCERNS THE MAINTENANCE OF YIELDS ON CERTIFICATES OF INDEBTEDNESS

Since May 1942, the Federal Reserve Bank of New York, as agent of the Federal Open Market Committee, has been instructed by the executive committee of the Federal Open Market Committee to maintain about the present general level of prices and yields of United States Government securities. The "present general level of prices and yields" has been based on a so-called pattern of rates of which the 3/8 per cent bill rate is the short-term anchor and the 2 1/2 per cent long-term bond rate the upper limit. This pattern has been maintained, with only small variations, except in the short-term section of the market where yields on certificates of indebtedness have been allowed to rise substantially above the yield curve. The latter deviation has been in accordance with the expressed but unrecorded views of the Federal Open Market Committee.* System account transactions in certificates of indebtedness, therefore, have been executed primarily for the purpose of maintaining an adequate amount of funds in the market, although at times, when bank demand was insufficient to absorb substantial selling by nonbanking investors, purchases have been made in order to check or to prevent a too rapid rise in yields. No general attempt has been made to force yields on certificates back into line with the "pattern of rates" by means of System account operations when the market was not in need of funds.

To an increasing extent, banks have been making use of certificates, rather than Treasury bills, as a medium for adjusting reserve positions, both through sales and borrowing. Concurrently a gradually diminishing supply of new funds available to corporations for investment has led to increased selling of certificates prior to

* For example, in August 1943. Chairman Eccles said in a telephone conversation with Mr. Sproul that in his opinion we are not committed to any pattern of rates between 3/8 per cent for bills and 7/8 per cent for one-year certificates; that the bill rate is no longer a market rate, but a discount rate, and that he would allow certificate prices gradually to decline until the level of market support is reached or the yield reaches 3/4 per cent whichever comes first. Similar expressions have been made at meetings of the Committee and its executive committee.

each War Loan drive in order to raise funds with which to subscribe to the new issue. Consequently, much of the pressure on the certificate market has come prior to and during the early days of War Loan drives and yields on certificates have tended to rise most markedly at such times. (Yields have also risen at other times, when there has been no need for the System to put funds into the market, which would have had the effect of combating the rise, and when the only demand for certificates came from a few banks willing to buy them on a scale up in yields.) Due to the great increase in the amount of certificates outstanding and the gradually diminishing amount that nonbanking investors have been able to add to their holdings, commercial banks have generally been able to fill their requirements without bidding up prices between drives except for a short period immediately following the close of drives when yields temporarily declined. The progressively higher level of yields on certificates is indicated in the following table:

Readings from Rate Curve Based on Market Bid Prices for 7/8% Certificates

	3 Month Maturity	6 Month Maturity	9 Month Maturity	11 Month Maturity
Pattern of Rates (10/24/42 curve)	0.375%	0.64%	0.72%	0.78%
On issue date of new certificates offered in				
3rd War Loan	0.58%	0.71%	0.76%	0.77%
4th War Loan	0.53%*	0.73%*	0.79%	0.80%
5th War Loan	0.66%*	0.77%	0.80%*	0.81%
Present	0.68%	0.78%	0.81%	0.82%

* Actual issue

This situation in certificates has been accompanied by diminished holding of Treasury bills by all classes of investors (except Federal Reserve Banks). As can be seen from attached chart 1, holdings of Treasury bills outside the Federal Reserve System have declined almost steadily from the peak of $9.0 billion on June 16, 1943

to $4.4 billion on November 8, 1944, despite an increase from $11.5 billion to $16.2 billion in the total amount of bills outstanding.

Although until recently, at least, no question has been raised by the Treasury regarding the policy followed by the System in connection with market yields on certificates,* the deviation in certificate yields from the rate curve has reached and remained at a point where a redetermination of System policy seems necessary.

In giving consideration to a redefinition of policy on the part of the System, the following observations might be made:

1. By our purchases of certificates when they cannot be readily placed by a bank needing funds, we have encouraged the use of certificates rather than bills as an investment medium available for reserve adjustments, although our transactions account for only a small portion of the volume traded.
2. No marked improvement in the Treasury bill situation can be expected unless the bills are made more attractive or certificates made less attractive or both. The best we can anticipate is that banks, primarily the central reserve and reserve city banks, will continue to keep a part of their funds in bills in order to be in a position to meet large daily changes in their money position without borrowing.
3. As long as certificates sell at a premium there will be heavy sales prior to War Loan drives by various classes of investors wishing to raise funds with which to subscribe for new certificates during the drive, and nonbank investors will continue to prefer certificates to bills as a short-term medium of investment due to the more attractive

* The Treasury has now had the problem brought to its attention, in specific terms, by the necessity for fixing rates on short-term borrowing of the Federal Intermediate Credit Banks and Federal Home Loan Banks.

rate, supplemented by the premium if a sale is made. Such transactions are inherent in the plan for financing the war with a fixed "pattern of rates" and by the drive method. It is better to have them centered in certificates than in notes or bonds where the cost to the Treasury is higher and profits to those riding the pattern would probably be greater.

4. As long as the Treasury uses certificates as a principal means of financing, a broad market above par must be maintained.

5. A System policy designed to reestablish and maintain a fixed level of yields for certificates more nearly in line with the earlier "pattern of rates" will, at times, require purchases for System Account when there is no other need to put funds into the market. Owing to the general policy of banks to keep fully invested, however, it does not necessarily follow that funds the System puts into the market in support of the rate pattern will add materially to the amount of excess reserves of banks for any length of time, although it will encourage increased bank holdings of Governments.

6. The yield on any market issue of Government securities outstanding is directly related to the yield on every other issue and the market as a whole, rather than just a few key issues, must be maintained if the "pattern of rates" is to be maintained.

7. The payment of small premiums on market purchases by the System in maintaining a rate pattern on certificates or maintaining an adequate supply of funds in the market is unimportant by itself in comparison with the over-all objective of successfully financing the war at low rates of interest with a minimum of bank participation.

Our dilemma has been and is to reconcile these conflicting forces to maintain a "pattern of rates" while avoiding too strong an invitation to riding the

pattern at the certificate level where the tendency to do so is greatest. In reconsidering the policy, the committee might wish to give consideration to a "pattern of rates" on certificates which would result in the market premium for certificates being about the same for the first nine months after issuance. While this would call for the sale or purchase of certificates by the System whenever the premium moves markedly above or below the pattern, it should result in the elimination of a good part of the market activity brought on by the difference in premiums prevailing for various maturities of certificates. For example, when the market price per $100, such as $100.053, is larger than the price on another maturity of certificates, say $100.042, there is usually some selling of the issue with the higher premium against the purchase of the issue with the lower premium.

The next step would be to determine the yield at which a three-month certificate would be supported, in view of the 3/8 per cent rate on Treasury bills. It can be assumed that the bill mechanism established by the System makes Treasury bills a somewhat more attractive three-months investment than certificates, so that certificates of comparable maturity should sell at a slightly higher yield. The following table shows the size of market premiums on a three-months 7/8 per cent certificate at several yields which bear a close relationship to the Treasury bill rate after making allowance for the sale and repurchase option on bills:

Yield	Price	Premium in Nearest 64ths
.40%	100.1184	7/64 - 8/64
.45%	100.1059	7/64
.50%	100.09336	6/64

It will be noted that the difference in cost of maintaining an 0.40 per cent yield as compared with an 0.50 per cent yield is only slightly more than 1/64

If the prices for a three-month certificate at yields of 0.40 per cent and 0.50 per cent are applied to other maturities of certificates the yields on certificates would be approximately as follows -

	Price Indicated by a 3 Mos. 7/8% C/I on an 0.40% basis	Yield	Price Indicated by a 3 Mos. C/I on an 0.50% basis	Yield
12 Mos.	100.1184	0.76%	100.09336	0.78%
11 "	"	0.74%	"	0.77%
10 "	"	0.73%	"	0.76%
9 "	"	0.71%	"	0.75%
8 "	"	0.69%	"	0.73%
7 "	"	0.67%	"	0.71%
6 "	"	0.64%	"	0.69%
5 "	"	0.59%	"	0.65%
4 "	"	0.52%	"	0.59%
3 "	"	0.40%	"	0.50%

These yields are plotted on attached chart 2 and are compared with the pattern established in the fall of 1942 and with the current yields.

The principal objection to fixed yields of 0.40 per cent or 0.50 per cent on three-month certificates is the relatively high premium, 3/32 more or less, which will be immediately established on a new certificate. Based on the "pattern of rates" line a new certificate should open at about 2/32 premium and not until it has been outstanding about two months should the premium reach or exceed 3/32. The larger premium on a new issue would not have to be supported by the System, of course, until the certificate had been outstanding for two months, and even then the System would not readily buy or sell on the slightest variation of premiums. As in all of our "pattern of rate" operations, support would be given the certificate market only at approximately the levels indicated.

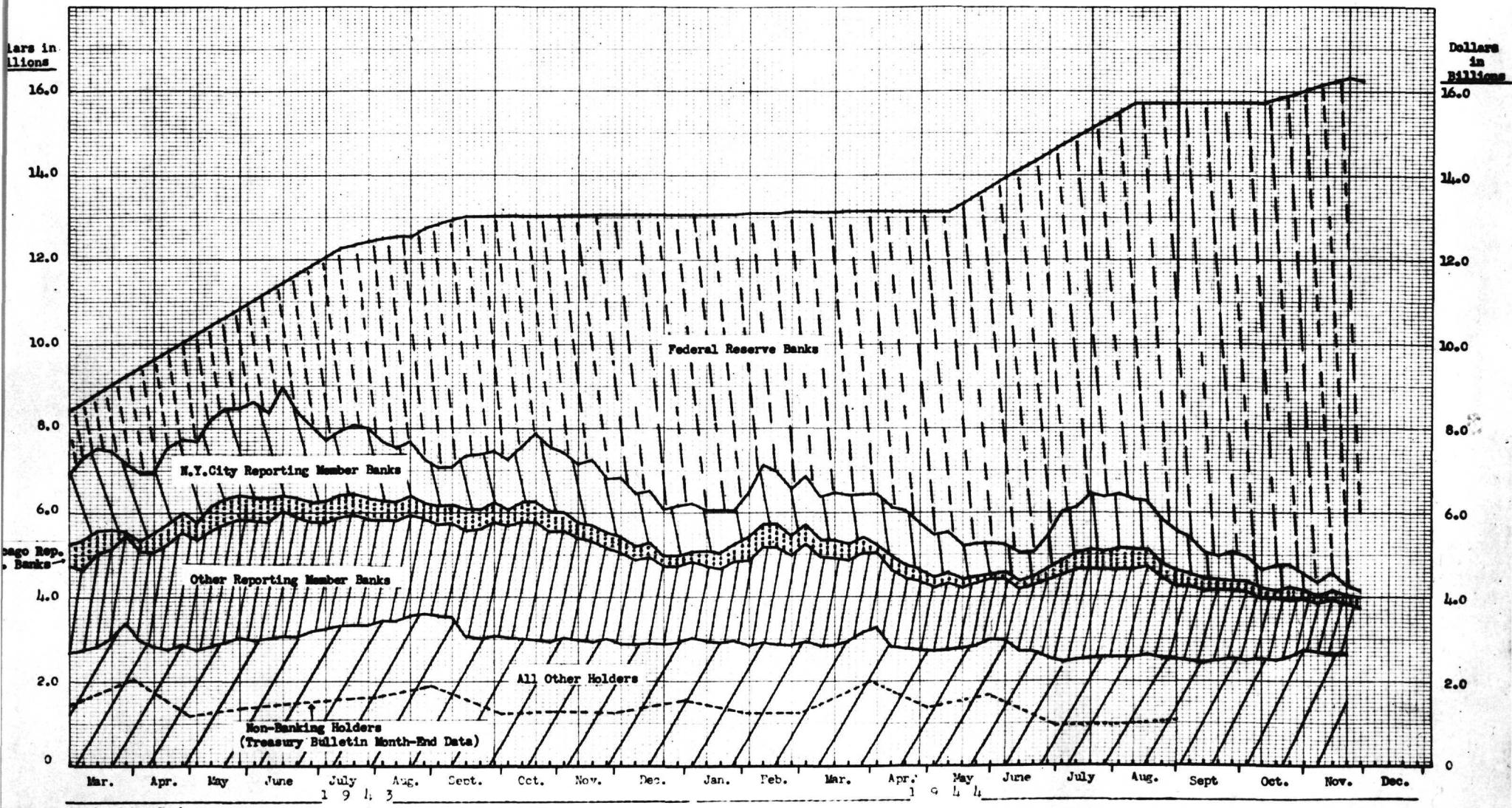
It might also be objected that the premium indicated by an 0.40 per cent or 0.50 per cent yield for a three-month certificate is too high to be maintained and that 2/32 would be more desirable. However, this presents difficulties at the short end of the rate pattern if the pattern is to be maintained in this area, as a three-month 7/8 per cent certificate selling at 100 2/32 would yield 0.622 per cent, a yield 0.247 per cent above the bill rate. (The present market yield on a hypothetical three-months certificate is estimated at 0.68 per cent.)

This whole problem has been recognized as a difficult one almost from the beginning of the "pattern of rates" program. It has now reached a point where a reconsideration of our policy, precedent to a reviewal of our understanding with the Treasury, is necessary.

Federal Reserve Bank of New York,
Securities Department,
December 1, 1944.

Chart 1

DISTRIBUTION OF U.S. TREASURY BILLS
Wednesday Series



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YIELDS ON CERTIFICATES OF INDEBTEDNESS

Chart 2