Mr. Eccles

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON 25, D. C.

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

December 28, 1949.

STRICTLY CONFIDENTIAL

Dear Sir:

As a matter in which you will be interested, there is enclosed a copy of a strictly confidential memorandum prepared by members of the Board's staff with respect to recent developments in the short-term Government securities market.

Very truly yours,

S R Carpenter

S. R. Carpenter, Assistant Secretary,
Federal Open Market Committee.

Enclosure

TO THE PRESIDENTS OF ALL FEDERAL RESERVE BANKS
(with an extra copy marked for Mr. Rouse)

December 23, 1949.

STRICTLY CONFIDENTIAL

Recent developments in the short-term Government securities market merit special attention. For various reasons short-term rates rose to and remained at levels which endangered a successful January refunding at the 1 1/8 per cent coupon rate announced by the Secretary of the Treasury on November 30. The Treasury has shown concern over developments and Mr. Haas called Mr. Rouse on December 15 to inquire about possible System operations in view of the refunding.

As a consequence of the danger to the Treasury financing program inherent in the new rate structure, the System has during the last few days engaged in vigorous operations in the bill and certificate markets to the extent of lowering yields on these securities.

Pressure in the money market was anticipated by the Executive Committee of the FOMC at its meeting on November 18, and to some extent was augmented by System action in permitting its maturing bills to be redeemed at a time when the market was temporarily flush with funds. The pressure on the market, however, was somewhat greater than had been expected, partly because of a more rapid credit expansion and consequent increase in required reserves, and partly because of uncertainty in the market resulting from public discussions of System policy. Excess reserves of member banks averaged only 650 million dollars over the week ending November 30. Yields on short-term Government securities had risen by November 28 to a level breaching at least technically, the 1 1/8 per cent rate on one-year securities.

In recognition of the announced refunding program, particularly the 1 1/8 per cent certificates of January 1, the System held the short-term rate from rising further by purchasing about 600 million dollars of Government securities during the first two weeks of December. Excess reserves rose sharply the first 10 days of December and averaged over 900 million dollars during the following week.

Despite vigorous System buying and the resulting expansion in bank reserves, short-term rates continued close to the System buying rates over this period. This upward pressure on rates apparently reflected a combination of factors: (1) bank deposit expansion increased required reserves substantially while the seasonal currency demand absorbed reserves; (2) it was expected that any fall in short-term rates would be short-lived in view of an expected drain on bank reserves in the last half of December; (3) testimony before Congress together with System operations around the end of November, was taken to indicate a change in System policies; and (4) large dealer's positions in bills were overhanging the market.

At the close of trading on December 15, dealers marked up the yields on bills from 1.11 to 1.12 per cent, threatening the 1 1/8 per cent, 1 year rate. This coincided with announcement of the opening of the books for the January refunding.

In order to protect the refunding operation, particularly in view of expected drains on bank reserve positions resulting largely from currency outflows and Treasury quarterly income tax receipts, the System entered the market aggressively on December 15 and 16, purchasing bills and certificates in large volume, primarily from dealer portfolios. Bill purchases on December 16 began at a rate of 1.11 per cent (longest issue), but subsequently over the day purchases were made at successively lower yields. Purchases of certificates by the System followed a similar pattern. The longest bill issue closed that day at 1.09 - 1.05 per cent and the longest certificate at 1.10 - 1.08 per cent. Total purchases on December 16 were 229 million dollars (including 70 million of the January certificates). On December 19 and 20, the System purchased 91 millions of bills and certificates (including 46 million of the January certificates) to hold short-term yields at these levels.

Accompanying the decline in short-term yields, there has been a renewed rise in long-term bond prices to the highest levels in more than two years, although the market continued small in volume.

Some questions and conclusions as to System policies and operations are suggested by these developments:

(1) Under the circumstances substantial purchases by the System since December 15 have been essential to assist the January refunding.

(2) It appears that the <u>bidding down</u> of yields through aggressive buying was also necessary, but this operation has aroused suggestions in the market that the System has been engaged in deliberate "rigging" operations. Despite the aggressive nature of the System operations, however, excess reserves declined slightly over the week, and as a consequence this type of talk has died down.

(3) Even with aggressive support by the System, the new offering of 1 1/8 per cent certificates may draw a heavy voluntary redemption of cash. Purchases by the System of January certificates (a form of cash redemption) have been rather large in past few days and may need to continue in order to assure success of the refunding because of the feeling in the market that the rate may be too low in view of immediate economic prospects and possible Federal Reserve policies consistent with that situation.

(4) More fundamentally, question may be raised as to the desirability of the System having to force down yields in its market support operations under conditions of strong credit demands. If some rise in rates could have been permitted, the necessary volume of System operations would probably have been much less. The market would have made its own adjustments to meet a partially temporary and a partially longer-term change in the situation. As it is now, the easing of the market which will follow in January, unless offset by System operations, will be much greater because of System purchases in December to peg the certificate rate at a level that appears to be too low under prospective conditions.

(5) The renewed rise in bond prices gives support to the view that maintenance of short-term yields at present low levels is likely to lead to further declines in long-term rates.

(6) These various developments have been in line with the Executive Committee's earlier judgment, although somewhat more severe.