How Long Will Government "Peg" Prices of Its Securities?

By ALLAN SPROUL, President, Federal Reserve Bank, New York

It was during the last half of the depression thirties that the concept of open market operations was expanded to include some responsibility for maintaining order in a Government security market swollen by the deficit financing of the depression years. When the Second World War began in 1939, this responsibility became really important, since it was essential to avoid any impairment of the Government's credit, no matter how financed at level, not rising rates of inflation, and an incentive to delay purchases. It was determined, therefore, to make it publicly clear that the war should be financed at level, not rising rates of interest. It was finally decided to permit the Treasury bill rate to rise to 3/4 of 1 per cent, to shorten slightly the maturity of 2½ per cent bonds, and to maintain a "pattern of rates" between these two basing points. In this way the Federal Reserve System embarked on a fixed rate support program, as well as an orderly market program in its open market operations. And in order to assure the rapid sale of all Government securities which had to be offered to finance the war they were, in effect, given many of the attributes of cash. It was quickly realized that this sort of mixture of cash and securities and this sort of rate structure would result in playing of the "pattern of rates", and that either short rates or long rates would have to decline. The Treasury would not agree to any increase in short rates at that time, and so there was a gradual decline in long rates.

Address at dinner given by Federal Reserve Bank of New York at the Baker Hotel in Dallas.
1946 was the wartime preferential dis-
count rate, \( \frac{1}{2} \) of 1 per cent on ad-
varies collateralized by Government
securities maturing within one year, discar ded. It was not until July 1947
that the \( \frac{3}{4} \) per cent rate on new
Treasury bills and the buying and re-
purchase agreements with respect to
such bills were discontinued. It was
not until the late summer of 1947
that the rate on one-year certificates
of indebtedness was permitted to rise.
All during this period, the long term
2\% per cent bonds were selling at
premums, and we were able tem-
porarily to continue a policy of orderly
markets, as distinguished from a policy
of fixed rate support, in the long bond
market. This situation continued until
the fall of 1947 when the demand for
capital funds overtook and passed the
amount of accumulated and accumu-
لانeling savings. By force of market
pressures, there being many sellers and
very few buyers, our policy of main-
taining an orderly market was quickly
forced into a policy of fixed rate
support. In order to minimize the
volume of sales of Government securi-
ties to us, and to emphasize the support
factor in our operations, we dropped
our prices in December 1947, sticking
at a 2\% per cent issuing rate for
22-27 year bonds. This meant a mar-
ket price of slightly above par for
those moderately shorter bonds which
were then outstanding. Our orderly
market policy had now merged into a
support policy, as is almost inevitable
in a market of the size and importance
of the Government security market, if
there are many sellers and no buyers,
and if order is to be preserved.
1947 to March 1948 we added approximately $5 bil-
liion to our holdings of Treasury bonds.
There followed 3 months of market
calm when no support of long term
bonds was necessary. With the special
sale of F and G bonds announced last
June and with the calling of the Special
Session of Congress to discuss anti-
inflation measures last July, substan-
tial sales of marketable Government
bonds again found an unwilling market
and we had to resume support. This
situation has continued since, with
rising concern as to the desirability of
our policy, and rising doubts as to our
willingness to continue it in the face
of persistent inflationary pressures.
We have not been nor are we now
entirely helpless, however. We have
been attempting—and fairly success-
fully—to offset the credit effects of
our support of long term Government
bonds, by permitting a further rise in
short term rates. It was hoped that
this would create some uncertainty
about the future course of rates, lead-
ing to some restraint upon borrowers
and lenders, that it would increase the
attractiveness of investments in short
Governments, and that it would thus
make it possible for us to sell short
maturities from our portfolio while we
were buying long. This policy was
helped tremendously, of course, by the
fact that there was a substantial sur-
plus in the Treasury cash budget dur-
ing fiscal year 1947-48, which surplus
was used largely to retire Government
obligations held by the Reserve Banks
and by the commercial banks. The
Treasury cash surplus was the dog and
we were the tail. Taking dog and tail
Df) together, from November 1947 to No-
vember 1948 the total amount of
Government bonds purchased by the
Federal Reserve Banks in support of
the Government security market
amounted to $10,904,683,100. Of
these gross purchases, about $3 billion
resulted from bank sales to us to meet
the three successive increases in mem-
ber bank reserve requirements during
the past year. Thus, only $9 billion
of our purchases were more or less "nor-
mal" transactions, and as offsets to
these, roughly $10 billion of other
Government securities were sold or
redeemed out of our portfolios. The
difference between $8 billion "normal"
purchases and $10 billion sales meant
an absorption of about $2 billion in
member bank reserves. This roughly
offset the rise in member bank reserves
resulting from gold inflows of $1.7
billion and a return flow of $4.4 billion
circulating currency. In other words,
sales and redemptions of short term
Government securities by the Federal
Reserve Banks have very largely offset
the money market effects of our own
purchases of short term Government
bonds, as well as the effects of gold inflows
and currency returning from circulation.

HOWEVER, there have been two or
three important changes in the situa-
tion which are affecting our present
operations and will affect our future
operations. Taxes have been reduced,
increased military expenditures have
become necessary, a large-scale foreign
aid program has had to be continued,
and the Treasury cash surplus of fiscal
1947-48 has largely disappeared in fis-
cal 1948-49. Long term Government
purchases have now become an
orderly market policy which almost by
force of circumstance has become a
market support policy. It is not indi-
cated by blind adherence to low in-
terest rates, nor by Treasury insistence
on keeping down the cost of servicing
the debt. It is a policy which the
Federal Open Market Committee be-
lieves is the best policy, for the present,
in the light of the necessity of main-
taining high level production at home
and in the light of our commitments
abroad. It is the best policy if we are
not to fail a world which is critically
and perilously divided. We cannot
allow long term Governments to go
unsupported, and fall no one knows
how far, nor can we risk undermining
sales to us which might follow our
shifting the pegs below par, if we do
not also accept the premise that a
likely collapse of the securities markets
(and perhaps the deliberate precipita-
tion of a depression) would be health-
ful. Nor can we risk impairment of
the Government's credit as a result of
such a collapse, unless we feel there is
no chance that the Government may
soon have to borrow to meet our in-
ternational (or our defense) commit-
ments. Whatever we do involves risks
—and that cannot be avoided. We are
taking what in our judgment appears
to be the lesser risks. Our critics think
we are mistaken, but I have not yet
heard one who I thought had taken into
account all the factors and assessed
all of the risks.

WHAT do our critics suggest? Some say that we are wrong to support
Government securities at par or slight-
lY above—that this invites selling in a
supported market, whereas if the sup-
port price were slightly below par, say
99, it would deter selling since the
seller, in most cases, would have to
show a loss on his sales. Other coun-
selors, also wise in the ways of timid
investors, say, however, that another
engineered drop in prices, which would
create this loss-sale situation, would
also lead to further selling of Govern-
ment securities to prevent possible
further losses. They say the urge to
cut losses is at least equal to or stronger
than the urge to take a small profit.

That leads to a second group of
critics who say that the engineered
decline in prices should be to a point at
which the yield on long term Govern-
ment bonds would be about 2\% per-
cent—that such a yield would provide
a living for insurance companies and
other institutional investors, that faced
with a loss on sales and a living wage
on purchases, they would soon become
buyers instead of sellers of long term
Governments, and thus our support
problem would disappear. I am not
going into the social-economic question
of "providing a living for institutional
investors". Quite apart from such
broad considerations, this suggestion
resolves itself into a matter of judg-
ment, or opinion, as to the level at
which the whole market, including the
institutional investor market, with
whatever aid we might give, would
 regain approximate balance under pres-
ent conditions. Would it be at a price
of 95 and a yield of slightly over 2 3/4 per cent or at 91 1/2 and a yield of 3 per cent or at 83 1/2 and a yield of 3 1/2 per cent or where? Opinions differ because no one knows how all kinds and types of investors and investments would react to such a price and yield change in a market still subject to support and to administrative determination of the level of that support.

Then there are those who say we should abandon our support program altogether, permitting a "natural" market to determine its own prices and yields; by which they mean, I suppose, a market as "natural" as a market can be in which open market operations are being used as an instrument of credit policy. That suggestion has a ring of fundamentalism about it, and it is, of course, a good long range suggestion. Eventually we all want to get away from a supported market and advertised commitments as to prices, and, in a peaceful world, it is not unlikely that we should find the market for riskless long term investments balancing itself at 2 1/2 per cent. Meanwhile, however, the chief appeal of the abandonment theory is the idea that the way to let go of a bear's tail is to let go. At least you will resolve your problems one way or another, although the solution may be a pretty messy one.

I could go on. This is one of those affairs which properly concerns everyone, and on which many people find need to express their views. There are those who say we should juggle prices a bit—not be so rigid in our support—and thus take advantage of the competitive spirit of prospective buyers and sellers of Government securities, sometime make purchases or defer sales in the hope of a more favorable market. This technique is said to be effective, sometimes, in floating corporate securities which may be a little sticky. One wonders whether it applies to a 50 billion dollar market as well as to a 50 million dollar market? Taking a much broader view, there are those who say we should continue to support the Government security market, but that our support should be directed solely toward maintaining orderly conditions in the market, not toward maintaining particular prices and rates of interest. That is where we came in, of course, but experience indicates that you need more inherent balance in the market than has existed during most of the past year to make such a policy practical. Recognition of this fact led many others to suggest a variety of conversion operations, which would seek to restore inherent balance to the market while retaining the essential elements of present support policy, and conceivably this might be a way out of the present situation. Finally, and on an almost philosophical plane, there is the suggestion that we should buy Government securities only when we wish to put funds into the market and sell them only when we wish to take funds out of the market—the true open market operation. If we could do that, without running serious risks in a dangerous world, there would be no problem.

What is the core of our immediate problem? Whatever may have been our earlier sins of omission or commission, the core of our problem during the past year has been the fact that large expenditures for (a) plant and equipment, (b) residential, commercial, and public construction, (c) inventories, and (d) net foreign expenditures, have increased incomes without adding immediately to the flow of goods and services available for current consumption. Savings of business and individuals have not been large enough to finance this capital formation, and some part of it has been financed by borrowing from banks, insurance companies, and other lenders, those lenders obtaining some of the funds which they lent by selling Government securities to the Federal Reserve System. We have been trying to make capital out of credit. This situation and growing discussion of it led to some public doubt as to the desirability of our support of the Government security market, and increasing public doubt as to our willingness to continue that support if its means contributing to inflationary pressures.

The situation calls first, perhaps, for a reassessment of the prospects of further inflationary pressures. The developing and emerging weak spots in our economy do not seem to be of the kind which would seriously endanger the underlying strength of the current position. However, most of the basic physical business indicators could be expected to level off (as they have been doing in recent months) rather than continue to rise, and prices (and all indicators including a price element) would be likely to taper off somewhat—were it not for the demands of preparedness for war and even the possibility of actual war. That proviso immediately focuses attention on the fact that we are not blessed with peace, no matter how far we may be from war, and our economy can't and won't function as if we were at peace. The thinking and planning of businessmen and business men are affected in varying degrees by this situation, and it is already a considerable factor in the Federal budget. In the immediate future months the changed Treasury position (from one of large surplus in the budget to one of small surplus or no surplus) is likely to be the main element in the effectiveness or lack of effectiveness of a fiscal-monetary program and an element which will seriously compromise the chances of attaining a balance of demand for goods and services with the available supply. In other words, the cost of waging a "cold war" and the possibility of a "hot war" are the principal factors disturbing the present general tendency toward stability in prices and production.

If that is what we have to cope with, a tougher monetary policy isn't the answer. It is becoming a problem similar to the problems of war finance—in which it is essential that the Government's credit remain undisturbed; in which we continued to pay the increased costs of increased tapping of savings will be required; and, should the situation get worse, in which the question of controls would again have to be faced, controls which this time might need to include some control of capital expenditures or capital lenders. We must quit thinking and talking as if the immediate reconversion after war has been completed, and we can now proceed as if we were at peace to do the things we might do if we were completely at peace.

In terms of monetary action or credit control, that means to me that we shall have to continue with our modest policy for the present, buying long term Government securities so long as the market lacks sufficient balance to warrant a change from support to an orderly market technique; and making short term Government loans sufficiently attractive so that the net of our open market operations will be no addition, or better some withdrawal, of funds from the reserves of the member banks. Coupled with this modest credit policy, we shall have to make every use we can of the devices of debt management, to keep pressure on the banks, and we shall have to work and hope for a fiscal policy which will recognize the danger of piling a further inflation on top of the inflation we have already had.

If that seems too modest a policy for those who say they think it is time for the central banking system to crack down, or to increase the pressure, or to "get out from under the domination of the Treasury", I can only suggest that they might feel differently if they had the responsibility for policy. I hope so, because the risks they would run, in the light of the present world situation, are the risks of irresponsibility.

Reprinted from THE TEXAS BANKERS RECORD, November, 1948