FEDERAL RESERVE OPERATIONS: PEGGING, "BILLS USUALLY," AND PRESENT PROCEDURES

During World War II, when prices were controlled, materials allocated, consumer goods rationed, and manpower conscripted, the Federal Reserve developed a financial counterpart for the emergency conditions of over-all control. It made certain that there would be ample reserves in the banking system to provide whatever money the Government might need, above that ~~after the feasible maximum had been~~ obtained through taxation and through borrowing investor savings (in part by Savings Bonds). These reserves were provided by the Federal Reserve's purchasing securities at pre-determined, and relatively low rates; thus a fixed pattern of rates was established for the Government securities market. In time, these reserves furnished to the banking system enabled the banks to go ahead and purchase the additional issues of Government securities required to meet the Treasury's wartime needs for funds. Such bank purchases of Government securities, made possible by the reserves supplied by the Federal Reserve, represented corresponding additions to the money supply, but the immediate inflationary consequences were held in check by the wartime system of controls. The results of the rate pegging process were, therefore, really twofold:

(1) The money creation process was subverted to the exigencies of war finance, in effect setting a time bomb for an ultimate inflationary explosion.

(2) Artificialities and rigidities developed in the market and in the practices of the Federal Reserve and banking system as a whole -- artificialities clearly inconsistent with the operation of a competitive market economy.

Once the war had ended, some controls were dismantled rapidly, others gradually, in the transition back to a vigorous "free" economy. Because there were many problems involved in the transition back to relatively free markets for Government securities, and because the implications of pegged markets influenced all capaital values, the post-war transition for monetary controls was much more gradual than any other sector of the economy. There was a gradual movement away from the wartime rate pattern in the short end of the market but the process of Federal Reserve support was continued.[2] By 1950, the need to divorce the Treasury and the Government securities market from continuing dependence upon money creation by the Federal Reserve had become clear on all sides; the inevitable inflationary consequences of continuing the process were recognized generally. A Special Subcommittee of the Joint Congressional Committee on the Economic Report, under the chairmanship of Senator Douglas, conducted an exhaustive investigation leading to the recommendation that means must be found for discontinuing the pegged support of Government securities markets -- if financial stability and effective control over the creation of new money were to be~~come possible~~ achieved in the decade of the '50's.

After considerable negotiation, prompted in part by the thorough analysis of the "Douglas Subcommittee,"[3] the Treasury and the Federal Reserve System reached an "Accord," which was announced on March 4, 1951. This Accord reaffirmed the necessity for the Federal Reserve's policy to be directed toward the maintenance of appropriate monetary conditions for the economy as a whole and the necessity for the Treasury's borrowing requirements to meet the test of the market. It provided for the coordination of debt management and monetary policy in such a way as to restore the Federal Reserve's control over the money supply while assuring a successful Treasury financing in the context of a competitive market. Several procedures were instituted to provide for the gradual withdrawal of the fixed arrangements that had been in effect.

Late in 1951 and during 1952, it became clear that the Federal Reserve System faced a difficult task in convincing the whole range of investors in the Government securities market, and the whole range of borrowers in other markets competitive with that for Government securities, that truly competitive conditions had again been restored. Investors continued to believe that the Federal Reserve would attempt to maintain certain predetermined interest rates, regardless of the over-all state of demand and the volume of other savings entering the market. The Federal Reserve, therefore, decided that it would limit all of its necessary operations in the Government securities market to securities of the very shortest term -- usually Treasury bills -- in order to convince the market that it was not engaged in specifically pegging any rates of interest and, most particularly, those of intermediate and long-term. To minimize market uncertainty as to possible Federal Reserve operations affecting market rates this conclusion -- that the System henceforth would operate only in the area where its sizable operations would have least market impact -- was ~~relayed~~ made known to the market.

In carrying out this decision, the Federal Reserve continued to place primary emphasis in its operations upon supplying an adequate volume of reserves to support an adequate growth in the money supply. It no longer assumed responsibility for specific rates of interest, although the observation of interest rate movements continued to be one of the many bases taken into consideration when judgments were made concerning the need for larger or for smaller increases in the reserve base of the banking system. In fact, it was thought by some that the signal of interest rate movements, reflecting basic demand and supply forces, was clearer as a result of the Federal Reserve's procedure of limiting operations to shortest term securities. The Federal Reserve was not at any time, however, unmindful of the risk that unusual developments might create "disorderly conditions" in the Government securities market and thus in credit markets as a whole. Consequently, the Federal Reserve continued to be prepared to undertake operations in securities other than Treasury bills in the event disorder actually developed. While there were few occasions for such exceptional action, some did occur: notably, late in October 1955, when changing market conditions threatened the failure of a very large Treasury financing operation, the Federal Reserve became an active buyer of the specific issues involved in the Treasury borrowing operation. Again, in the summer of 1958, when disorderly conditions developed subsequent to a Treasury financing, the Federal Reserve temporarily changed its practice and made purchases of longer term securities to steady the market. Apart from these infrequent, unusual situations, however, the Federal Reserve did maintain its position of reliance on operations in Treasury bills without interruption until 1960. It did not purchase maturing securities involved in Treasury financing operations, the so-called "rights." Nor did it engage in "swaps" in which Treasury bills might have been exchanged for other kinds of Government securities through the market. It did, however, engage frequently in short-term lending operations, to provide reserves for a few days under conditions of temporary technical shortages of funds, through "repurchase agreements" extended to Government securities dealers. The Federal Reserve was willing to take any Government security maturing in up to 15 months on this kind of short-term arrangement, in which these Government securities serve virtually as collateral for a temporary loan.

By 1960, it had become clear, however, that there were likely to be more frequent occasions when conditions in the market bordering on disorder might develop, particularly in circumstances such as those experienced toward the close of 1959, when borrowing demands were intense and interest rates were rising rapidly in the free markets. The Federal Reserve, therefore, began to experiment by making some purchases of Government securities outside the Treasury bill area. The Federal Reserve entry into this field had been assisted, too, by the Treasury's action in 1959 in introducing Treasury bills of 1-year maturity, so that the System could continue to trade in "discount obligations" while reaching into a maturity range of as much as one year. The new developments giving particular force to the System's desire to lengthen the range of its operations were related to the balance of payments position. By the third quarter of 1960, the outflow of short-term funds from the United States to money market centers abroad had become substantial. At the same time, the need for easing of bank reserves and credit availability had become clearer, as the economy moved closer to recession. In essence this was the conflict: if the Federal Reserve continued to buy only the shortest term securities, it might drive those rates to unduly low levels, thereby encouraging a further outflow of funds which would aggravate the already serious balance of payments deficit. Thus, in order to minimize the balance of payments repercussions of increases in bank reserves, the Federal Reserve began to provide some of the reserve increases through purchases of securities that were not as closely interchangeable with Treasury bills. (It also reduced reserve requirements to provide last half-year seasonal reserve needs with less rate impact than by security purchases.)

Under the pressure of balance of payments considerations, this experimentation still continues. The Federal Reserve is prepared to reach out even further in order to provide reserves, as needed, in a manner that will minimize reductions in the short-term interest rates and provide the maximum initial impact toward that reduction in long-term rates which would most assist in helping to check and reverse recessionary developments. In effect, the balance of payments situation has become so extreme as to represent virtually a "disorderly situation." In consequence, the Federal Reserve is now moving to broaden its operations in a manner that is consistent with its previous principles but involves new procedures made necessary by the application of those same principles to a new and changing situation in the financial markets.