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KIND OF MATERIAL OR NUMBER 333.

NAME OR SUBJECT Open Market Operations
Operations of FRBanks - FRBanks

DATES (Inclusive) 1937 - ~~1940~~ 1954

PART NUMBER Part 3

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MEMORANDUM

TO: Executive Committee of the Federal Open Market Committee

November 5, 1954

FROM: Mr. Solomon

Subject: "Approval and Ratification" of Open Market Transactions Already Carried Out.

At the meeting of the executive committee of the Federal Open Market Committee on October 20, 1954, there was discussion of the question whether "approval and ratification" of open market transactions since the preceding meeting, one of the items on the agenda for such meetings, was necessary or desirable, and Counsel was requested to consider this matter.

Since the full Federal Open Market Committee similarly "approves and ratifies" open market transactions as well as actions of the executive committee that take place between meetings of the full Committee, this memorandum treats these matters together.

Discussion

History of "Approval and Ratification"

The draft minutes of the October 20, 1954 meeting of the Executive committee, in terms which are identical (except for the period covered) with those of other recent meetings of the executive committee and full Committee, state that:

> ". . . upon motion duly made and seconded, and by unanimous vote, the open market transactions during the period October 5-19, 1954, were approved, ratified, and confirmed."

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The minutes of the executive Committee and the full Committee have been reviewed since early 1936, when the Federal Open Market Committee, as now organized, began operations.

It appears that there was some slight variation in the procedure and terminology at the first few meetings. However, at each of those early meetings where there was a report of open market transactions, there was some resolution "approving" or "ratifying" them. Furthermore, within the first year of operation the practice was adopted of "approving, ratifying, and confirming" such transactions as well as the actions of the executive committee; and that practice has since been followed continuously.

Effect of Transactions Being "Approved, Ratified, and Confirmed".

When the transactions in the System account are "approved, ratified, and confirmed" the result, in legal terms, is a "ratification" of the transactions. Such a "ratification" has certain legal consequences under the principles of the law of agency. Accordingly, it is convenient to discuss them in terms of those principles.

When a principal "ratifies" the contract of his agent, the effect, in general, is to provide (or perfect) authorization from the principal to the agent for the action which the agent has already taken. In legal contemplation, the authorization resulting from the ratification relates back to the time when the action was taken. It binds the principal as to both (1) the party with whom the contract was made, and (2) the agent who made it.

If the action of the agent was within authority previously granted him, the principal is already fully bound even without a

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"ratification" and, of course, cannot legally repudiate the transaction. In such a case a "ratification" is, of course, legally superfluous; but it can do no harm.

Questions as to Legal Necessity. - To apply these principles to a transaction in the System account, suppose there has been a particular purchase of Government securities which is made for the System account by the Federal Reserve Bank of New York, and then ratified by the executive committee and the full Committee.

If the transaction was within the scope of the authority granted, the System account (i.e., the 12 Reserve Banks) would be bound by the transaction even without the ratifications. If there were by some chance any doubt as to whether the transaction was within the authority, and therefore as to whether the System account was bound, the ratifications would remove any such doubts. It would remove them both (1) as to the right of the seller to require the System account to carry out and abide by the contract, and (2) as to the right of the New York Reserve Bank to make the contract and be protected in carrying it out.

In so far as the rights of the seller are concerned, it is most unlikely that there would be any appreciable doubt to be removed. Since it is a principle of the law of agency that the agent warrants his authority, the seller could require the New York Reserve Bank to carry out the contract if the System account refused to accept it. Thus he would rarely if ever find it necessary to assert his rights against the System account.

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If the seller should proceed against the System account, it is likely that, except in a most extraordinary case, a court would hold that the transaction was within the authority expressly granted in the relevant directives. Even if the court by some chance concluded that such express authority was not sufficient to cover the particular transaction, it would most probably find that at least for the purposes of the seller adequate authority had been conferred in some other fashion, such as by implication, by a holding out, by estoppel, or by an implied ratification. For example, a court might very well hold that the purchase for the System account had been ratified even without a formal motion of ratification. As stated in Restatement of the Law of Agency:

> "An affirmance of an unauthorized transaction may be inferred from a failure to repudiate it." [sec. 94]

> "Ordinarily, the receipt by a purported principal who knows the facts, of things to which he would not be entitled unless the transaction were ratified and to which he makes no claim independently of the act of the purported agent, indicates his consent to become a party to the transaction as it was made." [sec. 98, Comment]

Thus, the formal ratification probably has little legal effect of any consequence in so far as the rights of the person selling to the account are concerned.

With respect to the rights of the New York Reserve Bank or the executive committee, there is perhaps slightly more chance that a ratification might have some practical legal effect. For example, some forms of authority, such as by holding out or estoppel, are recognized more for the protection of innocent third parties than of agents. However, as indicated above, the transaction would probably be held to have been authorized by the relevant directives, or ratified by implication. Accordingly, even here, it is highly unlikely that any substantial rights or liabilities would depend upon whether or not a formal motion of ratification is adopted.

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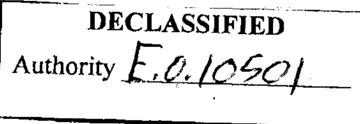

Questions as to Desirability. - However, such a motion of ratification may be desirable notwithstanding the fact that its legal effect would probably be quite limited. It is often desirable to take certain actions as a precautionary measure even though the risk against which they insure may be slight. Such action may be desirable in the case of transactions in the System account, since the directives under which they are carried out are necessarily general in terms.

The nature of these directives, as well as the heavy responsibilities resting upon the Open Market Committee, the executive committee, and the New York Reserve Bank, require close cooperation and collaboration between principal and agent. In such a difficult and responsible relationship, it can often be important that all parties concerned not only carry out their responsibilities diligently but that they also maintain a suitable record that will reflect, so far as practicable, the full extent of their diligence. A formal motion of ratification can help to serve the purpose of maintaining such a record, since it gives at least some indication that the principal has specifically considered the acts of the agent and that the acts have been found satisfactory.

Such a motion of ratification could, therefore, be helpful not merely before a court but, perhaps of more moment, before the bar of public opinion. This would appear to be particularly true in the case of open market operations, since they have such an important relation to the public interest and can so easily be the subject of later discussion or criticism. If the principal or agent for some

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reason should later be called upon to explain or justify their stewardship, it might possibly prove regrettable for both if such an explicit ratification had been omitted.

It is probably for such reasons that it is customary for a corporate board of directors to ratify the acts of its executive committee. As stated in Fletcher on Corporations, sec. 9028:

> "Where the corporation has an actively functioning executive committee, to which the management of the corporation is intrusted between meetings of the directors, the meetings of the directors may be very few and far between, particularly if the board is a large one, the members of which are widely scattered as to location, ... In such case the meetings, even when held, are apt to be formal in their nature, the principal business being the ratification of the acts of the executive committee."

When a member of the executive committee or full Committee votes to "approve" or "ratify" open market transactions, it could perhaps be argued that he approves the directives under which they were carried out. It is believed, however, that this would not necessarily be the case, and that it clearly would not be the case if he indicated that he merely intended to accept the transactions as being in accord with the directives, or if there was a resolution or understanding by the members that such was the effect of such a vote.

Form of Motion

As indicated above, some form of motion ratifying the transactions seems desirable, and such a motion can take various forms. It is not imperative that it use the terminology of "approving, ratifying, and confirming", which has customarily been used by the executive committee and the full Committee. Actually, the three words have similar meanings in the present context, and any one of them probably

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would be sufficient. However, the present form of motion seems to be satisfactory to accomplish the purpose; and since it has become customary to use it, any change might be misunderstood in the absence of some persuasive reason for making the change.

If some different phraseology were desired, it probably would serve the purpose to adopt a motion to the effect that the transactions "as carried out were within the authority previously granted", or that the transactions are "adopted as transactions authorized" by the Federal Open Market Committee (or the executive committee), or that they are "accepted" as transactions so authorized. However, as already indicated, the present motion would also seem to serve the purpose and would not necessarily need to be changed.

A related aspect of this matter is the way in which the item "approval and ratification" is listed on the agenda of the meetings. It would seem preferable, especially since the question has been raised, that the subject should be listed in a manner which does not seem to suggest or anticipate the conclusion which may be reached at the meeting.

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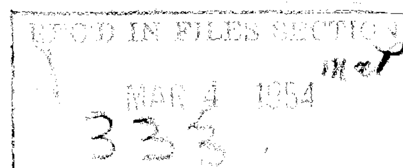

February 26, 1954.

Chairman Martin — Recommendations of I. B. A.

Woodlief Thomas — Committee on Treasury Financing.

The executive committee of the Government Bond Committee of the I.B.A. today made recommendations to the Treasury with respect to (1) near-term financing, and (2) policing of subscriptions for new money issues of long-term securities.

With respect to the financing, three alternative programs were suggested. The first included a long-term bond and a June tax certificate; the second, to be used in case no long-term bonds were offered, included the June tax certificate and a note of about 1957; and the third was for all money to be raised through a medium-term note issue.

The proposals were based on the assumption that something like $5 billion would be needed and that all of that might be obtained in March. The committee definitely favored the first of these proposals with only one member, Mr. Pattberg, believing that a long bond would not be appropriate at this time. It felt that the long-term bonds should be offered in an amount of $1-1/2 to $2 billion, sold on a formula basis. With respect to the rate, they presented three alternatives. The first choice was for a 3 per cent bond at par with a maturity that might extend as far as 35 years. In case the market did not justify that high a coupon with maturity of not over 35 years, then the second choice would be a 3 per cent bond of shorter maturity to be offered at a premium. The third choice was for a 2-7/8 per cent bond at par, which they thought might be of about 25-year maturity.

They believe that $1-1/2 to $2 billion of long-term funds could be raised at this time although they recognise that it would require some switching. The amount of switching could be reduced by providing for deferred payments and for formula allotments. Mr. Pattberg's chief objection to the long-term bond at this time was that since the recent issue of $11 billion of 1961 bonds the possibility for institutional investors to shift intermediate holdings to banks was much more limited. The members of the committee seemed to believe that pension funds and trust funds wanted and needed the long-term Treasury bonds. There was some discussion of the possibility of a Series K bond serving the purpose but apparently there are technical disadvantages to that bond for trust accounts. The committee had no concern about the possible effects on the economic situation of a long-term bond offering at this time. They indicated, however, that the market was not expecting such an issue and the announcement would cause some market adjustment. Such

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adjustment, they believed, was called for and might actually help distribution of the issue.

The reason for suggesting a June tax certificate is primarily the heavy demand for liquidity reasons because of the Mills Plan operation and particularly because of the $11 billion of short-term issues that have just been shifted into medium-term bonds. A rate of not over 1-1/8 per cent was considered to be appropriate for the certificate issue in case partial tax and loan credits were given.

One argument advanced in favor of the combination of a long-term bond and a June tax certificate was that it would result in a maximum of nonbank buying and reduce the Federal Reserve problem of supplying reserves. There was no discussion of the question as to whether this should be considered as a problem to be avoided. It was said, however, that any sort of spectacular offering requiring considerable amount of Federal Reserve action might be interpreted as indicating fear about the economic situation and result in a reverse effect on business confidence.

Mr. Burgess asked about the possibility of issuing tax bills instead of tax certificates but the members of the committee definitely preferred certificates. The indicated advantages were that bill bidding is likely to give a more artificial rate and that bills would attract less in the way of country bank and corporation funds directly into the new issue. The distribution would have to be accomplished through city banks.

The Treasury people indicated that they would probably not need as much as $5 billion in March and could raise some of it as late as June. They expressed some desire to keep the Treasury balance from becoming unnecessarily large. The discussion of this point brought forth a possible fourth alternative which apparently had been considered by the committee but not recommended, namely, the offering of a long-term bond and a small amount of June tax notes in March and later in the spring the offering of some $2 billion of 3-year notes.

With regard to the question of policing, a special subcommittee has worked out detailed proposals for an allotment formula which it believed would tend to reduce oversubscriptions and also avoid penalizing the more desirable type of subscribers. A memorandum on this subject is being prepared and will be sent to the Treasury and to Mr. Rouse. The latter will take it up with the System Committee operating on this subject. If the Board wants more information on the proposals before these memoranda are prepared, I shall be glad to transmit such details as I have on my notes, or we could obtain more information from Mr. Rouse.

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To: Chairman Martin

Addendum to Memorandum on Recommendations of I.B.A. Committee on Treasury Financing

In private conversation, the banker members of the committee seemed to feel very strongly that the Federal Reserve policy has been responsible for undue lowering of interest rates. They were particularly critical of operations since December.

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FOR FILES
Woodlief Thomas

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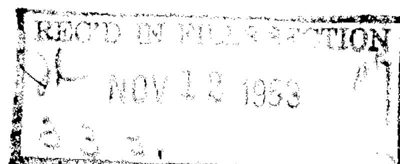
November 10, 1953.



Chairman Martin

Woodlief Thomas

The other day Newell Childs, accompanied by James Day, President of the Midwest Stock Exchange, came in to inform us about developments with respect to plans for formation of a futures market in Government securities. They said that they particularly wanted to keep you informed about the plans and progress. Recent publicity with respect to them was premature, they said.

Apparently the Midwest Stock Exchange, which is a consolidation of the Chicago Exchange and exchanges in other cities in the midwest, is interested in promoting the idea and is trying to work out something to be carried out on their exchanges. They have a committee of Chicago and presumably some other midwest business and financial leaders who are working with them. The only name I recognized was that of John Fennelly of Glore Forgan. They want to have a study made of the problem by some academic person or group in Chicago and reported that one is already being undertaken by the Harvard Business School and another is being considered by someone in Princeton.

We did not endeavor to discuss to any great extent the merits of the proposal. Apparently the principal questions that have been raised about the possibility of operating such an exchange concern the difficulty of finding buyers for the future contracts. They can see how there might well be a number of sellers--corporations and others wanting to have money on a particular day. The principal potential buyers are insurance companies and pension funds. They mentioned also corporations that may be floating a big issue on a certain day; specifically the American Telephone Company had expressed an interest.

Mr. Childs indicated that he wanted to keep the Board informed and know whether there was any objection from the Federal Reserve to such a scheme. I indicated that the System's interest was primarily in the short-term market. He thought that perhaps a futures market in bonds might be used by some short-term investors. The effect, therefore, might tend to bring short-term and long-term rates close together. It should, however, tend to increase rather than to decrease the total amount of funds invested in Government securities.

I did not mention it to them, but I believe that to locate the operation of the market in Chicago rather than in New York would be a great handicap to its success, if on other grounds it were decided that such a market were feasible.

cc: Messrs. Riefler and Youngdahl

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 10, 1953.

To Chairman Martin

From Woodlief Thomas

Subject:

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W. T.

cc: Messrs. Riefler and Youngdahl

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FEDERAL RESERVE BANK

OF NEW YORK

NEW YORK 45, N. Y.

September 9, 1953

Mr. Woodlief Thomas
Economic Adviser to the
Board of Governors of the Federal Reserve System
Washington 25, D. C.

Dear Mr. Thomas,

In accordance with your request to Tilford Gaines, I am forwarding a copy of Mr. Treiber's seminar paper on "Open Market Operations of the Federal Reserve System".

Very best regards,

Sincerely,

Charles A. Coombs,
Manager, Research Department

Enclosure

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FEDERAL RESERVE BANK OF NEW YORK

February 2, 1953

Open Market Operations of the Federal Reserve System

(This material has been prepared in connection with a discussion of open market operations at the central banking seminar of the Federal Reserve Bank of New York on February 17, 1953, by William F. Treiber, First Vice President, Federal Reserve Bank of New York.)

SIZE AND NATURE OF PUBLIC DEBT

U. S. Government debt is one of the most significant features of American economic life.

Size of U. S. Government debt

Roughly $267 billion (12/31/52).

Almost as large as total personal income for 1952. Monthly Federal Reserve Chart Book, p. 52.

Over three-fourths of gross national product for 1952. Monthly Federal Reserve Chart Book, p. 48.

Over twice the market value of all stocks on New York Stock Exchange.

$1,688 per capita.

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Growth of U. S. Government debt

(Growth of Government debt in last three decades shown in chart on page 57 of Federal Reserve Chart Book, Historical Supplement, September 1952)

1916	$ 1 billion
Dec. 1919	26 billion
1930	16 billion
Jan. 1940	42 billion
Feb. 1946 (all-time high)	279 billion
Dec. 31, 1951	259 billion
Dec. 31, 1952	267 billion

Public and private debt

(Growth of public and private debt in last three decades shown in chart on page 56 of Federal Reserve Chart Book, Historical Supplement, September 1952)

1916 U. S. Government debt	1% of total debt
1929	10%
1952	almost 50%

Short comment on U. S. Government debt

Principal investment medium for most financial institutions and individuals.

Yields on Government securities most influential factor in money market and long-term capital market.

Ability to carry debt depends less on size than on:

Composition
Distribution
Cost in terms of annual interest charges in relation to national income

Size of debt has direct effect on:

Annual interest cost
Tax policy
Credit policy and interest rates
Volume of bank deposits.

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Composition of interest-bearing debt

More than half marketable.

	Amount 12/31/52	Per cent
Non-marketable:		
U. S. Savings Bonds	$ 57.9 billion	22
Treasury Savings Notes	5.8 "	2
Depositary Bonds	.4 "	-
Treas. Bonds-Invest. Series	13.5 "	5
	$ 77.6 billion	29
Special Issues to Govt. Trust Funds	39.1 "	15
Marketable:	148.6 "	56
Total interest-bearing securities	$265.3 billion	100

In this seminar we are interested in the marketable debt ($149 billion)--in the Government securities market which deals with such debt.

Desire of public to buy (and hold) non-marketable debt is affected by developments in the Government securities market, but this is beyond the scope of present discussion.

Types of marketable issues

(Total amount of various types of issues in last decade shown in chart on page 30 of monthly Federal Reserve Chart Book)

Treasury bills

Non-interest-bearing obligations issued by Treasury on discount basis, payable at par; usually issued with maturities of 91 days; 13 issues with one maturing each week, each issue currently between $1.2 billion and $1.5 billion in amount; public submits tenders every Monday for issue to be paid for by purchasers on Thursday, which is same day Treasury must pay maturing bills. The 13 regular issues outstanding on December 31, 1952 totaled about $17.2 billion. In October and November 1951, and again in October and November 1952, the Treasury sold special issues of Treasury tax anticipation bills

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maturing in March and June, respectively. The issues due March 18 and June 19, 1953, totaling $4.5 billion, remain outstanding.

Certificates of indebtedness

Maturity of 1 year or less when issued; customarily issued at par by Treasury; entire interest payable at maturity. As of December 31, 1952, three issues outstanding totaled $16.7 billion. The largest of these ($8.9 billion) matures February 15, 1953.

Notes

Maturity more than 1 year but not more than 5 years when issued; customarily issued at par by Treasury; interest payable semi-annually (except when maturity close to one year, in which case interest payable at maturity as in case of certificates of indebtedness). Eight issues now outstanding--$30.3 billion.

Bonds

Maturity ordinarily more than 5 years when issued; customarily issued at par by Treasury; usually callable by Treasury at an option date a few years before maturity; option date generally mentioned in name of issue--e.g., 2 1/2 per cent Treasury Bonds of Dec. 15, 1967-72. Twenty-six issues now outstanding, totaling $79.8 billion.

Partially tax-exempt bonds

Government bonds issued before 1941 partially exempt from Federal income taxes; supply, of course, diminishing; all P.T.E. (partially tax-exempt) bonds eligible for purchase by commercial banks. Interest on P.T.E. bonds exempt from Federal normal tax. For most large corporations, normal

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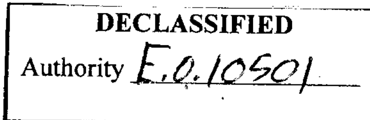
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tax is 30 per cent and surtax is 22 per cent. P.T.E. bonds exempt from 30 per cent normal tax. In the case of individuals, interest on P.T.E. bonds exempt from normal tax and also from surtax to extent holdings do not exceed $5,000 principal amount. Because of advantage of tax exemption, P.T.E. bond customarily sells at higher price than taxable bond of comparable maturity and coupon. All Treasury bills, certificates of indebtedness and Treasury notes now outstanding have been issued since 1941 and hence all such securities fully taxable. Six P.T.E. issues now outstanding, totaling $7.4 billion.

Bank-eligible taxable bonds

Fully taxable bonds eligible for purchase by commercial banks can be divided into three maturity groups. Five issues totaling $24.5 billion mature in 5 years. Seven issues mature between 5 and 10 years:

2 1/2s	56-58	$ 1,449 million
2 1/2s	56-59	3,822 "
2 3/8s	57-59	926 "
2 3/8s	1958	4,245 "
2 1/4s (J.& D.)	59-62	8,752 "
2 1/2s	62-67	2,118 "
		$21,312 million

Only two issues mature in more than 10 years:

2 1/2s	63-68	$2,830 million
2 1/2s Sept.	67-72	2,716 "
		$5,546 million

All bank-eligible taxable bonds involve fourteen issues, totaling $51.3 billion.

Restricted bonds

Some bonds, when issued, have stated date before which commercial banks cannot purchase, e.g., 2 1/2s Dec. 67-72

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(the last issue of restricted bonds) eligible for commercial bank ownership 12/15/62. During 1952, four issues of restricted bonds became bank-eligible. Six issues of restricted bonds are currently outstanding, totaling $21 billion.

Original issue of Government securities

Treasury bills are sold at a discount on a competitive basis for cash. Other securities--certificates of indebtedness, notes and bonds--are generally sold at par (sometimes plus accrued interest if not paid for on date on face of security) for cash or in exchange for maturing securities other than Treasury bills.

Treasury bills

Each week, generally on Thursday, the Treasury invites tenders for a specified amount of Treasury bills to be dated and issued the following Thursday. Tenders may be submitted to any Reserve Bank or branch at or before 2 o'clock p.m., Eastern time, Monday. As bids are received by a Reserve Bank, they are placed in a locked tin box. At closing time, the box is sealed with a time stamp on the seal. The box is opened by a specially designated operating officer in the presence of the General Auditor. Tenders are sorted as to competitive and non-competitive. A tabulation of details regarding the tenders is furnished the Treasury immediately by telephone, and subsequently confirmed by telegram, followed by a detailed typewritten tabulation of all tenders. Late on Monday, the Treasury determines the extent to which tenders are accepted; gives the press a statement announcing the results--showing total bills applied for, total accepted, average price, high bid, low bid accepted, and percentage of low bid accepted--for publication

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Tuesday morning. Non-competitive bids up to $200,000 are automatically awarded at average price of accepted competitive bids; this arrangement is very helpful to country banks and others who do not keep in constant contact with the market.

Other issues

The last offering of marketable securities for cash, other than Treasury bills, was the 2 3/8% Treasury Bonds of June 15, 1958, issued on July 1, 1952. Since 1945, all other marketable certificates of indebtedness, notes and bonds have been issued in exchange for maturing securities (certificates, notes or bonds) on a par-for-par basis, with adjustments to the extent necessary on account of accrued interest. (Except that holders of the non-marketable 2 3/4% bonds of 1975-80 are able to convert to marketable 1 1/2% five-year notes.)

Maturity distribution of marketable debt

Maturity distribution of marketable debt has important bearing on Treasury borrowing problem. Also affects directly rates of interest and ownership stability of different segments of marketable debt. Average maturity relatively short. Heavy concentration of debt due or callable in five years ($104.4 billion - 70 per cent). Floating debt (Treasury bills, certificates, notes, and bonds due or callable in one year) also large, amounting to $74.2 billion (50 per cent). Provides some idea of the magnitude of the Treasury's immediate refunding problem.

Due or first callable	Amount 12/31/52	Per cent
Within 1 year	$ 74.2 billion	50
1 - 5 years	30.2 "	20
5 - 10 years	17.5 "	12
10 - 15 years	26.6 "	18
Over 15 years	--	--
Total	$148.6 billion	100

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Rates

At the present writing (1/26/53), market yields range from 1.90 per cent (bid) for three-month Treasury bills and 1.94 per cent (bid) for eight-month certificates of indebtedness to 2.80 per cent for longest term Treasury bond (19 years, 11 months to maturity). Rates ascend as maturity increases, forming a well-defined and fairly smooth curve of yields--the level and slope of which are subject to constant change, depending on the influences at work at any given time.

Classes of investors and ownership distribution

(Ownership of Government securities in last three decades shown in chart on page 58 of Federal Reserve Chart Book, Historical Supplement, September 1952)

Breakdown of marketable debt by types of issue and by groups of holders is significant with respect to debt management problem. Major groups of investors are:

Commercial banks

Mutual savings banks

Insurance companies, and

"All other", a miscellaneous group including corporations, individuals, trust funds, securities houses, etc.

Also--not "investors", but very important holders:

Federal agencies and trust funds

Federal Reserve Banks

(Ownership of Government marketable securities by class of security and by earliest callable or due date, in last decade shown in charts on pages 32 and 33 of monthly Federal Reserve Chart Book)

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Wide variations in types of securities held by various types of investors; different investors have different needs:

Commercial banks - ideal investment; safety, market stability, ready convertibility into cash, collateral (loan at Federal Reserve Bank), diversity of maturity schedule.

Hold 27 per cent of marketable debt;

83 per cent of holdings due or callable within 5 years.

Mutual savings banks, insurance companies, and pension and other trust funds (institutional investors) - minimum risk for income, and limited supply of other securities.

Business corporation - temporary funds (tax accruals, funds accrued for dividend disbursements, proceeds of new financing until used for capital outlays, etc.) Treasury bills quite important.

Mutual savings banks - hold 5 per cent of marketable debt; 62 per cent of their holdings are due or callable in 10-20 years.

Insurance companies - hold 8 per cent of marketable debt (12 per cent three years ago); 53 per cent of their holdings are due or callable in 10-20 years.

"All others" (excludes Federal Reserve System and Treasury) - hold 31 per cent of marketable debt; 66 per cent of their holdings are due or callable in 5 years.

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Investment needs of various groups influence Treasury in financing operations. One group may constitute most important factor in one segment of market, and another group in another segment; commercial banks historically most important re Treasury bills and certificates of indebtedness; but recently corporations have assumed increasing importance in markets for these issues.

ORGANIZATION AND OPERATION OF GOVERNMENT SECURITIES MARKET

Over-the-counter market

Purchases and sales of marketable United States Government securities are generally effected in the "over-the-counter" market. The over-the-counter market is that broad market in securities which takes place outside of the organized securities exchanges; it is a trading market maintained by several thousand securities houses throughout the United States. It is the principal market for many types of securities. This market has no organized meeting place or tangible center such as the New York Stock Exchange.

Within the over-the-counter market are various specialized markets, of which the Government securities market is one of the most important.* The Government securities market exists and is given substance through the operations of a relatively small group of securities dealers specializing in Government securities.

For many years United States Government bonds have been listed on the New York Stock Exchange but, at least in recent years, the trading in such bonds on the Exchange has been negligible. Shorter term Government securities (Treasury bills, certificates of indebtedness and notes) are not listed or traded on any securities exchange.

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* Another large and important specialized market is the municipal securities market.

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The over-the-counter market is a negotiated market; a certain amount of negotiation is necessary between buyer and seller before a sale can be effected. In the organized markets (the exchanges), the auction principle is used; securities are purchased by the highest bidders and sold by the lowest offerors.

Location of market

The principal market for Government securities is located in New York City and a smaller one in Chicago. The market is centered in the business of a relatively small number of Government securities dealers who have their principal offices in either city. The other principal cities of the country are served directly through the branch offices of the large Government securities dealers; direct wire connections maintained by these dealers bring the larger cities into direct contact with the New York market. Other areas are served directly by these dealers through the use of telephone and teletype contact with the main offices or branches.

In addition, dealers in other types of securities and brokers operate in most of the larger cities, and indeed in any city where the volume of business available makes possible their profitable operations; they satisfy their customers' wants with respect to Government securities by dealing with the large Government securities dealers and their customers pay them for their services. Many banks throughout the country also have trading departments that in turn deal with the Government securities dealers. Many other banks encourage their correspondent banks and other customers to place orders through them. Except for orders usually small in size, which are matched off by banks and securities firms in local markets, the trading is done ultimately with or through the offices or branches of the Government securities dealers in New York City and Chicago.

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An "over-the-telephone" market

Most business in Government securities is done over the telephone; indeed a more correct name for the market might be an "over-the-telephone" market. The dealer has elaborate telephone connections involving private wires with other dealers and also with important customers. There is active communication by dealers with other dealers and with customers. The telephone is a primary factor in the operation of the Government securities market.

General function of dealer

Broadly speaking, dealers in Government securities bring buyers and sellers together; they facilitate ownership change. A dealer (as the name indicates) buys from A and sells to B. A dealer makes a market by establishing bid and offer prices at which he is willing to buy or sell as principal; he normally keeps a substantial investment in a variety of issues (his portfolio). Sometimes a dealer may act as the agent of a buyer in dealing with a seller, or as the agent of a seller in dealing with a buyer; in such a case the dealer is acting as a broker.

Dealer's legal form

As to legal form, a Government securities dealer may be an individual, a partnership or a corporation (including a bank). The most frequent form is that of partnership or corporation. If a dealer is a bank, it is frequently referred to as a "dealer bank".

Dealer's capital

The capital funds which a nonbank dealer has in the business are actually small in relation to the portfolio of securities generally carried by the dealer. It is customary to borrow extensively from commercial banks and others at rates that are lower than those on other types of loans.

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The dealer banks are very large member banks of the Federal Reserve System with large capital funds, and with general banking powers including the power to create deposits.

Sources of dealer's income

A dealer makes his principal income by selling at higher prices than he buys; he frequently makes 1/32nd or 1/64th, which is $312.50 or $156.25 respectively, per $1 million par value of longer-term securities. On short-term securities he may make $100 per $1 million, or less. The dealer also receives some income from interest on his portfolio in excess of carrying charges. He may have capital gains or losses in connection with the sale of securities carried in his portfolio. When a dealer acts as a broker his compensation is a commission.

Customers

The customers of the Government securities dealers are chiefly business corporations, institutional investors (such as savings banks, life insurance companies, pension and retirement funds and charitable foundations) and commercial banks and securities houses acting for their own account or for account of customers. As a rule, individuals do not deal directly with a Government securities dealer; individuals generally arrange their transactions through banks or securities houses. Thus the customers of Government securities dealers generally are informed and experienced in business matters; indeed, many of them are informed and experienced investors but some, e.g., small country banks, have only occasional contact with the Government securities market.

Quotations

There is no published report of purchases and sales in the over-the-counter market. There is no ticker, nor are there daily reports of

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sales and quotations such as are published with respect to transactions on national securities exchanges. The large dealers, however, do issue quotation sheets at the close of business each day,* and they make quotations, upon request, throughout the day. The dealers mail their quotation sheets to a broad list of customers and business prospects. The closing quotations of the principal dealers are printed in the metropolitan newspapers.

Form of quotations

Longer-term securities

Under present practices Treasury notes maturing in more than one year and bonds** are quoted in terms of price--in 1/32nds, sometimes 1/64ths. For example, a quotation of 100.2-100.6 with respect to a particular bond means that $100 and 2/32nds ($100.0625) is bid by the dealer for each $100 par value of the bond, and $100 and 6/32nds ($100.1875) is asked by the dealer.*** The dealer is willing to buy the bond at the "bid price", and he is willing to sell the bond at the "asked price". Payment is made in this amount plus the amount of interest accrued to the date of delivery.

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* The spread between the bid and offer (i.e., the difference between the bid price and the offering price) shown in the quotation sheets is an "outside market spread" which is generally greater than the actual spread at which the dealer is willing to make quotations and do business during business hours.

** Quotation practices with respect to short-term bonds have not always been uniform. Although currently all bonds are quoted on a price basis, at times in the past bonds maturing or callable within one year have been quoted on a yield basis (which will be described shortly in the text).

*** In the pricing of securities which do not mature and are not callable within one year, it is customary to use the decimal system indicated in the text. The digits appearing after the decimal point are customarily 32nds; when these 32nds are translated into dollars and cents (an infrequent occurrence) a dollar sign is placed in front of the quotation, or there is some other special indication that the figure is in terms of dollars and cents.

If, in the example given in the text, the dealer were bidding 100-5/64ths, the bid would be expressed: 100.2+

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Short-term securities

Treasury bills are traded at a discount from par; they are quoted in terms of a rate of discount, e.g., 1.60%-1.53%, or 1.60-1.53. This means that the dealer is willing to pay an amount less than the face amount of the bill so that the income return on the purchase price (assuming the bill is held to maturity, at which time it is paid at par) brings a return at the rate of 1.60 per cent per annum. Similarly, the dealer is willing to sell on a basis which would provide a return to the purchaser of 1.53 per cent until maturity. Before payment is actually made, it is of course necessary to convert the yield at which the trade is made into a price expressed in dollars and cents. As the yield goes down the price goes up, and as the yield goes up the price goes down.

Certificates of indebtedness and notes maturing within one year are customarily quoted on a yield basis, e.g., 1.72%-1.65%, or 1.72-1.65. This means that the dealer is willing to pay an amount which will produce a yield of 1.72 per cent per annum on the investment if it were held to maturity. He is willing to sell at a yield of 1.65 per cent.*

When securities are quoted on a yield basis, the unit is called a "basis point"--1/100th of 1 per cent. If the bid and asked quotations are 1.72%-1.65%, the spread is seven basis points. The value in dollars of a basis point declines as the security approaches maturity.**

* As in the case of Treasury bills, in determining the amount of money to be paid by the purchaser it is necessary to convert the yield at which the trade is made into dollars and cents. The price (of short-term securities other than bills) thus determined is customarily expressed as so many dollars and cents (in respect of principal) plus accrued interest (which, in turn, is so many dollars and cents).

** For example, a basis point with respect to a certificate of indebtedness maturing in six months amounts to $50 per $1 million par value; a basis point with respect to a certificate maturing in fifteen days amounts to $4 per $1 million par value.

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"When issued" securities

Quotations may be made, and purchases and sales may be effected, with respect to securities which have been offered by the Treasury for subscription but have not yet been actually issued by the Treasury. Whenever the Treasury offers a new security for subscription, either for cash or in exchange for a maturing security, it is customary for the dealers to trade in the new security on a "when issued" basis. Such trading may commence the day the subscription books open, in the case of an exchange offering, and the day after the subscription books close, in the case of a cash offering, even though the security is to be issued some time in the future, normally within a couple of weeks. Sometimes "when issued" quotations are referred to by the abbreviation "W.I." on quotation sheets.

Size of trade and duration of quotation

In the absence of an agreement to the contrary, it is generally understood that when a dealer makes a quotation to a customer regarding a particular security, he is ready and willing to buy or sell a minimum amount of the security at the bid or asked price quoted by him; the amount depends upon the type of issue, the condition of the market for that issue and the character of the customer relationship. Generally a primary dealer would be willing to make an immediate commitment "over the wire" for upward of $100,000 par value of longer maturity taxable Treasury bonds,* and $1,000,000 or more in shorter maturities such as Treasury bills and certificates of indebtedness. It is, however, difficult to generalize about the size and reality of dealer markets. They vary not only between different dealers at a given time, but also for the same dealer at different times in accordance with the trend of prices, the volume of trading, Federal Reserve open market

* This would include the various issues of restricted bonds which, pursuant to the Treasury offering circulars describing the respective issues, may not be purchased by commercial banks.

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policy, the dealer's position and a variety of other considerations. No really meaningful statement can be made about the size of a dealer's quoted market except with reference to a specific set of conditions.

Frequently a dealer will make his quotations in such a way as to indicate that they are for information purposes only and that he does not wish to trade at such quotations. He may say, "The market seems to be 100.24 bid 100.28 asked, but I prefer not to buy at that level."

There is frequent checking of quotations by telephone all during the day by customers and other dealers. Bids and offers given over the telephone are good "over the wire"; they are firm bids or offers only while the telephone conversation is going on, unless the dealer expressly agrees that the bid or offer will remain good for a specified period of time, e.g., ten minutes.

Contracts

Purchases and sales are customarily made by oral agreement over the telephone, a written confirmation being dispatched by hand delivery or by mail later in the day.

Delivery and payment

Purchases and sales in the Government securities market are customarily made for delivery "regular way"--that is, delivery and payment on the next full business day following the day of the contract.* In the case of a transaction for "cash", delivery and payment are made on the day of

* A similar rule is applicable to transactions in Government securities on the New York Stock Exchange. Rule 110(b) of Board of Governors of New York Stock Exchange, N.Y.S.E. Directory and Guide, p. E-23. In the case, however, of other securities sold on the New York Stock Exchange, transactions "regular way" call for delivery on the fourth full business day following the day of the contract; the rule was changed to the fourth full business day from the third full business day, effective March 3, 1952. Rules 109(b), 111(b) and 112(b), id., pp. E-22 - E-23. Transactions "regular way" in non-Government securities sold in the over-the-counter market call for delivery on the fourth full business day following the date of the contract. NASD Manual.

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the contract. Occasionally a transaction may involve deferred or delayed delivery; in such case delivery and payment are postponed longer than in the case of delivery regular way. In the case of a transaction on a "when issued" basis, delivery and payment are made on the day the security is issued by the Treasury.

Delivery and payment usually take place in the city in which the dealer's head office is located--that is, New York City.* Sometimes it may occur at other places. Prices, however, are customarily based on New York delivery, and if delivery is made elsewhere there may be an adjustment in the date of delivery or in the price, or both. Payment of the contract price plus accrued interest (except with respect to Treasury bills which are sold on a discount basis) to the day of delivery may be made in "clearing house funds"**

* Government securities may be transferred by wire between Federal Reserve Banks and Branches in order to assist in the consummation of the sale of the securities. Thus if a person in Dallas wishes to sell a security to be delivered to a purchaser in New York, the seller may deliver the security to the Federal Reserve Bank of Dallas, and the Federal Reserve Bank of New York will deliver an equivalent amount of the same security to the designated person in New York. A small charge is made by the United States Treasury for this wire transfer service with respect to Treasury bonds where transactions with the Federal Reserve Banks are not involved; no charge is made with respect to Treasury bills, certificates of indebtedness and notes. F.R.B. Memo No. 554 (First Revision dated June 19, 1950, and First Amendment dated September 22, 1950) from Treasury Department.

** "Clearing house funds" are normally evidenced by a check on a member of the clearing house--the New York Clearing House. The check is collected by presentation by or on behalf of the collecting bank to the drawee bank through the clearing house. The net credit or debit balance of each clearing house bank resulting from the total clearings of the day is settled by an appropriate entry in the reserve account of such bank on the books of the Federal Reserve Bank of New York. Thus, in effect, the reserve balance of the drawee bank is reduced by the amount of the check and the reserve balance of the collecting bank is increased by the amount of the check. Since the latest clearing on any day is at 10:00 a.m., a check received by a collecting bank on one day is normally not cleared until the following business day; therefore, the collecting bank does not get credit for the check until the business day following receipt of the check by it.

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or in "Federal funds".* When the Federal Reserve Bank is a buyer or seller, payment is made in Federal funds; and when delivery is made through the Federal Reserve wire transfer facilities, payment is made in Federal funds. In the case of transactions not involving the Reserve Bank, the use of clearing house funds has been decreasing in favor of Federal funds. Commercial banks frequently enter into transactions calling for payment in Federal funds since many of their transactions are for the purpose of effecting adjustments in their reserve balances at the Federal Reserve Bank; in this way the adjustment of reserves can be made one day earlier. Some corporate sellers also seek payment in Federal funds either because they can sell such funds profitably or because payment in this medium enables the seller to reinvest a day earlier.

Making and maintenance of market

A dealer makes a market when he is prepared both to buy and sell at his quoted price in reasonable amounts. A dealer maintains a market when he continues over a period of time to state prices at which he is ready and willing to buy and sell. He generally owns a substantial quantity of a variety of issues (his portfolio or his position) and normally stands ready to buy and sell in size. He may freely sell a particular issue even though he may have none of the issue in his portfolio; he makes a "short sale" and borrows the security from someone who has it in order to make delivery to

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* "Federal funds" are normally evidenced by a check or other demand order on a Federal Reserve Bank. Upon presentation of the check to the Reserve Bank by a member bank, the member bank may obtain immediate credit to its reserve account. Special arrangements are often made between a dealer and his customer (especially if the customer is a bank) for settlement in Federal funds, but since such funds are themselves traded in a negotiated market at a price an additional charge is normally made for the Federal funds.

See article on "Federal Funds" at pp. 13-16 of FRBNY publication entitled "Money Market Essays", March 1952.

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the purchaser.* The size of the transactions into which he is willing to enter is determined by many factors, including his total position, the condition of the market, the issue in question, his capital and borrowing capacity, and the customers involved.

Dealer positions are not rigidly maintained in periods of changing prices. At any given time, a dealer is generally long certain issues and short certain others; in other words, he owns certain issues and he has sold other issues without owning them at the time of sale. In the latter case he will have to buy an equivalent amount of the securities sometime in the future to replace those he has borrowed in order to make delivery pursuant to his contract of sale. In maintaining such long position and short position the dealer obtains some protection against changes in the general average of Government securities prices.** Usually the long position and the short position are not equal; the dealer may purchase securities, or sell securities short, in order to satisfy the demands of a customer without the dealer's undertaking to "hedge" his position by entering into an offsetting sale or purchase. The dealer is generally content to be either net long or net short, depending on his judgment of the future course of the market. In the case of day-to-day market fluctuations (as distinct from more sustained basic changes in rates and prices) dealers, in varying degree, accumulate securities on declining markets and dispose of securities on rising markets.

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* The lender generally charges a fixed rate, e.g., 1/2 per cent per annum, for the period the securities are loaned, and the borrower pledges cash or other securities as collateral to his obligation to replace the securities he has borrowed.

** If the securities owned decline in market value, the securities sold short are also likely to decline in market value, and the dealer will be able to "cover" his short position by buying the securities at a lower price than that at which he sold them; thus the book loss on the long side is offset, at least in part, by the book profit on the short side. The converse occurs when there is a general rise in the market value of Government securities.

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Ordinarily, the creation and maintenance of a market is a delicate task and can be done profitably only by constant contact with investors, other dealers and other segments of the market, and by close study and careful estimates of current and prospective Federal Reserve credit policy and other Government policies. As a general rule, the market trend is not determined by one dealer but by all dealers, who reflect their appraisal of demand and supply by the markets they make (their bid and offered quotations) and constantly refine their quotations through telephone calls from dealer to dealer.

In the case of extraordinary market conditions, such as those which might be precipitated by war, economic crisis, or abrupt and basic changes in Treasury debt management policy and Federal Reserve credit policy, the dealer is not likely to function in the manner outlined in the three preceding paragraphs; he tends to act merely as a broker, bringing buyers and sellers together without taking a substantial position of his own in the securities. Under extraordinary market conditions he may operate as a dealer on a limited basis within a wide and sharply fluctuating range of prices, but his willingness and ability to do so generally vary in the light of his judgment of prevailing conditions.

Dealers' participation in primary and secondary distribution of Government securities

While the first function of the dealers is the maintenance of an effective market for outstanding Government securities, the dealers are of substantial importance from time to time in the primary and secondary distribution of new Treasury issues. They explain the market position and relative attractiveness of new issues of Government securities to their customers, and, before World War II, acquired large amounts of new securities on original issue in anticipation of selling the securities to their customers. The new securities may be acquired for cash paid to the Treasury

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or in exchange for maturing securities surrendered to the Treasury, depending on the nature of the Treasury offering. The dealers assist in the secondary distribution by promptly making a market for the new issue.

When the Treasury offers a new issue in exchange for a maturing issue, the dealers assist in the making of the exchange and the redistribution of the new issue. If the holder of a maturing security does not wish to make the exchange (perhaps because the maturity of the new issue is not suited to the holder's investment needs), a dealer will buy the maturing security* and sell it to a person who would like to acquire the new security; or the dealer may sell the new security on a "when issued" basis, meanwhile tendering the old security in exchange for the new security which the dealer will deliver to the buyer.

Purchases and sales of new securities on a "when issued" basis assist in the distribution of the new security among investors.

Dealers' advice to customers

The dealers also function to an important degree as a clearing house for information related to Treasury securities and policy and they furnish their customers with an extensive amount of statistical material and investment advice.

The dealers have men whose business it is to be familiar with their customers' portfolios and to maintain frequent contact, by telephone and otherwise, with customers. These men are referred to sometimes as "salesmen", "contact men", "account advisers", and the like. A dealer's staff generally includes one or more statisticians who are continually analyzing the comparative yields, tax data and other features of various Treasury issues. They pass this information along to the contact men, and the latter use it in conjunction with their knowledge of a particular customer's situation

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* The maturing securities are frequently referred to as "rights" because they entitle the holder to get the new securities.

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and the conditions in the market. Thus the contact men are in a position to, and do, give advice to customers.

The dealers are an important factor in the shaping of public opinion regarding the management of the public debt and related matters.

Credit risk not a factor

In certain respects the problems of the Government securities market are simpler than those of the over-the-counter market in other securities. The Government securities market concerns the issues of only one obligor. This obligor has a variety of issues of varying maturities and interest rates. Differences in the various securities result from different maturities, different interest rates, different degrees of taxability and different rules as to eligibility for commercial bank investment. The credit risk which differs so greatly with respect to issues in the corporate and municipal markets is not a factor in the Government securities market.

Advantages of over-the-counter market over exchange market

Historically, the over-the-counter market for Government securities grew in competition with the market for Government securities on the New York Stock Exchange. The fact that the former has displaced the Exchange as a market mechanism seems to indicate that the over-the-counter market was better adapted to handle the volume and type of business which has developed in Government securities over the past three decades. Some of the advantages which have led to this development are as follows:

(1) In trading in the over-the-counter market, the buyer or seller does not have to disclose his "hand", as is necessary in the case of an auction on the Exchange; consequently large blocks of Government securities are generally salable at better terms through the private negotiations which characterize the over-the-counter market.

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(2) Since orders to buy and sell on an exchange must be executed in order of receipt, a small order would take precedence over a large order, and at times might materially affect the price of the large block.

(3) The over-the-counter market provides the means for a quicker and simpler transaction--generally it involves only a telephone call. Since a dealer generally acts as principal and "makes a market", he immediately furnishes the customer with quotations. The customer may execute many of his trades at the quoted prices "on the wire", frequently on the first call depending on the size of the transaction and the issue involved.*

(4) The concentration of marketable Government securities in the hands of large investors narrows the market in a numerical sense and affords the dealer closer contact with investors.

(5) Since the carrying of a portfolio facilitates a dealer's service, the dealer has the opportunity to make a profit over and above the trading profit whenever the money needed to cover the cost of the securities is obtainable at interest rates lower than the coupon rates on the securities held.

(6) Dealers assume risks, thereby reducing the possibility of a trade going uncompleted, provided the

* This is especially important in the shorter term issues such as Treasury bills, certificates of indebtedness and notes, which are the principal medium for adjustment of bank reserves; the larger commerical banks frequently find it desirable to sell or buy on very short notice to maintain their reserve positions or to keep as fully invested as possible.

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investor does not require execution at a specific price or prices which the dealer will not meet.

Supervision of Government securities market

Unlike the stock market, the Government securities market is not generally subject to detailed supervision by a Governmental body.

The Securities Act of 1933 is generally applicable to the issuance and distribution of securities, and the Securities Exchange Act of 1934 is generally applicable to transactions in securities on national securities exchanges and in the over-the-counter market. Under both Acts, however, United States Government securities are classified as "exempted securities", and the general rules under those Acts do not apply to such securities.

Nevertheless, most Government securities dealers are subject to supervision or regulation in varying degrees. The dealer banks are, of course, subject to general supervision by the bank supervisory authorities. Some of the nonbank dealers are members of the New York Stock Exchange, and some are members of the National Association of Securities Dealers, Inc. (sometimes referred to as NASD)*. Dealers who are members of the Exchange are subject to some supervision and disciplinary action by the Exchange, even with respect to transactions involving Government securities. Many of the nonbank dealers are also registered with the Securities and Exchange Commission under section 15(b) of the Securities Exchange Act of 1934. In addition, some of the provisions of the Securities Act of 1933 and of the Securities Exchange Act of 1934--e.g., those prohibiting fraud--are

* The NASD is registered as a national securities association pursuant to subsection (b) of Section 15A of the Securities Exchange Act of 1934. Said section, popularly known as the Maloney Act, which became effective in 1938, was adopted primarily to provide for cooperative regulation of the over-the-counter securities market by placing the burden of such regulation upon representative organizations with the Government (through the Securities and Exchange Commission) exercising supervisory powers.

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applicable to transactions by dealers even though "exempted securities" are involved. Since some of the nonbank dealers also do business in non-exempted securities, they are subject to supervision in respect of such business and this is a general restraining influence upon their activities.

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FEDERAL RESERVE PARTICIPATION IN GOVERNMENT SECURITIES MARKET

Resume

Purchases and sales of Government securities by the Federal Reserve Banks are effected in the Government securities market by the Federal Reserve Bank of New York (hereinafter sometimes referred to as the New York Bank). Such transactions are referred to as "open market operations", and are conducted under the direction of the Federal Open Market Committee. The securities acquired pursuant to such operations are held in a "System Open Market Account" in which the twelve Federal Reserve Banks participate.

Although conceivably the New York Bank might deal with practically any person wishing to buy or sell Government securities, as a matter of policy and practice established by the Federal Open Market Committee the Bank deals only with a limited number of Government securities dealers. The Reserve Bank maintains a trading room which has direct telephone connections with such dealers located in New York City. It is through these dealers that primary contact with the Government securities market is maintained.

The Bank deals only with the market, i.e., with dealers. The satisfaction of normal buying and selling desires of investors is carried out by the dealers who endeavor to match off buyers and sellers at prices determined by the balance of supply and demand, but who are prepared to increase or reduce their own portfolios when necessary to balance what appear to be temporary excesses of demand or supply.

By confining System dealings to the market, the volume of System Account transactions is minimized while their effects on the market are magnified.

Federal Reserve objectives

The Federal Reserve System is primarily concerned with providing those monetary and credit conditions which, when coupled with sound fiscal

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and other Governmental policies, will help preserve the integrity of the dollar and facilitate the continuance of a high level of production and employment in the country. Preservation of the integrity of the dollar and its purchasing power seems to the System to be the most important and effective method of preserving confidence in Government securities.

Traditionally, the Federal Reserve System has sought to provide desirable monetary and credit conditions by general and impersonal steps affecting member bank reserves. The principal instruments of credit control have been the discount rate, open market operations and changes in reserve requirements.* Open market operations constitute the most flexible and most used instrument in the expression of Federal Reserve policy. These operations affect not only the supply and availability of bank credit by increasing or reducing member bank reserves, but also the cost of such reserves; such operations influence the prices and yields of Government securities and therefore the terms on which the Treasury can borrow. Their influence is pervasive and reaches out beyond the narrower limits of the Government securities market into the entire securities market and the mortgage market.

In addition to its primary responsibility of influencing the money and credit supply in the light of economic conditions, the Federal Reserve System at times undertakes to moderate extreme fluctuations in money market conditions, such as those arising from shifts in the distribution of Treasury balances between Federal Reserve Banks and Treasury Tax and Loan Accounts at

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* The authority to change reserve requirements, conferred upon the Board of Governors of the Federal Reserve System by the Banking Act of 1935, was first used in the summer of 1936.

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the commercial banks, variations in Federal Reserve float*, changes in gold stock, seasonal demands for currency, etc.

Apart from its strictly credit functions, the System has assumed other important responsibilities which have been subject to different degrees of emphasis at different times in the past. Among these are:

(1) The maintenance of orderly conditions in the Government securities market to (a) provide a sound background for effective implementation of Federal Reserve credit policy, and (b) encourage an atmosphere conducive to investor confidence and interest in Government securities as an investment medium.

(2) Conditioning the market at times when the Treasury is refunding maturing securities, or selling new securities for cash, by providing, within the limits of Federal Reserve monetary and credit policies, (a) rate stability which will encourage the placement of subscriptions for the new securities, and (b) whatever funds are needed to accomplish satisfactory placement of the new securities.

For a number of years up to March 1951, the Federal Reserve also provided rate stability even to the extent of outright support at times when there was pressure on the rate structure.

<u>Effect of open market operations on member bank reserves</u>

Purchases of Government securities by the Federal Reserve Banks increase the supply of reserves available to the commercial banks, while

* Federal Reserve "float" is one form of Federal Reserve Bank credit; it is available for use by member banks in meeting reserve requirements. Float arises because under certain circumstances a Reserve Bank credits a member bank's reserve account in respect of some of the checks deposited by the member bank with the Reserve Bank, before the Reserve Bank is able to collect such checks. Float is the difference between the "uncollected items" on the assets side of a Federal Reserve Bank statement and the "deferred availability items" on the liabilities side. The amount of float is subject to wide variation from day to day.

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sales have the opposite effect.* Stated in an oversimplified way, if the Reserve Banks buy Government securities the check of the Reserve Bank to the seller is deposited in some member bank, and when the member bank presents the check to the Reserve Bank for payment the member bank gets a credit to its reserve account. Thus open market purchases by the Reserve Banks increase bank reserves. Conversely, if the Reserve Banks sell Government securities, payment by the purchaser is ultimately effected by drawing down some member bank's reserve account with the Federal Reserve Bank.

If a member bank is the ultimate seller or purchaser of securities which are purchased or sold by the Reserve Bank, there is no change in the total deposits of the commercial banks of the country. The member bank's reserves are increased or reduced, but there is no change in its liabilities; the member bank has merely exchanged one type of asset for another (securities for "cash" or "cash" for securities). But the ability of the member bank to expand its deposits, by making loans or acquiring investments, is effected several-fold by the change in its reserves. On the other hand, if a person other than a bank is the ultimate seller or purchaser, funds are deposited in or withdrawn from a member bank and the commercial bank deposits of the country, as well as member bank reserves, are increased or reduced.

Speaking more precisely, this is how open market operations affect member bank reserve balances. The Reserve Bank makes its purchase

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* When member banks make loans or purchase investments (except loans to, and purchases from, other banks), the deposits of the banking system are increased by the amount of the loans or investments; and since, by law, every member bank is required to keep on deposit in its Federal Reserve Bank a certain percentage of its deposits, the required reserves of the banking system increase as the banks make loans or purchase investments. Conversely, as loans are repaid or investments are sold or paid, deposits contract and the required reserves are less. Thus by influencing the amount of availability of member bank reserves the Federal Reserve System is able to influence the credit policies of the member banks.

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from, or sale to, a Government securities dealer. The Government securities dealer maintains an account with one or more local member banks which lend him the funds needed to finance his purchases and to carry his position. In some cases, the bank also acts as clearing agent for his securities transactions. In making or receiving payment for his transactions with the System Account, the dealer arranges with his bank of account to make debits and credits to the bank's reserve account at the Federal Reserve Bank. For example, when a dealer delivers securities to the Federal Reserve Bank against payment, he instructs the Reserve Bank to credit payment to the reserve account of the member bank at which he keeps his deposit, and he receives from the Federal Reserve Bank a "certified credit advice" which he presents to that bank. Under certain circumstances, the dealer may prefer to receive payment by check on the Federal Reserve Bank in which case the Reserve Bank issues its officer's check. When a dealer picks up securities at the Federal Reserve Bank he must pay for them with Federal funds. To do this he may arrange with his bank to obtain either a debit to its reserve account or a check drawn by it on the Federal Reserve Bank. The debit to the reserve account is generally in the form of a letter of authorization to the Federal Reserve Bank from the member bank to charge its reserve account.

Effect of management of Treasury
balances on Federal Reserve operations

The way in which the Treasury handles its cash balances has a bearing upon the money market, and upon the Government securities market, especially upon the market for shorter-term Government securities.

The Treasury maintains working deposit balances at each Reserve Bank and branch. It also has deposits in depositary accounts designated as "Treasury tax and loan accounts" in more than ten thousand special depositaries; such depositaries are usually commercial banks and, for purposes

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of simplicity in this memorandum, all such depositaries are considered as being commercial banks. With limited exceptions Treasury disbursements are made only out of deposits in the Reserve Banks and branches. The commercial banks serve, in effect, as collection points in which a substantial proportion of Treasury receipts is initially deposited. These tax and loan accounts are carried on the books of the depositary in the name of the Federal Reserve Bank as fiscal agent of the Treasury.

Nearly all such deposits are transferred from the commercial banks to the Reserve Banks before they are spent. These transfers are made pursuant to "calls" announced by the Treasury in advance; member bank reserve balances on the books of the Reserve Banks are transferred to the accounts of the Treasurer of the United States at the Reserve Banks. Thus the flow of receipts through the commercial banks into the Treasurer's working accounts from which disbursements are to be made inevitably results in a reduction of member bank rese ves. In addition, a substantial proportion of the Treasury's receipts is deposited by the collectors of internal revenue directly in the Federal Reserve Banks, and unless special arrangements are made, collection of the items so deposited reduces member bank reserves. In the absence of offsetting factors, member bank reserves remain reduced until the Treasury pays out the funds. When the Treasury spends the money and the recipients deposit the Treasury checks in the commercial banks, the latter collect the checks from the Reserve Banks and member bank reserves are increased.

As member bank reserves are reduced or increased as a result of the routine receipt and disbursement of Treasury funds, a corresponding tightening or easing influence is exerted upon the money market. Since it is impracticable to achieve a precise matching of the amount of Treasury receipts and disbursements on any given day, Treasury transactions must always be expected to exert an important day-to-day influence upon conditions in the money market. During 1952, the flow of funds through the Treasury tax and loan accounts exceeded $42 billion.

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The Treasury must be sure that it has adequate balances on hand to assure payment of checks drawn on the Treasurer of the United States, whenever those checks are presented at any Federal Reserve Bank or branch throughout the United States. To meet this operating requirement, the Treasury maintains balances at the Federal Reserve Banks sufficient to cover its estimated daily needs on a regional basis. The Treasury seeks to maintain a total of at least $200 million; for operating convenience, $400 million is desirable. For the scale of expenditures prevailing in 1953, many of them subject to erratic fluctuations, the Treasury should have at least $1 billion of balances in the commercial banks upon which calls can be made to replenish the balances in the Federal Reserve Banks.

The Treasury generally has sought to manage its balances in such a manner as to minimize the impact of changes in its cash receipts and disbursements upon the money market and the Government securities market.

Forecasting techniques

For some time, but particularly during the last decade, the staffs of the Treasury, the Board of Governors of the Federal Reserve System, and the Federal Reserve Bank of New York have devoted considerable effort to developing and refining techniques of forecasting the factors which affect the Treasury's cash receipts and disbursements. Detailed forecasts are now prepared by each staff on a daily, weekly, monthly and annual basis.

The demands of the public for currency, the direction and the amounts of gold flows, changes in foreign accounts at the Reserve Banks and the movement of Federal Reserve float are also estimated on a daily and weekly basis. Prospects for employment, production, national income, and consumer expenditures are considered in order to estimate the tax liabilities of individuals and businesses, the rate of defense expenditures, unemployment compensation and the like. After yearly or quarterly totals

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for the various classes of Treasury cash receipts and disbursements have been derived from the estimates of the business situation, monthly and daily distributions of these totals are worked out, and the proportion of the receipts which will be deposited in the Reserve Banks or the commercial banks is estimated.

The conclusions of the forecasts are exchanged and compared among the three staffs. Although forecasts are still frequently wide of the mark, as actual circumstances develop, they have for several years been very useful.

Criteria

The projections having given a picture of prospective Treasury receipts and disbursements, consideration must be given to (1) other projections estimating changes in bank reserves, and (2) System policy regarding the supply, availability and cost of member bank reserves.

As a general rule, when bank reserves decline to a point where excess reserves of all member banks are below $600 million some banks are hard put to keep their reserves equal to their requirements, although no firm figure can be used because much depends on the distribution of these excess reserves among the banks (particularly as between New York City and the rest of the country). The banks possessing reserve funds above their requirements become reluctant to sell their excess, and rates on Federal funds rise. The banks needing reserve funds hesitate to buy Government securities and, indeed, if the pressure is great enough, may offer Government securities for sale in order to acquire reserves. Developments of this kind result in falling prices for Government securities. On the other hand, when member bank reserves rise above their requirements by more than about $800 million for more than a day or so, the supply of Federal funds usually becomes flush and some banks become buyers of short-term investments. In

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response to these influences prices of short-term securities tend to rise and the rates on such securities tend to decline.

Obviously, from time to time there will be situations in which a reduction or postponement of a Treasury call, or a special call, or a call in an increased amount will bring about an adjustment in member bank reserves which may avert or reduce the need for System action to reduce or increase bank reserves through sales or purchases of Government securities.

Making the calls

In order to facilitate the making of calls, depositaries are classified into two groups: Group A includes all depositaries having Treasury tax and loan balances of $150,000 or less at the close of business on a date specified by the Treasury; Group B includes all depositaries having Treasury tax and loan balances of more than $150,000 on that date. The Treasury chooses a new bench mark date from time to time (generally at least once a year) in order to keep the classification of banks in line with continuous changes in the magnitude of the Treasury accounts on their books.* When frequent calls are made they generally apply only to the Group B banks. Normally only one call is issued each month for the Group A depositary accounts. Income and profit tax payments of $10,000 or more are usually deposited in whole or in part in these tax and loan accounts, but they are segregated as "X balances." Separate calls may be made on these X balances, too.

There is frequent consultation by the operating officials of the Treasury and the Federal Reserve officials charged with conducting System open market operations. On the days that calls are announced, officials of the Reserve Bank and of the Treasury consult over the telephone as to the timing and the amount of the calls for the coming period. Call days customarily are Monday and Thursday. Payment days for calls made on Monday are the following Friday and the next Monday. Payment days for Thursday

* For example, see FRBNY Circular No. 3938, January 23, 1953.

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calls are Tuesday, Wednesday and Thursday of the next week. In these telephone conversations an agreement is reached on the funds to be withdrawn and the days on which payment is to be made.

The details of a call having been determined by the Treasury, it announces that a call is being made on the Group A or Group B banks in an amount equal to a specified percentage of the deposits in their Treasury tax and loan accounts at the close of business on a specified date, and that payment of such amount is to be made on a specified date or dates. The Reserve Bank advises each commercial bank in the district of the amount of the call upon such banks and handles the details of getting payment into the Treasurer's account on the books of the Reserve Bank.

General

Apart from the actual calls themselves, there are a number of other techniques which the Treasury has developed over the past few years to minimize the possibility of unusual stringency in the money market as the result of Treasury cash operations. Several of these techniques have been described briefly in an article entitled "The Treasury's Cash Balances" which was published in the Monthly Review of the Federal Reserve Bank of New York for July 1951.

Authority for Federal Reserve operations

The Federal Reserve Banks have broad authority to buy and sell in the open market a variety of credit instruments.* In recent years purchases and sales have been confined in practice chiefly to obligations of the United States. In earlier times, however, bankers acceptances played an important role in System operations, and may again. For present purposes, only transactions in United States Government securities need be considered. The Federal Reserve Act provides that these operations "shall be governed

* Federal Reserve Act, § 14.

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with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country".*

Open market operations are conducted under the direction of the Federal Open Market Committee, composed of the seven members of the Board of Governors of the Federal Reserve System, the President of the Federal Reserve Bank of New York, and the Presidents of four other Reserve Banks who are chosen in rotation annually.** It has been customary for the Committee to select the Chairman of the Board of Governors and the President of the New York Bank as Chairman and Vice Chairman, respectively, of the Committee.

The Committee has issued a Regulation which provides, among other things, for an Executive Committee consisting of five members. The principal function of the Executive Committee is "to direct the execution of transactions in the open market in accordance with open-market policies adopted by the Federal Open Market Committee."*** In practice the Executive Committee has consisted of the Chairman and Vice Chairman of the full Committee (who also serve as Chairman and Vice Chairman, respectively, of the Executive Committee), two other members of the Board, and one other Reserve Bank President. The full Committee is required to meet at least four times a year; the Executive Committee meets more frequently, generally monthly or oftener.

The Federal Open Market Committee selects one of the Federal Reserve Banks to execute transactions for the System Open Market Account. Such Bank selects a Manager of the Account, satisfactory to the Committee.****

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* Id., § 12A(c).

** Id., § 12A(d)

*** FOMC, Rules on Organization and Information, § 3(c)(1).

**** FOMC, Rules on Organization and Information, § 4(b).

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The Manager serves at the pleasure of the Committee and attends all meetings of both the Committee and Executive Committee. The Federal Reserve Bank of New York has always been selected by the Federal Open Market Committee to execute transactions for the System Open Market Account, and the Vice President of the Bank in charge of such transactions has always been Manager of the System Open Market Account.

No Federal Reserve Bank may engage or decline to engage in open market operations except in accordance with the directions of the Committee.*

Delegation of authority by FOMC

It has been the practice of the Federal Open Market Committee to delegate broad authority to its Executive Committee, and for the Executive Committee in turn to delegate broad authority to the Federal Reserve Bank of New York to operate the System Open Market Account. The authorizations by the full Committee to its Executive Committee and by the Executive Committee to the New York Bank include, among other things, directions to arrange for transactions for the System Open Market Account, either in the open market or directly with the Treasury**, as may be necessary in the light of economic conditions and of the general credit situation of the country, for the practical administration of the Account, for the maintenance of orderly conditions in the Government securities market, and for the purpose of relating the supply of funds in the market to the needs of commerce and business.

* Federal Reserve Act, § 12A(b).

** It is customary to include authority to purchase for the System Open Market Account direct from the Treasury special short-term certificates of indebtedness needed from time to time for the temporary accommodation of the Treasury, provided the total amount of such certificates held at any one time does not exceed a specified amount.

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The full Committee generally places a limitation, e.g., $2 billion, upon the increase or decrease that may take place (pursuant to the authorization) in the amount of securities held in the System Account, and the Executive Committee generally prescribes a lesser maximum in its directive to the New York Bank. The amount of the limitation depends upon anticipated market and economic conditions and Committee policies.

Although the formal authorization to the New York Bank is broad, in practice its operations are directed by the nature of the discussion taking place at the meetings of the FOMC and of the Executive Committee. The consensus expressed at such meetings and the highlights of the discussion are customarily recorded in the minutes of the meetings. The authorizations of the FOMC together with the reasons underlying the action of the Committee are published in the "Record of Policy Actions" of the FOMC which is set forth in the Annual Report of the Board of Governors.* There is, however, no public record of action by the Executive Committee or of the discussion at its meetings.

Since the President of the New York Bank is Vice Chairman of both Committees, and since the Manager of the System Open Market Account attends all meetings of both Committees and both receive copies of the minutes of all meetings, they are fully informed of the consensus and discussion, and the New York Bank is able to conduct its operations in the light thereof. There is also timely consultation, oral or otherwise, by the Vice Chairman and the Manager of the Account with the Chairman and other members of the Executive Committee (or of the FOMC), and there is frequent discussion, oral or otherwise, by the Manager of the System Open Market Account and his staff with the Board's staff which is also the staff of the FOMC.

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* See 1950 Annual Report of B/G FRS, pp. 80 et seq.

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Thus the Federal Reserve Bank of New York acts within broad formal authority, being guided within that authority by the tenor of the discussion at the meetings of the FOMC and of the Executive Committee, supplemented by informal discussion with members of such Committees and members of the staff.

Allocation of securities in System Open Market Account

Securities in the System Open Market Account are allocated by the Federal Open Market Committee among the individual Federal Reserve Banks on the basis of their expense and dividend requirements. The formula is based on estimates for the year of each Federal Reserve Bank's expenses, dividends and earnings from sources other than securities in the System Open Market Account. Ratios of the estimates for each Federal Reserve Bank to those for the twelve Federal Reserve Banks combined are then computed and securities in the System Open Market Account are allocated on the basis of these ratios.

Adjustments may be made in the allocations from time to time if the reserve position of a particular Federal Reserve Bank indicates that an adjustment is desirable or if the allocations on the basis of the original estimates are no longer appropriate.* If, for example, the reserve ratio of a particular Reserve Bank should fall below a certain point, the quantity of Treasury bills or other securities allotted to such Bank might be reduced by a transfer to other Reserve Banks with higher reserve ratios. Settlement for such a transfer, through the Interdistrict Settlement Fund, increases the reserves of the Bank whose holdings are reduced, and reduces the reserves of the Banks whose holdings are increased.

* The foregoing description appears in Hearings before Subcommittee on Monetary, Credit and Fiscal Policies of the Joint Committee on the Economic Report (pursuant to Sec. 5(A) of P. L. 304, 79th Cong.), 81st Cong., 1st Sess. 38 (1949).

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Federal Reserve operations limited
to Government securities dealers

The Federal Reserve Bank of New York transacts open market operations with dealers in Government securities (including certain dealer banks), and may also do business on the New York Stock Exchange with qualified member firms. It does not do business directly with banks or other investors, except to a limited extent with the United States Treasury and foreign central banks and international organizations having accounts with the Federal Reserve Bank of New York. Open market transactions are effected with a small number of Government securities dealers who do a substantial business on a national scope in the various types of Government securities and who have adequate capital to conduct such business.

The Federal Open Market Committee has directed the New York Bank to transact business in Government securities for the System Open Market Account with responsible dealers (or through responsible brokers) who meet certain qualifications prescribed by the Committee.

Underlying these standards of qualification are certain basic principles of which the most important is that there should be an active market for Government securities among investors and dealers, independent of Federal Reserve transactions. The satisfaction of normal buying and selling desires of investors should be the primary function of the dealers, who endeavor to match off buyers and sellers at prices determined by the balance of supply and demand, but who are prepared to increase or reduce their own portfolios when necessary to balance what appear to be temporary excesses of demand or supply.

The purposes served by the System's open market operations have had an important bearing upon the System's relations with dealers in Government securities. As previously indicated,* the System's objectives have been

* At pages 27-29.

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primarily to influence the availability of credit and secondarily to prevent disorderly conditions in the Government securities market, to condition the market at times of Treasury financing operations, and to provide rate stabilization under certain extreme conditions. The System aims to conduct its operations so as to promote the effective functioning of the market mechanism, not to replace that mechanism. The Reserve Bank has sought to accomplish its purposes with a minimum of buying and selling. In seeking to prevent disorderly market conditions, the System has operated in the market to supplement the activities of dealers when imbalances between demand for and supply of securities developed.

In determining those with whom the Federal Reserve System might do business, there are two broad approaches: (1) the System might deal directly with any investor or dealer who wishes to buy or sell Government securities; or (2) the System might deal with that portion of the Government securities market where the final effort at private purchase and sale takes place.

It has been the view of the System that if the first alternative were followed the System would run the risk of becoming almost the sole market for Government securities and, therefore, of losing the opportunity for discretion or initiative in its open market operations for the purpose of affecting the supply of bank reserves. Under the second alternative, investors would continue to effect their transactions in Government securities through ordinary market channels with or through brokers and dealers of all sizes in all parts of the country, and the bulk of all transactions would be effected privately. In order that System actions relating primarily to credit policy might be readily completed and that actions relating primarily to orderly markets, Treasury operations, and rate stabilization would not result in unnecessary recourse to the System, the Federal Open Market

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Committee adopted the second alternative of dealing with the portion of the market where the final effort at private purchase and sale takes place, the dealer market.

The Federal Reserve has followed the practice of effecting its purchases and sales of Government securities only with dealers who make primary markets, have broad national contacts, do a large volume of business in all types of these securities, and have the capital to support the requisite volume of credit. The standards of qualification are built around these considerations. Restricting Federal Reserve business to dealers who meet these standards (through whom in the ordinary course of events the greater part of the business ultimately flows) was considered desirable, for it is better calculated to preserve a Government securities market in which brokers and dealers, both large and small, might continue to participate. The problem of drawing the line between qualified dealers and others is not always easy, but unless the System is to undertake to buy and sell directly with everyone, a line must be drawn.*

Relationship of FRBNY and
Government securities dealers

In 1944, after long consideration, the Federal Open Market Committee formalized the relationship which had previously existed between the Federal Reserve Bank of New York and the principal brokers and dealers in Government securities. At a meeting held February 29, 1944, the Committee approved in substance a statement of proposed terms upon which the Federal Reserve Bank of New York would transact business with brokers and dealers in Government securities for the System Open Market Account. (Such statement

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* See Reply by Chairman of Federal Open Market Committee (in collaboration with the Vice Chairman) to questionnaire addressed to him by Subcommittee on General Credit Control and Debt Management of Joint Committee on the Economic Report, set forth in Joint Committee Print, entitled "Monetary Policy and Management of the Public Debt" (82d Cong., 2d Sess.) Part I, pp. 623-625 (Feb. 1952).

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is sometimes referred to in this memorandum as the "Statement of Terms".) The record of the Committee's action and the Statement of Terms are set forth in the 1944 Annual Report of the Board of Governors, at pages 48-51. A copy of the Statement of Terms is attached hereto, marked Exhibit A.

The Committee authorized its Executive Committee to decide when the approved procedure should be put into effect and to issue appropriate instructions to the New York Bank. Such instructions were issued by the Executive Committee on May 6. By May 15 the New York Bank had concluded written agreements with all brokers and dealers who, in the opinion of the Bank, met the qualifications prescribed by the Committee, and on May 15, 1944, the new procedure was put into effect.

Pursuant to the Statement of Terms, the New York Bank does its Government securities business with reputable brokers and dealers who meet certain qualifications and make certain agreements with the New York Bank. There are now ten dealers, including five dealer banks, who have met such qualifications and have made such agreements. The Reserve System has never published the names of the qualified dealers because it felt that it should avoid any public act which might be interpreted as disadvantageous to or a reflection upon the dealers who were not "qualified". It is believed that the "qualified" dealers account for about ninety per cent of the business transacted in Government securities by the dealers in New York City.

The factors to be considered in determining whether the Federal Reserve Bank of New York will transact business with a particular dealer are set forth in paragraph 1 of the Statement of Terms, as follows:

(a) Integrity, knowledge, and capacity and experience of management;

(b) observance of high standards of commercial honor and just and equitable principles of trade;

(c) willingness (in the case of a dealer) to make markets under all ordinary conditions;

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(d) the volume and scope of business and the contacts such business provides;

(e) financial condition and capital at risk of business; and

(f) the reliance that can be placed on such person to cooperate with the Bank and the Federal Open Market Committee in maintaining an orderly market for Government securities; to refrain from making any recommendations or statements or engaging in any activity which would encourage or stimulate undue activity in the market for Government securities; and to refrain from disclosing any confidential information which he obtains from the Bank or through his transactions with the Bank.

Having met these tests, a dealer must then agree in writing to comply with certain terms and conditions set forth in paragraph 2 of the Statement of Terms. These involve principally an undertaking to furnish certain information to the Federal Reserve Bank on a confidential basis (par. 2(a)), and generally not to solicit business from others for the purpose of putting himself in a position to do business with the Reserve Bank (par. 2(e)).

The information called for under paragraph 2(a) of the Statement of Terms includes a daily report showing, among other things, the dealer's gross long position, gross short position, net position in Government securities and borrowings as of the close of business each trading day, and the volume of transactions on such day. The information is furnished according to classes of securities, on a form furnished by the Reserve Bank. At times, when a Treasury financing operation is under way, the reports are expanded to include data on the dealer's own subscriptions to the new issue or issues and his purchases and sales of such issue or issues.*

Three of the factors set forth in paragraph 1 of the Statement of Terms are deserving of special comment at this time. They are factors (c), (d) and (e).

* Similar reports are also received on a voluntary basis from several unqualified dealers.

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(c) Willingness (in the case of a dealer) to make markets under all ordinary conditions

The positions which a dealer maintains in the various classes of securities (Treasury bills, certificates of indebtedness, notes and bonds of various kinds) are evidence of his willingness to make a market; hence these figures are important, although not conclusive.

Where a dealer consistently has an insignificant position in one or more classes of Government securities, one may tentatively conclude that the dealer is unwilling or unable to make a market in that segment under all ordinary conditions; he would probably transact an "order business" in that segment of the market. On the other hand, the fact that a dealer consistently has a substantial long position in certain securities does not necessarily mean that he is willing to sell those securities freely and to make a market in those securities; perhaps he is merely holding the securities in anticipation of selling them at some future date at a substantially higher price, or he is holding them in order to realize the "carry"--the difference between the interest received on the securities and the interest paid to a bank for a loan to carry the securities.

(d) The volume and scope of business and the contacts such business provides

It is the view of the Reserve System that the satisfaction of normal buying and selling desires of investors should be handled as far as possible by the dealers who can match off buyers and sellers or (if necessary) meet their customers' needs by increasing or reducing their own portfolios. Therefore, it has been considered essential that the dealers with whom the Federal Reserve deals make primary markets, have broad national contacts, and do a large volume of business in all types of Government securities so that the dealers may reasonably be

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expected to handle normal market supply and demand without resorting to the System and at the same time afford scope for System action when it takes the initiative.

This means dealing by the Federal Reserve only with those dealers who are national factors in the market, since such dealers provide the central point of activity through which the major portion of the operations of buyers and sellers is cleared, and at which the final effort at purchase and sale takes place. In this way it is possible to maximize the effectiveness of System open market operations with a minimum of transactions since they are directed at the gap between market demand and supply rather than at the full magnitude of the market on both sides. Thus if the System is engaged in the market to prevent disorderly market conditions or to stabilize rates, there is a better chance of keeping the System's participation in the market to a minimum consistent with its credit objectives.

If a dealer does not meet these tests there could be a tendency on his part to seek to "unwind" with the Reserve Bank many of the transactions entered into with his customers rather than to direct his efforts toward "unwinding" the transactions with other customers. The possibility of his "unwinding" the transactions with other customers is more limited as the geographical location of his customers is more concentrated and as the business of his customers is more concentrated in specialized lines, as would be the case, for example, if most of his customers were savings banks.

Another important consideration in connection with this factor is the ability of the dealer to keep the Reserve Bank informed about the relative amount of buying and selling interest in all segments of the securities market. The Reserve Bank should know the thinking of dealers and of potential buyers and sellers throughout the country; and the most effective and expeditious way of obtaining this information promptly is from the dealers. In order

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to be in a position to furnish such information, a dealer must have broad contacts throughout the country and his coverage must include all segments of the market.

(e) Financial condition and capital at risk of business

The need for financial strength is twofold--first, to protect the Reserve Bank against loss in respect of any business transacted by it with the dealer, and second, to enable the dealer to serve the market well. Wider fluctuations in market prices of securities increase the risks and make substantial capital more important.

Obviously the Reserve Bank does not want to take any chance on the ability of a dealer to perform.

The greater need for financial strength on the part of a dealer is tied in with and measures his ability to serve the market. As pointed out in the discussion with respect to factor (d), it is important that a dealer's business be national in scope. Such a business, of course, requires a substantial amount of capital. The more capital a dealer has, the greater is his freedom and ability to do business in the market, the less vulnerable is he to market fluctuations, and the greater is his access to large volumes of credit.

Open market policy

Long-run policy

Federal Reserve credit policy, determined in the light of economic conditions (including production, employment and prices), and the general credit situation of the country, generally falls within one of the following broad positions: restraint, ease or neutrality.

Restraint

When the general credit policy is one of restraint, the Federal Reserve System seeks to make member bank reserves less readily available,

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with a resultant increase in cost. Under such circumstances the Reserve Bank becomes a reluctant buyer and a willing (sometimes an active) seller of Government securities.

Ease

When the general credit policy is one of ease, the Reserve System normally seeks to make member bank reserves more readily available, with a resultant reduction in cost. Under such circumstances the Reserve Bank becomes a willing buyer and a reluctant seller of Government securities.

Neutrality

Under a general credit policy of neutrality, the Reserve System seeks to avoid action which would make credit harder to obtain or easier to obtain. This may involve the absorption by the System of bank reserves under certain circumstances or the creation of bank reserves under other circumstances; for example, it may involve the absorption of reserves created through imports of gold or a return flow of currency and reserves freed by reductions in bank loans and investments, or it may involve an expansion in Federal Reserve credit in connection with the seasonal requirements of business. Under such circumstances the reserve needs of the member banks are likely to be in a range that can be met by changes in borrowings from the Reserve Banks without the necessity of substantial intervention through open market operations. Open market operations may, however, be involved in the absorption of released reserves or in the furnishing of reserves needed for seasonal business purposes.

Short-run policy

Upon such a long-run general credit policy of restraint, ease or neutrality, with the appropriate open market policy outlined above, there may be superimposed a short-run policy of furnishing member banks with

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reserves or of absorbing reserves for the purpose of ironing out sharp day-to-day movements in the money market.

Bank reserves may fluctuate greatly from day to day and from week to week. The reserves of the banks of the country are affected by the various factors shown in the weekly statements published by the Federal Reserve System, such as an inflow or outflow of gold, changes in float*, changes in the deposits of foreign central banks in the Federal Reserve Banks, changes in public demands for currency, net receipts or disbursements by the Treasury reflected in changes in its balances with the Reserve Banks, shifts by the Treasury of balances from commercial banks to the Reserve Banks, and changes in the reserve requirements of the banks.

In addition, the reserves of individual banks may be adversely affected even though there be no change in the aggregate reserve position of the banking system; a particular bank may lose funds to other banks through the acts of its depositors in drawing down their deposits and in transferring the funds to other banks. The net balance owing by one bank to another in the clearance of checks is settled by the transfer of funds on deposit in the Reserve Bank. Similarly, the reserves of the banks in a particular city, e.g., New York, may be reduced by a flow of funds to banks in other parts of the country without any substantial change in the total reserve position of all the banks in the country.

Thus it may be desirable for the Reserve Banks to furnish member banks with additional reserves temporarily even though the over-all Federal Reserve policy is to make member bank reserves less readily available. These additional reserves may be furnished to the banking system through loans by the Reserve Banks to member banks or through purchases of Government securities; both methods are used. Frequently the reserve needs of the member

* For a definition of float, see footnote on page 29.

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banks can be met by changes in borrowings from the Reserve Banks.* Sometimes, however, sharp movements in the money market may be a threat to orderly conditions in the Government securities market, and open market operations may be called for.**

The Reserve Bank does not deny reserves to a bank that properly needs them. Certain reserves are required by law and penalties are assessed if there is a deficiency. Nevertheless, the Reserve Bank does make it more difficult or costly for a member bank to get reserves when such policy seems called for; this is an over-all deterrent to the bank's increasing its reserves and expanding credit on the basis of increased reserves.

In addition, the Federal Reserve may engage in open market operations in Government securities in order to condition or steady the market in connection with the issuance by the Treasury of a new security. Purchases of securities by the Reserve Bank for such purpose, or to facilitate the maintenance of an orderly market for outstanding securities, furnish member banks with reserves even though the over-all Federal Reserve policy is to make member bank reserves less readily available. System credit policy would generally call for subsequent sales or redemptions to offset such purchases.

Analysis of factors important to operations

The Federal Reserve System must analyze all factors affecting the money market and Government securities market, not only as a guide to its

* Borrowing from the Reserve Banks has become much more common since short-term market rates have been near the Federal Reserve discount rate. This greater use of the discount or loan mechanism is a desirable development because the particular member bank that needs reserves gets them, and when the immediate need for the Federal Reserve credit is past, the member bank normally seeks to repay the loan promptly and the Federal Reserve credit is extinguished.

** Sometimes the Reserve Bank may avoid outright purchases by entering into repurchase agreements with qualified nonbank dealers, as described at pages 54-55.

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long-run policy but to make allowances for the short-run influences which result in day-to-day fluctuations caused by temporary factors.

Financial data

As an aid to short-run policy, the Reserve Bank follows closely the reserve position of all member banks, with special emphasis upon the large New York City banks which are the largest single factor in the money market; it watches clearings and large wire transfers involving such banks; it keeps close contact with all money market developments including current and prospective inflow and outflow of funds and public and private financing through the securities markets; and it is familiar with and advises the Treasury with respect to Treasury calls on Treasury Tax and Loan Accounts.* Thus generally it can tell the extent of pressure or ease in the money market throughout the country and in New York.

Trading room wires

The Federal Reserve Bank of New York has a trading room with private telephone wires to all of the qualified dealers in New York City. Frequent quotations are obtained from the principal dealers, and are posted on a board in the trading room. From time to time during the day, dealers inform the Reserve Bank regarding significant developments in the market. The tone and characteristics of the Government securities market are continually described to the Reserve Bank through telephone conversations over the private wires. In addition, the dealers report information that has come to their attention concerning the money market.

Conferences with dealers and investors

Every business day, prior to the opening of the Government securities market at 10:00 a.m., representatives of two or three qualified dealers

* Techniques and criteria regarding the determination of Treasury calls are discussed at pages 33-36.

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call at the Reserve Bank on a rotating schedule to confer with the Reserve Bank officers directly responsible for the conduct of open market operations. At these conferences the representatives review the most important developments in the market, summarize their transactions, and pass on to the Reserve Bank any comments or suggestions which they wish to make or which they have heard in their contacts with investors and in which they think the Reserve Bank would be interested. Also, the Reserve Bank officers maintain fairly close contact with the officers of large institutional investors who have charge of their institutions' investments in Government securities. Information obtained in this way amplifies and checks the information received from the dealers.

How Reserve Bank trades

From time to time during the day the dealers suggest, over the trading room private wires, transactions to the Reserve Bank, offering to purchase from or sell to the Reserve Bank a given quantity of a particular security at a certain price. The Reserve Bank usually waits to hear the terms of a dealer's offer and accepts or declines.

At times, however, the Reserve Bank may on its own initiative solicit an offer or bid from a dealer or may place an order with a dealer. The extent to which the Reserve Bank may take the initiative depends upon the objective at the time; the initiative is more likely to be taken when credit policy requires more aggressive efforts to sell or buy.

As a general rule, open market operations are accommodated to the different sections of the market and to the actions of investor groups which make up those sections, within the limitations of the general policy of the Federal Open Market Committee which the Bank is trying to express. Measured in terms of volume, open market transactions ordinarily are predominantly in short-term Treasury obligations (Treasury bills, certificates of indebtedness

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and short-term Treasury notes) which are largely held by commercial banks and which are the first issues to reflect a changing credit situation. Normally, activity in the Treasury bill and certificate markets follows the ebb and flow of funds between banks and the general course of money market forces; in the short run, Federal Reserve operations have been conducted so as to moderate extremes in the swings of such forces--at times anticipating developments, and at times waiting for them to be reflected in price and market pressures, depending on the size and duration of the forces at work and the psychology which the Bank has wanted to create in terms of "long-run" Federal Reserve policy. Since the Treasury-Federal Reserve accord of March 1951, the Federal Reserve has intervened in the market much less frequently, and the market has become more accustomed to substantial fluctuations in prices which, of course, are an attribute of a "free market".

Repurchase agreements

As one means of smoothing out the operations of the money market, the Federal Reserve Bank of New York from time to time enters into repurchase agreements with qualified nonbank dealers. Under such an agreement the Reserve Bank buys short-term Government securities--generally Treasury bills--from a dealer, paying therefor on the day of the agreement. The dealer agrees to buy back the securities at any time at the option of either party within a period specified in the agreement, not exceeding fifteen days. The dealer pays the same price at which he sold the securities to the Reserve Bank plus an interest charge for the period the Reserve Bank holds the securities. This interest charge has customarily been at or close to the discount rate.

Such repurchase agreements are used by the Reserve Bank with care and discrimination as a means of providing the money market with Federal funds in order to lessen a temporary strain on the market. The Reserve Bank

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pays the dealer Federal funds the day the agreement is made; this is the only way, other than through member bank borrowing, that the Reserve Bank puts Federal funds into the market immediately.* During periods of such strain, the commercial banks which normally finance the dealers frequently want their loans paid and charge penalty rates if the loans are not paid; when the cost of carrying the securities exceeds the income from them, the dealers are under pressure to sell the securities. If the Reserve Bank buys the securities under a repurchase agreement instead of outright for the System Open Market Account, the dealer is obligated to buy back the securities and he pays a charge to the Reserve Bank until he does so; thus he continues to seek to place the securities in the hands of investors. A dealer might not be as alert and aggressive to place the securities with investors if the dealer had sold the securities outright to the Reserve Bank. If the money market continues under strain for the entire period specified in the agreement, the Reserve Bank may renew the agreement. If the securities covered by the agreement are not repurchased by the dealer, or if the agreement is not renewed, the securities involved are transferred to the System Open Market Account or are sold in the market.

Although all the Federal Reserve Banks have been authorized by the Federal Open Market Committee to enter into repurchase agreements, in practice virtually all such transactions since reinstatement of this authority in 1948 have been entered into by the New York Bank.

Since the bank dealers are member banks they can borrow from the Reserve Banks at the discount rate to carry securities in their trading accounts. They have no need for the mechanism of the repurchase agreement.

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* In the case of an outright purchase (i.e., one not subject to a repurchase agreement) delivery and payment are customarily made on the next full business day following the contract of purchase.

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Federal Reserve operations
not effected with dealers

Handling maturing issues
held by Federal Reserve

The way the Reserve Bank handles maturing issues of Treasury bills and, to some extent, other maturing Treasury obligations, is also an important phase of Government securities operations.

In the case of Treasury bills, when the System holds such bills, it has a weekly decision to make as to the disposal of its holdings of the maturing issue. It is customary for the Treasury each Thursday to invite tenders on a competitive basis for new Treasury bills maturing in 91 days. Ordinarily, tenders are received up until 2:00 p.m. Eastern time on the following Monday and payment is made on the following Thursday in order to provide the Treasury with funds to meet the issue maturing on that date. If the System declines to enter a bid for the new issue, or if its bid is not accepted, the maturing bills held by the System will be paid by the Treasury. If the amount of such payment is substantial the Treasury will probably draw down its balances at the commercial banks to make the payment or to replenish its General Account with the Reserve Bank; this will bring about a reduction in member bank reserves. Customarily, however, the Reserve Bank enters a bid for the new issue in the amount of the maturing issue held by the Federal Reserve in order to assure the Treasury of a necessary volume of tenders at some price. If the System's holdings are substantial, the price bid by the Federal Reserve may be very important. By raising or lowering its bid in the light of its estimate of the bids that will be made by others, the Reserve Bank may be relatively sure of an award of new bills in about the same amount as its maturing bills, or of an award of a substantially less quantity or even of none. Until recently, when a broader market developed in response to the rising trend in short-term rates,

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the System was a large holder of Treasury bills and, depending on its maturity schedule, could assume an active role in affecting reserve balances and influencing rates.

Other issues of Treasury securities (certificates of indebtedness, notes and bonds) are maturing frequently--several times a year. The maturing issues are generally refunded by the Treasury by the offering of a new issue in exchange for the maturing issue. If the Federal Reserve decides to subscribe to the new issue for the full amount of the maturing issue it holds, member bank reserves will not be affected. On the other hand, if the Federal Reserve decides to subscribe for a lesser amount of the new issue--if it lets some of the maturing issue "run off"--the Treasury will probably have to draw down its balances at the commercial banks and this will put pressure on member bank reserves.

Treasury "overdrafts"

Under limited circumstances the Federal Reserve may purchase an obligation of the Government directly from the Treasury.

This is done on a temporary basis at the time of the quarterly income tax payments. For example, on March 15, 1952, the Treasury had very heavy expenditures. In addition to ordinary Treasury expenditures there were interest payments due that day and there were several hundred million dollars of marketable Government securities becoming due that day. Although large income tax payments were also due March 15, in the nature of things they could not be collected that day. It takes a number of days for the various collectors of internal revenue to deposit tax checks and for the checks to be collected.

In such circumstances the Federal Reserve Bank of New York bought for the System open market account a special certificate of indebtedness of about $800 million, maturing at the end of the month, with an option on the

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part of the Treasury to repay it in whole or in part at any time. It was paid off before the end of the month.

The Federal Reserve Act provides, in effect, that when the Federal Reserve Banks buy Government securities, the securities must be bought in the open market, except that up to $5 billion may be bought directly from the Treasury.* The only Government securities purchased directly from the Treasury have been these special certificates of indebtedness used at tax payment dates.

They have never been outstanding more than a few days.

Summary conclusion

Open market operations are one instrument of general credit control. In recent years they have been the most important instrument.

The primary purpose of open market operations is to influence the supply, availability and cost of member bank reserves, and thus influence the policy of the banks in making loans--in extending bank credit. The System does, however, recognize two other responsibilities for taking action:

(1) to help see that conditions in the Government securities market do not become disorderly;

(2) to help condition the market in connection with the flotation of a new issue of securities by the Treasury.

The indirect impersonal method of restraining credit through general credit controls is an important instrument in the fight against inflation. It complements and in turn is complemented by, fiscal policy.

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* Fed. Res. Act, § 14(b).

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EXHIBIT A

TERMS ON WHICH FEDERAL RESERVE BANK OF NEW YORK WILL TRANSACT BUSINESS WITH BROKERS AND DEALERS IN UNITED STATES GOVERNMENT SECURITIES FOR THE SYSTEM OPEN MARKET ACCOUNT

The Federal Open Market Committee has directed the Federal Reserve Bank of New York (hereinafter referred to as the Bank) to transact business in United States Government securities for the System open market account with reputable brokers and dealers in such securities who meet the qualifications and agree in writing to comply with the terms and conditions set forth below.

1. In determining whether a person (individual, partnership or corporation, including a bank) is a qualified broker or dealer with whom the Bank will transact business, and the extent to which business will be transacted with such person, the following factors will be taken into consideration:

(a) Integrity, knowledge, and capacity and experience of management;

(b) Observance of high standards of commercial honor and just and equitable principles of trade;

(c) Willingness (in the case of a dealer) to make markets under all ordinary conditions;

(d) The volume and scope of business and the contacts such business provides;

(e) Financial condition and capital at risk of business; and

(f) The reliance that can be placed on such person to cooperate with the Bank and the Federal Open Market Committee in maintaining an orderly market for Government securities; to refrain from making any recommendations or statements or engaging in any activity which would encourage or stimulate undue activity in the market for Government securities; and to refrain from disclosing any confidential information which he obtains from the Bank or through his transactions with the Bank.

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2. The Bank will obtain from such person an agreement in writing to comply with the following terms and conditions:

(a) He will furnish the Bank with a statement for the confidential information of the Bank and the Open Market Committee showing as of the close of business each business day:

(1) The total amount of money borrowed (directly and indirectly);

(2) The par value of all Government securities borrowed;

(3) His position, both long and short, in Government securities, classified by classes of securities and maturity groups (or by issues, if so requested by the Bank);

(4) The volume of transactions during the day in Government securities, classified by classes of securities and maturity groups (or by issues, if so requested by the Bank); and

(5) Such other statistical data as in the opinion of the Bank will aid in the execution of transactions for the System open market account.

(b) At or before the completion of each transaction with the Bank, he will furnish the Bank with a written notification disclosing whether he is acting as a broker for the Bank, as a dealer for his own account, as a broker for some other person, or as a broker for both the Bank and some person. In the absence of a special agreement to the contrary with the Bank with respect to a particular transaction, he will not act as broker for any other person in connection with any transaction with the Bank, and he will receive no compensation or profit of any kind in connection with the transaction other than the specified commission paid him by the Bank.

(c) In the absence of special arrangements with the Bank, delivery of securities will be made at the office of the Bank before 2:15 p.m. on the next full business day following the day of the contract and all payments by the broker or dealer will be in immediately available funds.

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(d) He will furnish the Bank not less frequently than once during each calendar year with a report of his financial condition as of a date not more than 45 days prior to the delivery of the report to the Bank in form acceptable to the Bank and prepared or certified by a public accountant acceptable to the Bank; and, upon the request of the Bank, he will furnish it with a statement of condition as shown by his books as of a date specified by the Bank.

(e) Unless the Bank shall have informed him of its desire to purchase or sell a particular issue of Government securities, he will not solicit from any other person offerings of or bids for any issue of Government securities for the purpose of placing himself in a position to offer to sell to or to buy from the Bank securities of such issue.

The Federal Open Market Committee has further directed that the Bank decline to transact any further business with a broker or dealer in any case in which the Bank has concluded that the broker or dealer no longer meets the qualifications set forth above or has willfully violated or failed to perform any of the terms and conditions set forth in the agreement.

To the Federal Reserve Bank of New York:

The undersigned hereby agrees to meet the qualifications and to comply with the terms and conditions set forth above.

Dated:........................ ....
(Signature)

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May 29, 1953.

PROPOSAL FOR CHANGES IN THE DIRECTIVES
OF THE OPEN MARKET COMMITTEE AND THE
EXECUTIVE COMMITTEE

At the meeting of the Federal Open Market Committee on March 4-5, 1953, it was understood that the staff would report on the steps that would be necessary in the way of changing the Committee's directives or issuing new directives to carry out changes in procedures agreed upon. In accordance with this understanding, the staff has prepared a draft of revision of the general directive of the full Committee consisting of general instructions and a separate specific directive. It has also prepared a draft of revision of the directive issued by the executive committee to the Bank which executes transactions for the System account. The revisions are intended to change only the form of the directives and are not intended to make any changes of substance in the directives. Under the proposed forms of directives, the procedure for their issuance would be somewhat as follows:

(1) There would be general instructions issued once a year by the full Committee, which would include the various conditions and terms relating to operations of the System Account and cover a substantial portion of the matters heretofore included in the directive issued at each meeting. (See Exhibit A attached).

(2) A specific directive stating a more definite and limited objective would be issued to the executive committee by the full Committee at each of its meetings (Exhibit B); and a similar, and possibly more specific and limited, directive would be issued by the executive committee at each of its meetings to the Federal Reserve Bank of New York (Exhibit C). For example, under certain conditions the specific directive would refer to restraint upon inflationary developments. Under other

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conditions, however, the objective might be to restrain deflationary developments, or the directive could be otherwise changed to suit the then existing situation.

(3) A paragraph on purchase of special certificates from the Treasury would be included both in the full Committee specific directive and the executive committee specific directive.

(4) Both the general instructions and the specific directive of the Federal Open Market Committee would, of course, have to be published as a part of the policy record of the Committee, but the directive of the executive committee to the New York Reserve Bank would not be published.

There are a number of matters that would not be comprehended by general instructions or the specific directives from the full Committee to the executive committee, and, as in the past, matters of this type would come up once a year for review by the full Committee. They could, of course, be reviewed or changed at any other meeting of the full Committee. These would include:

(a) Conditions under which Federal Reserve Banks are authorized to enter into repurchase agreements with nonbank dealers in United States Government securities;

(b) Conditions, including minimum buying rate, under which Federal Reserve Banks may purchase bankers' acceptances in accordance with the regulations of the Federal Open Market Committee;

(c) Purchase and sale of cable transfers, bills of exchange, and bankers' acceptances payable in foreign currencies;

(d) Allocation of securities in the System Open Market Account;

(e) Persons to whom weekly report of open market operations prepared by New York Reserve Bank is distributed;

(f) Authority of the Chairman to appoint a Federal Reserve Bank as agent to operate the System Account temporarily in case the Federal Reserve Bank of New York is unable to function;

(g) Technique of open market operations and relationships with Government securities dealers.

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In connection with paragraph (5) of the proposed General Instructions (Exhibit A attached), which relates to the necessity in an emergency for executive committee action in order to correct a disorderly situation in the market, it has been suggested that the following language be added at the end of the paragraph: "and in such circumstances such intervention may be initiated by the Federal Reserve Bank selected to execute transactions for the System Open Market Account with the approval of the members of the executive committee with whom it is able to communicate." While this suggested additional language is merely explanatory in character, it has not been included in the draft of the proposed General Instructions pending consideration of the matter, because the instructions and directives attached are intended to conform as closely as possible and without change to the record of action already taken.

Attachments

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EXHIBIT A

PROPOSED GENERAL INSTRUCTIONS FROM FEDERAL OPEN MARKET COMMITTEE TO EXECUTIVE COMMITTEE

(1) The executive committee of the Federal Open Market Committee is hereby instructed, until otherwise instructed by the Federal Open Market Committee, to conduct transactions and operations for the System Open Market Account in accordance with the conditions and restrictions set forth in the following paragraphs and in accordance with such operating instructions and with such special directives as may be prescribed by the Federal Open Market Committee from time to time.

(2) All such transactions and operations for the Account (being hereinafter referred to as "operations") shall be conducted in the light of current and prospective economic conditions and the general credit situation of the country and with a view to relating the supply of funds in the market to the needs of commerce and business and to the practical administration of the Account. Operations, under the present policy of the Federal Open Market Committee, are not to be conducted to support any pattern of prices and yields in the Government securities market, and intervention in the Government securities market is to be solely to effectuate the objectives of monetary and credit policy (including intervention to correct disorderly markets).

(3) Operations may comprise purchases, sales, exchanges of maturing securities directly with the Treasury, and letting securities mature without replacement, and may include transactions for the System Account with a Federal Reserve Bank for foreign account or for miscellaneous Treasury trust or agency accounts.

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(4) Securities may be purchased directly from the Treasury in accordance with special directives issued from time to time by the Federal Open Market Committee.

(5) Operations may be conducted for the purpose of correcting a disorderly situation in the Government securities market, but intervention in the market for this purpose may be initiated only upon the affirmative vote of the executive committee after the existence of a situation seeming to require correction has come to its attention through notice from the Manager of the Account or otherwise; but it is recognized that in the event of an emergency, such as an international crisis, it may not be possible to canvass all members of the executive committee before initiating such intervention.

(6) Under present conditions, operations should be confined to short-term securities (except in the correction of disorderly markets in accordance with the provisions of the preceding paragraph). During a period of Treasury financing (except the issuance of Treasury bills) the executive committee should refrain from purchasing or arranging for the purchase of (i) any maturing issues for which an exchange is being offered, (ii) when issued securities, and (iii) any outstanding issues of comparable maturity to those being offered for cash or exchange.

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EXHIBIT B

PROPOSED SPECIFIC DIRECTIVE FROM FEDERAL OPEN MARKET COMMITTEE TO EXECUTIVE COMMITTEE

General. - (a) The executive committee is directed until otherwise directed by the Federal Open Market Committee to arrange for such transactions and operations for the System Open Market Account as may be necessary with a view to exercising restraint upon inflationary developments*;

(b) The aggregate amount of securities held in the System Open Market Account (including commitments for the purchase or sale of securities for the Account) at the close of this date shall not be increased or decreased by more than $ __________ billion;

(c) All such transactions and operations shall be conducted in accordance with the general instructions issued by the Federal Open Market Committee to the executive committee on ________, 195_.

Special Certificates of Indebtedness. - The executive committee is directed, until otherwise directed by the Federal Open Market Committee, to arrange for the purchase directly from the Treasury for the account of the Federal Reserve Bank of New York of such amounts of special short-term certificates of indebtedness bearing a rate of 1/4 of 1 per cent per annum as may be necessary from time to time for the temporary accommodation of the Treasury. The Federal Reserve Bank of New York is authorized in its discretion, in cases where it seems desirable, to

*The words "with a view to exercising restraint upon inflationary developments" would, of course, be changed or made more specific to accord with the special objective of operations under conditions existing at the time.

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issue participations in such certificates to one or more Federal Reserve Banks, and such Reserve Banks are authorized to accept such participations. The total amount of such special certificates held at any one time by the Federal Reserve Banks shall not exceed in the aggregate $ ____________ billion.

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EXHIBIT C

PROPOSED SPECIFIC DIRECTIVE FROM EXECUTIVE COMMITTEE
TO FEDERAL RESERVE BANK OF NEW YORK

General. - (a) The Federal Reserve Bank of New York is directed until otherwise directed by the executive committee to make such purchases, sales or exchanges for the System Open Market Account as may be necessary with a view to exercising restraint upon inflationary developments*;

(b) The aggregate amount of securities held in the System Open Market Account (including commitments for the purchase or sale of securities for the Account) at the close of this date shall not be increased or decreased by more than $ billion;

(c) All such purchases, sales and exchanges shall be carried out in accordance with the general instructions issued by the Federal Open Market Committee to the executive committee on ______, 195_, and the special directive issued by the Federal Open Market Committee on ______, 195_.

Special Certificates of Indebtedness. - The Federal Reserve Bank of New York is directed, until otherwise directed by the executive committee, to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York such amounts of special short-term

*The words "with a view to exercising restraint upon inflationary developments" would, of course, be changed or made more specific to accord with the special objective of operations under conditions existing at the time. Where circumstances require it, the language of the directive might contain a specific instruction to purchase or to sell securities up to a stated amount or within certain ranges.

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certificates of indebtedness bearing a rate of 1/4 of 1 per cent per annum as may be necessary from time to time for the temporary accommodation of the Treasury. The Federal Reserve Bank of New York is authorized in its discretion, in cases where it seems desirable, to issue participations in such certificates to one or more Federal Reserve Banks, and such Reserve Banks are authorized to accept such participations. The total amount of such special certificates held at any one time by the Federal Reserve Banks shall not exceed in the aggregate $ billion.

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PROPOSAL RE OPEN MARKET DIRECTIVE

At the meeting of the executive committee of the Federal Open Market Committee on April 8, 1953, it was understood that the staff would prepare a revision of the general directive of the full Committee and of the executive committee for consideration at a subsequent meeting. Accordingly, the staff has studied this matter and now wishes to suggest for the consideration of the executive committee, and for possible recommendation by the executive committee to the full Committee, the following proposal:

(1) There would be general instructions issued once a year by the full Committee, which would include the various conditions and terms relating to operations of the System Account and cover a substantial portion of the matters heretofore included in the directive issued at each meeting.

(2) A special directive stating a more specific and limited objective would be issued to the executive committee by the full Committee at each of its meetings; and a similar, and possibly more specific and limited, directive would be issued by the executive committee at each of its meetings to the Federal Reserve Bank of New York. For example under certain conditions the special directive would refer to restraint upon inflationary developments. Under other conditions, however, the objective might be to restrain deflationary developments, or the directive could be otherwise changed to suit the then existing situation.

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(3) A paragraph on purchase of special certificates from the Treasury would be included both in the full Committee special directive and the executive committee special directive.

(4) Both the general instructions and the specific directive of the Federal Open Market Committee would, of course, have to be published as a part of the policy record of the Committee, but the directive of the executive committee to the New York Reserve Bank would not be published.

(5) There are a number of matters that would not be comprehended by general instructions from the full Committee to the executive committee, and these would also come up once a year for review by the full Committee. These would include:

(a) Conditions under which Federal Reserve Banks are authorized to enter into repurchase agreements with nonbank dealers in United States Government securities;

(b) Conditions, including minimum buying rate, under which Federal Reserve Banks may purchase bankers' acceptances in accordance with the regulations of the Federal Open Market Committee;

(c) Purchase and sale of cable transfers, bills of exchange and bankers' acceptances payable in foreign currencies;

(d) Allocation of securities in the System Open Market Account;

(e) Persons to whom weekly report of open market operations prepared by New York Reserve Bank is distributed;

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(f) Authority of the Chairman to appoint a Federal Reserve Bank as agent to operate the System Account temporarily in case the Federal Reserve Bank of New York is unable to function;

(g) Technique of open market operations and relationships with Government securities dealers, including use of technique of reluctant buying; conduct of transactions with dealers as principals on a net basis; statement that there should be no refusal to buy bills acquired by dealers on a cash basis; informing nonbank dealers in advance when repurchase facilities will be made available; restricting information solicited by the trading desk to eliminate identification; furnishing on a voluntary basis of reports by dealers as to their positions; and statement as to asking dealers to report during the trading day in detail.

In connection with paragraph (5) of the proposed General Instructions, attached, which relates to the necessity in an emergency for executive committee action in order to correct a disorderly situation in the market, it has been suggested that the following language be added at the end of the paragraph: "and in such circumstances such intervention may be initiated by the Federal Reserve Bank selected to execute transactions for the System Open Market Account with the approval of the members of the executive committee with whom it is able to communicate." While this suggested additional language is merely explanatory in character, it has not been included in the draft of the

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proposed General Instructions pending consideration of the matter by the executive committee, because the instructions and directives attached are intended to conform as closely as possible and without change to the record of action already taken.

Attachments

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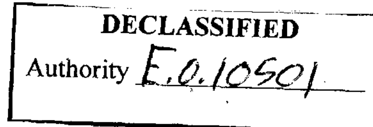
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PROPOSED GENERAL INSTRUCTIONS FROM FEDERAL OPEN MARKET COMMITTEE TO EXECUTIVE COMMITTEE

(1) The executive committee of the Federal Open Market Committee is hereby instructed, until otherwise instructed by the Federal Open Market Committee, to conduct transactions and operations for the System Open Market Account in accordance with the conditions and restrictions set forth in the following paragraphs and in accordance with such operating instructions and with such special directives as may be prescribed by the Federal Open Market Committee from time to time.

(2) All such transactions and operations for the Account (being hereinafter referred to as "operations") shall be conducted in the light of current and prospective economic conditions and the general credit situation of the country and with a view to relating the supply of funds in the market to the needs of commerce and business and to the practical administration of the Account. Operations, under the present policy of the Federal Open Market Committee, are not to be conducted to support any pattern of prices and yields in the Government securities market, and intervention in the Government securities market is to be solely to effectuate the objectives of monetary and credit policy (including intervention to correct disorderly markets).

(3) Operations may comprise purchases, sales, exchanges of maturing securities directly with the Treasury, and letting securities mature without replacement, and may include transactions for the System Account with a Federal Reserve Bank for foreign account or for miscellaneous Treasury trust or agency accounts.

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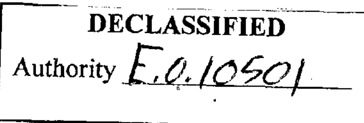

(4) Securities may be purchased directly from the Treasury in accordance with special directives issued from time to time by the Federal Open Market Committee.

(5) Operations may be conducted for the purpose of correcting a disorderly situation in the Government securities market, but intervention in the market for this purpose may be initiated only upon the affirmative vote of the executive committee after the existence of a situation seeming to require correction has come to its attention through notice from the Manager of the Account or otherwise, but it is recognized that in the event of an emergency, such as an international crisis, it may not be possible to canvass all members of the executive committee before initiating such intervention.

(6) Under present conditions, operations should be confined to short-term securities (except in the correction of disorderly markets in accordance with the provisions of the preceding paragraph). During a period of Treasury financing (except the issuance of Treasury bills) the executive committee should refrain from purchasing or arranging for the purchase of (i) any maturing issues for which an exchange is being offered, (ii) when issued securities, and (iii) any outstanding issues of comparable maturity to those being offered for cash or exchange.

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PROPOSED SPECIAL DIRECTIVE FROM FEDERAL OPEN MARKET COMMITTEE TO EXECUTIVE COMMITTEE

General. - (a) The executive committee is directed until otherwise directed by the Federal Open Market Committee to arrange for such transactions and operations for the System Open Market Account as may be necessary with a view to exercising restraint upon inflationary developments*;

(b) The aggregate amount of securities held in the System Open Market Account (including commitments for the purchase or sale of securities for the Account) at the close of this date shall not be increased or decreased by more than $ ________ billion;

(c) All such transactions and operations shall be conducted in accordance with the general instructions issued by the Federal Open Market Committee to the executive committee on June __, 1953.

Special Certificates of Indebtedness. - The executive committee is directed, until otherwise directed by the Federal Open Market Committee, to arrange for the purchase directly from the Treasury for the account of the Federal Reserve Bank of New York of such amounts of special short-term certificates of indebtedness bearing a rate of 1/4 of 1 per cent per annum as may be necessary from time to time for the temporary accommodation of the Treasury. The Federal Reserve Bank of New York is authorized in its discretion, in cases where it seems desirable, to

* The words "with a view to exercising restraint upon inflationary developments" would, of course, be changed or made more specific to accord with the special objective of operations under conditions existing at the time.

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issue participations in such certificates to one or more Federal Reserve Banks, and such Reserve Banks are authorized to accept such participations. The total amount of such special certificates held at any one time by the Federal Reserve Banks shall not exceed in the aggregate $ ____________ billion.

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PROPOSED SPECIAL DIRECTIVE FROM EXECUTIVE COMMITTEE
TO FEDERAL RESERVE BANK OF NEW YORK

General. - (a) The Federal Reserve Bank of New York is directed until otherwise directed by the executive committee to make such purchases, sales or exchanges for the System Open Market Account as may be necessary with a view to exercising restraint upon inflationary developments*;

(b) The aggregate amount of securities held in the System Open Market Account (including commitments for the purchase or sale of securities for the Account) at the close of this date shall not be increased or decreased by more than $ billion;

(c) All such purchases, sales and exchanges shall be carried out in accordance with the general instructions issued by the Federal Open Market Committee to the executive committee on June __, 1953, and the special directive issued by the Federal Open Market Committee on June __, 1953.

Special Certificates of Indebtedness. - The Federal Reserve Bank of New York is directed, until otherwise directed by the executive committee, to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York such amounts of special short-term

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*The words "with a view to exercising restraint upon inflationary developments" would, of course, be changed or made more specific to accord with the special objective of operations under conditions existing at the time. Where circumstances require it, the language of the directive might contain a specific instruction to purchase or to sell securities up to a stated amount or within certain ranges.

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certificates of indebtedness bearing a rate of 1/4 of 1 per cent per annum as may be necessary from time to time for the temporary accommodation of the Treasury. The Federal Reserve Bank of New York is authorized in its discretion, in cases where it seems desirable, to issue participations in such certificates to one or more Federal Reserve Banks, and such Reserve Banks are authorized to accept such participations. The total amount of such special certificates held at any one time by the Federal Reserve Banks shall not exceed in the aggregate $ billion.

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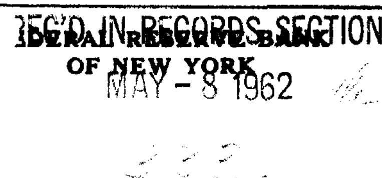

RESEARCH MEMORANDUM

To Mr. Carr

From M. McWhinney

Date May 8, 1952

Subject Measuring the "neutrality" of Federal Reserve open market operations

Copies To members of the Informal Credit Policy Group

The first problems that arises in measuring the "neutrality" of Federal open market operations is a definition of "neutrality". It may be defined as a policy dedicated to maintaining the volume of bank reserves available for use on an approximately stable level, with longer-term changes in bank reserves resulting from seasonal currency flows and similar factors compensated for by System purchases or sales of securities, and with short-term (day-to-day and week-to-week) changes adjusted by increases or decreases in member bank borrowings from the System. Such a definition, however, raises two questions: (1) whether Reserve System credit should be used to increase the money supply in response to seasonal demands for commercial loans, and if so, how much credit should be supplied; and (2) whether Federal Reserve credit should be supplied through open market operations, or through an increase in member bank loans and discounts.

When deposits are declining as a result of seasonal loan repayments and no appreciable amount of borrowings are outstanding, it seems logical to absorb the reserves thus freed by means of open market operations, and in the following tables and discussion changes in required reserves have been included with the group of factors geared to open market operations. However, a theoretical basis also exists for shifting required reserves to the group of irregular factors, losses from which the banks must meet by borrowing. Table I illustrates this point. At first glance System sales of securities in the period August 1, 1951 to March 5, 1952 (the reasons for the selection

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Table I

Net Change in the Factors Affecting Member Bank Reserve Positions
August 1, 1951 - March 5, 1952

(In millions of dollars;
(+) denotes increase, (-) denotes decrease in excess reserves)

Feb 27
May 21

Factor	Change	Mar 5–Mar 30 / May 21	Total
Items showing seasonal or longer-term trends			
1. Gold and foreign account	+1,759	+89	+1,848
2. Currency circulation	- 622	+4	-618
3. Required reserves	- 736	+22	-714
Total of items 1,2, and 3	+ 401	+115	+516
Federal Reserve holdings of securities	- 567	-151	-718
Widely fluctuating or irregular items			
4. Treasury transactions	- 38	+245	+207
5. Float	+ 193	-393	-200
6. Other F. R. deposits, etc.	- 13	+67	+54
Total of items 4,5, and 6	+ 142	-81	+61
Excess reserves less borrowings	- 24	-118	-142
Federal Reserve discounts and advances	- 24	+293	+269
Excess reserves	- 48	+175	+127

Total 1,2,4,5,6	+1279	+12	+1291
FR securities	-567 (+712)	-151 (139)	-718 (572)
required reserves	+736	-22	+714
Excess reserves	-48 (188)	+175 (+153)	+127
Borrowings	-24	+293	+269

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of these dates are outlined later) appear to have more than offset bank reserve gains from longer-term factors. However, a closer examination of the figures indicates that sales of securities absorbed only half of the net reserves gained through gold and foreign account operations and currency flows and that the net increase in required reserves during this period was larger than the amount of reserves absorbed by System sales of securities.

The selection of a starting point for measuring the success of the Reserve System's current neutrality policy is somewhat difficult. Ideally the starting point should be the coincidence of the beginning or end of a cycle for as many as possible of the factors affecting the volume of bank reserves. It should also be a period when the money market was about in balance with no slack in the banks' reserve positions and at the same time no unusual pressure on them.

The period which comes closest to meeting these criteria is probably the beginning of last August, just prior to the end-of-year rise in currency circulation and commercial loans, and the start of renewed gold inflow. However, the situation has changed somewhat since last August and for analysis of current developments, it seems more appropriate to use a more recent date. The next best starting point, therefore, seems to be March 5. Currency was returned to the banking system in volume in January and then the total amount outstanding leveled off in February, although there were still minor week-to-week fluctuations. Commercial loans of the weekly reporting member banks also declined in January and leveled off in February prior to a temporary rise over the March tax date. The Reserve System sold a large amount of securities in January to compensate for those purchased at the end of 1951 and then largely withdrew from the market. The required reserves of member banks declined almost steadily for the first two and a half months of 1952. While most of

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these factors would suggest a second best starting point as somewhere in the middle of February, the money market was under considerable pressure during most of that month, so March 5 would seem to be a better choice than a February date.

For the period March 5 through April 30, currency, gold and foreign account operations, and changes in required reserves resulted in a net gain to the banks of 115 million dollars (see Table II). Sales of securities from the System Account, on the other hand, absorbed 151 million dollars. The other more irregular market factors(primarily float and Treasury) absorbed an additional 81 million. To make up for these losses and increase their excess reserves slightly, the banks borrowed 293 million dollars from the Reserve Banks.

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Table II

Factors Affecting Member Bank Reserve Positions,
March 5 - April 30, 1952

(In millions of dollars; (+) denotes increase,
(-) denotes decrease in excess reserves)

Factor	Week ended March 12	March 19	March 26	April 2	April 9	April 16	April 23	April 30
Items showing seasonal or longer-term trends.								
1. Gold and foreign account								
Week	+ 35	+ 20	+ 1	- 20	+ 5	- 14	+ 40	+ 22
Cumulative		+ 55	+ 56	+ 36	+ 41	+ 27	+ 67	+ 89
2. Currency circulation								
Week	+ 12	+ 91	+ 32	- 116	- 81	+ 90	+ 103	- 127
Cumulative		+ 103	+ 135	+ 19	- 62	+ 28	+ 131	+ 4
3. Required reserves								
Week	- 16	- 445	+ 127	+ 296	+ 88	- 80	+ 113	- 61
Cumulative		- 461	- 334	- 38	+ 50	- 30	+ 83	+ 22
Cumulative total, items 1, 2, 3.	+ 31	- 303	- 143	+ 17	+ 29	+ 25	+ 281	+ 115
Federal Reserve securities								
Week	+ 16	+ 295	- 297	- 14	- 20	- 27	- 95	- 9
Cumulative		+ 311	+ 14	0	- 20	- 47	- 142	- 151
Widely fluctuating or irregular items								
4. Treasury transactions								
Week	+ 31	+ 647	+ 4	- 282	- 78	- 153	- 355	+ 431
Cumulative		+ 678	+ 682	+ 400	+ 322	+ 169	- 186	+ 245
5. Float								
Week	- 95	+ 374	- 550	+ 51	- 35	+ 289	- 249	- 178
Cumulative		+ 279	- 271	- 220	- 255	+ 34	- 215	- 393
6. Other F. R. accounts, etc.								
Week	+ 22	+ 62	+ 3	- 43	+ 10	- 74	+ 7	+ 80
Cumulative		+ 84	+ 87	+ 44	+ 54	- 20	- 13	+ 67
Cumulative total, items, 4, 5, 6.	- 42	+1,041	+ 498	+ 224	+ 121	+ 183	- 414	- 81
Excess reserves less borrowing								
Week	+ 4	+1,043	- 679	- 128	- 110	+ 32	- 438	+ 158
Cumulative		+1,047	+ 368	+ 240	+ 130	+ 162	- 276	- 118
Federal Reserve discounts and advances								
Week	- 26	- 231	+ 44	- 40	+ 38	+ 454	+ 208	- 154
Cumulative		- 257	- 213	- 253	- 215	+ 239	+ 447	+ 293
Excess Reserves								
Week	- 22	+ 812	- 635	- 168	- 72	+ 486	- 230	+ 4
Cumulative		+ 790	+ 155	- 13	- 85	+ 401	+ 171	+ 175

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July 13, 1951

Dear Mr. Morse:

I certainly appreciate your nice letter of July 10 giving me the comments of the individual members of the National Association of Mutual Savings Banks Committee on Government Securities and the Public Debt. These are very helpful, and I will be in touch with you again as our plans crystalize.

With all good wishes,

Sincerely yours,

(SIGNED) WM. McC. MARTIN, Jr.

Wm. McC. Martin, Jr.

Mr. J. Reed Morse
President
The Boston Five Cents
Savings Bank
Boston, Mass.

WMM:cte

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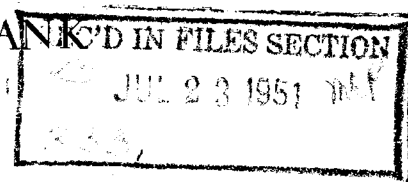
THE BOSTON FIVE CENTS SAVINGS BANK



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30 SCHOOL STREET
BOSTON, MASSACHUSETTS

J. REED MORSS
PRESIDENT

July 10, 1951

Mr. Wm. McC. Martin, Jr., Chairman
Board of Governors of
The Federal Reserve System
Washington, D. C.

Dear Mr. Martin:

Your letter to me of June 14 has been presented to the individual members of the National Association of Mutual Savings Banks Committee on Government Securities and the Public Debt. In view of the many complex and technical considerations necessary for a final conclusion, we would like to limit any observations to the rather direct effect on savings banks of any change in procedure in the Government Securities market. If it were possible by any method to broaden that market, such would obviously be a most desirable result. It would be heartily supported by the Savings Bank system.

We recognize that the present arrangement of a comparatively few qualified Government Securities dealers may appear in some instances as possibly undemocratic and restrictive and so worthy of review. However, as a practical matter there appears to be a real need for a group of sponsors and specialists willing and able to make a market out of their own inventory position without waiting in every case for matching orders. The interests of such a specialist group will be best served if they can be successful in creating a broad interest in government securities. Also it appeals to us as advantageous for the Government to be one step removed from the normal trading routine and to act only as a "hidden hand" and confidentially with its dealer group when necessary.

We recognize too that swings in dealer inventory position may accentuate rather than stabilize market trends and that present money market factors are working against the ability of dealers to "carry" an adequate inventory position. Still, for

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THE BOSTON FIVE CENTS SAVINGS BANK

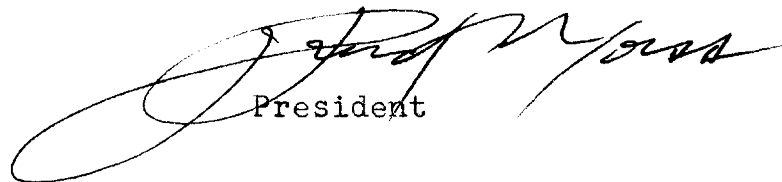
the time being, we would be first inclined to consider ways for strengthening and improving the dealer organizations rather than to discuss their weakening or possible elimination.

An additional point might well be as to the enlistment of brokerage support, probably on a compensation basis, for the actual retailing of government securities to individual buyers. There would be so many interests here involved that we would hesitate to initiate a study without further word that such would be of real interest to you.

Very possibly our imagination has not been sharp enough to consider the angles you have in mind, so that above statement perhaps should be marked "tentative" pending receipt of the further suggestions you mention. We agree that a discussion of this kind may well be productive of improvements of broad benefit. Certainly without provocative discussion and consideration progress is often too long delayed.

As will be the regular practice, I have asked the committee members to contribute only their own thinking and so not to stir up this or any future questions into public view.

Sincerely,



President

JRM:rcc

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JUN 18 1951

June 14, 1951

Dear Mr. Morse:

Thank you for your nice letter of June 13 placing the Committee on Government Securities and the Public Debt of the National Association Mutual Savings Banks at the disposal of the Federal Reserve. I appreciate this very much and can assure you we will cooperate completely.

I am gradually organizing a study of the adequacy and scope of the Government Securities Market. We have received a lot of criticism of the operations of the Open Market Committee and of the system of qualified dealers. There has been some discussion that perhaps the market should be moved from the Federal Reserve Bank of New York to the Stock Exchange or some other neutral point and our operations be conducted by Government broker or brokers along the lines of the British system. Several Congressmen have been urging that the market be transferred to Washington, which seems impractical to us, and many similar suggestions are floating around. It seems to me that this is a propitious time to rethink and re-examine this whole problem. It would be very helpful to have your group participate with us in such a study and in the course of the next few weeks, I will forward a few specific suggestions for your consideration. In the meantime, I am passing on what our preliminary thinking is so that you can discuss it with any members of your committee and let me have any ideas which occur to you.

I will keep in touch with you and appreciate very much your cooperation.

With all good wishes,

Sincerely yours,

Wm. McC. Martin, Jr.

Mr. J. Reed Morse
President
The Boston Five Cents Savings Bank
Boston, Mass.

WMM:ctc

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THE BOSTON FIVE CENTS SAVINGS BANK

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30 SCHOOL STREET
BOSTON, MASSACHUSETTS

J. REED MORSS
PRESIDENT

REC'D IN FILES SECTION
JUN 18 1951
333.

June 13, 1951

Carded

Mr. William McC. Martin, Chairman
Federal Reserve Board
Washington, D.C.

Dear Mr. Martin:

For the coming year Mr. Henry Bruere of the Bowery Savings Bank, New York, has expressed the wish that he not be re-appointed Chairman of the National Association Mutual Savings Banks Committee on Government Securities and the Public Debt. In his stead I have agreed to act as Chairman of that committtee. Enclosed is a list of the membership.

The real purpose of this letter is to place this committee at your disposal for any future activity that might serve your purpose. It occurs to me that you might at sometime like to have us gather information or estimates of the savings banks positions as to future loan commitments for instance, or that you might request the committees position on some future development in order that your file record might be complete. We naturally hesitate to grind out a series of opinions which might be of no interest to you, but we would be glad indeed to serve a useful purpose. In fact, I rather feel that the National Association of Mutual Savings Banks would appreciate a feeling of participation in the national effort and might as a result be more enthusiastically cooperative with future moves.

I can guarantee that, if you wish, any inquiry of me can be held in the most strict of confidence and I believe the same to be true of the other committee members.

It is possible that I may see you in the course of the next few months with Bob Fleming's ABA committee and may have an opportunity to speak of this matter at that time, in which event you will have at least this much advance notice of our thinking.

FOR FILES
C. Chupka

Very truly yours,

J. Reed Morss

JRM:nsc

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JUN 18 1951

COMMITTEE ON GOVERNMENT SECURITIES & THE PUBLIC DEBT

May 1951 - 1952

J. Reed Morss, president, The Boston Five Cents Savings Bank, Massachusetts
CHAIRMAN

Alfred J. Casazza, vice president, Savings Banks Trust Company, New York

John H. Duerk, assistant vice president, The Howard Savings Institution, Newark, New Jersey

C. Lane Goss, president, Worcester County Institution for Savings, Massachusetts

Richard A. Holton, vice president, East New York Savings Bank, Brooklyn, New York

Charles J. Lyon, president, Society for Savings, Hartford, Connecticut

Clifford F. Martin, president, City Savings Bank of Pittsfield, Mass.

Alfred C. Middlebrook, vice president, East River Savings Bank, New York City

John Ohlenbusch, vice president, The Bowery Savings Bank, New York City

A. Edward Scherr, Jr., vice president-treasurer, The Dime Savings Bank of Brooklyn, New York

Levi P. Smith, president, Burlington Savings Bank, Vermont

Frank W. Wrightson, president, Provident Savings Bank of Baltimore, Md.

FOR FILES
C. Chupka

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FEDERAL RESERVE BANK
OF
PHILADELPHIA
(ZONE 1)

April 18, 1951

Mr. Ralph A. Young, Director
Division of Research and Statistics
Board of Governors of the
Federal Reserve System
Washington 25, D. C.

Dear Ralph:

Attached is the tabular material that I mentioned to you over the phone. I hope it may be of some help in giving a chronology of Federal Reserve actions.

Sincerely,

Karl

Karl R. Bopp
Vice President

KRB/b
Enc.

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PRINCIPAL POLICY OPERATIONS

Date	Open Market (in millions of dollars)	New York Discount Rate	Prevailing Industrial and Credit Conditions
1917		+ 4 to 4½%	Large volume of discounts ($100 million in 1917 to $2.8 billion in 1920).
1918 1-20: 6-20		+ 4½ to 4¾% + 4¾ to 7 %	Potential inflation; unparalleled expansion of credit; prices double prewar level; reserve ratio near minimum; commodity speculation heavy; bank credit based upon inflated prices; prices of stocks and bonds declining.
5-21:12-21		- 7 to 4½%	Deflation in commodity prices and agricultural values; business activity at low level; discounts down to $1 billion; prices of bonds advancing sharply; stocks fairly steady.
1-22: 5-22	Bought $400	Unchanged	Business recovering from low in early 1921; agriculture still depressed and prices low; prices of other commodities advancing; prices of stocks and bonds advancing sharply; discounts declining.
6-22		- 4½ to 4 %	Business recovering but somewhat irregularly in first half; discounts down to $400 million; prices of bonds high.
6-22: 7-23	Sold $525	+ 4 to 4½%	Excesses developing in business recovery; prices rising; labor shortages appearing; too rapid expansion in some industries.
12-23: 9-24	Bought $510	- 4½ to 3 %	(First transaction in joint investment account.) Business and prices receded; European countries considering return to gold standard - hoped that easy money here would facilitate outflow of gold; stocks and bonds advancing.
11-24: 3-25	Sold $260	+ 3 to 3½%	Business at high level; discounts rising; acceptances high; prices rising; stocks and bonds advancing.
1-26		+ 3½ to 4 %	Business had advanced sharply in late 1925; bills discounted up sharply throughout 1925; acceptances up in later months. Food prices up in 1925; stocks and bonds advancing.
4-26	Bought $65	- 4 to 3½%	Business leveling off, following small decline; discounts declining; prices fairly steady at relatively high level; temporary break in stocks; bonds advancing.
8-26: 9-26	Sold $80	+ 3½ to 4 %	Productive activity advancing to peak; prices fairly steady; stocks and bonds fairly steady.
5-27:11-27	Bought $230	- 4 to 3½%	Production down substantially until November; commodity prices weak in early part of year - farm and food prices up sharply in second half; discounts low all year; stocks advancing sharply; bonds advancing; European finances strained.

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PRINCIPAL POLICY OPERATIONS

Date	Open Market (in millions of dollars)	New York Discount Rate	Prevailing Industrial and Credit Conditions
1-28: 4-29	Sold $405	+ 3½ to 5 %	Industrial production expanding rapidly; prices relatively stable except farm products and foods; bills discounted increased from $500 million to $1 billion; prices of stocks increasing sharply; prices of bonds declining.
8-29		+ 5 to 6 %	Stock prices advancing sharply; direct action applied to banks.
10-29:12-30	Bought $560	- 6 to 2 %	Outside lenders withdraw funds; production, commodity and stock prices drop sharply; bonds sustained until last few months; discounts declined sharply to $250 million.
5-31: 8-31	Bought $130	- 2 to 1½%	Production declining sharply; stocks, speculative bonds, and commodities declining.
9-31:12-31		+ 1½ to 3½%	Gold flowing out as England abandons gold standard; European financial systems strained; bills discounted increase from $¼ billion to over $¾ billion; stock, bond, and commodity prices declining sharply; drop in business temporarily halted.
2-32: 8-32	Bought $1,110	- 3½ to 2½%	Production and stock and bond prices reach depression low; commodities declining; discounts declining.
2-33: 3-33		+ 2½ to 3½%	Acceptances and bills discounted increase sharply; stock and bond prices receding after sharp spurt in third quarter of 1932; commodity prices reach depression low; production low but on verge of sharp advance.
4-33:11-33	Bought $570	- 3½ to 2 %	Production and stock, speculative bond, and commodity prices advance sharply; wage rates increase sharply; discounts and acceptances decline.
11-33: 3-37		- 2 to 1½%	Production recovers irregularly to peak in November 1936; prices of stocks, bonds, and commodities advance to peak; wage rates reach peak; inventory speculation heavy in 1936 and early 1937; reserve requirements raised 50% in August 1936 and further increases announced; large volume of gold coming into country.
4-37	Bought $96		Business and prices turn down into sharpest recession in history; shortage of reserves at individual banks feared; market for government bonds breaks.
8-37: 11-37	Bought $38	- 1½ to 1 %	Business and prices in a period of sharp decline.
5-39: 8-39	$141 bills redeemed*		Allowed bills to run off because of premium prices; production increasing; prices of commodities weak; bonds near record high.
9-39	Bought $470 bonds & notes		Outbreak of war; government bond market declines sharply.
11-39: 1-40	Sold $84 bonds & notes		Bond prices recovering; commodity prices declining from earlier war peaks; stock prices stable; production advancing to near end of year, then declining.

* $477 in bills redeemed between June and December.

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date February 15, 1951

To See below

From Governor Szymczak

MESSAGE:

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MAR 13 1951

To: ~~Chairman McCabe~~
Mr. Eccles
Mr. Evans
Mr. Vardaman
Mr. Norton
Mr. Powell
Mr. Riefler
Mr. Thurston
Mr. Carpenter

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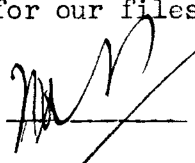

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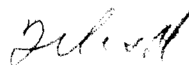

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April 18, 1950.

General Files

Mr. Tinsley

Authority of Secretary of Treasury to issue obligations that do not have a fixed maturity.

x Treasury Obligations

The first section of the Second Liberty Bond Act (Title 31, §752), as amended, provides:

"The Secretary of the Treasury ... is hereby authorised to borrow ... and to issue therefor bonds of the United States.

"The bonds ... shall be ... subject to such terms and conditions of issue, conversion, redemption, maturities, payment, and rate or rates of interest ... as the Secretary of the Treasury from time to time at or before the issue thereof may prescribe. The principal and interest thereof shall be payable in United States gold coin ..." (§463 later prohibited payment in gold). [underscoring supplied]

The question has been raised whether the Secretary of the Treasury has authority under this provision to issue obligations that do not have a fixed maturity. Any such obligations would be similar to the English "consols", i.e., the principal is never reimbursed, the interest only being paid, and the only way the Government can redeem them is by purchase in the open market.

One of the first arguments that could be made is that such an obligation would not be a "bond" as used in the statute. However, there seems to be no justification for saying that a "bond" must have a fixed maturity date. In fact, §751 of Title 31 provided for "bonds" which "shall be payable at the pleasure of the United States after thirty years from the date of their issue." And a similar provision was made by Act of July 12, 1882, (22 Stat.165) providing for the exchange of then outstanding bonds.

The statute provides for bonds subject to such terms and conditions of maturities as the Secretary may prescribe. It may be argued that this means the Secretary must prescribe a maturity date. But were not the "terms and condition" meant to be flexible? Could not the Secretary prescribe maturities of 10 years? Or 100 years? Or 1000? Or "at the pleasure of the United States"?

The statute provides that "the principal and interest thereof shall be payable in ..." It may be argued that this means that payment of principal is mandatory, and, therefore, there must be a maturity date. However, it also may be argued that this merely describes the mode or manner of payment (i.e., gold). Moreover, the statute provides for such terms and conditions of payment as the Secretary may prescribe.

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Sara A. Dyer

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Section 752a provides that if convertible bonds are issued under the authority of §752, then the bonds issued upon such conversion "shall have the same dates of maturity ... as the bonds converted." This would seem to imply that it was contemplated that bonds issued under §752 would have a fixed maturity.

Section 753(a) provides that United States notes issued under the section shall be payable not less than one nor more than five years from the date of issue; §754(a) provides that certificates of indebtedness and Treasury bills issued under the section "shall be payable at such time not exceeding one year from the date of issue ..."; and §757c provides that savings bonds and Treasury savings certificates issued under the section "shall mature, in the case of bonds, not more than twenty years, and in the case of certificates, not more than ten years, from the date as of which issued."

These three sections provide for time limitations on obligations issued under them, but there is no limitation in §752 (authorizing the issue of bonds).

The question whether Congress should prescribe maturity dates for bonds issued under authority of §752, or prescribe a limit beyond which the Secretary could not fix maturities, was discussed on the floor of Congress. Amendments were proposed and defeated apparently because Congress thought the Secretary should have discretion in prescribing the terms and conditions of the bonds to be issued. However, from the debates, one gains the impression that it was contemplated that the Secretary would fix the maturity date at thirty years or less. The debates may be found at 55 Cong. Rec. 6576, 6639-40, 6645, 7169-79.

No attempt has been made to come to any conclusion on this question. The purpose of this memo is merely to record arguments that could be used if the question is considered.

WHT/ewe
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November 24, 1950

Messrs. Thomas and Young

Mr. Sherman

Following is an excerpt from the meeting on November 21, 1950, of the Board with the Federal Advisory Council:

"4. A discussion of the Treasury refundings for December and January.

"The Board is familiar with the views of the Council, as expressed in previous discussions, regarding the necessity of shifting a portion of the debt to intermediate and longer maturities. The Council believes that the present is a desirable time to bring out an intermediate maturity in connection with the refundings of December and January. If the members of the Board wish to express their views, the Council will be pleased to have them.

"President Brown stated that the Council realized the difficulty of discussing matters affecting the Government security market which the System had under discussion with the Treasury, that the Board was familiar with the recommendations made to the Treasury by the American Bankers Association Committee on Government Borrowing, and that the Council did not know whether the Board would wish to express any opinion on this matter or whether it would favor the suggestion that the Treasury offer an intermediate issue in the December and January refunding. The objection to such an issue, he said, was that corporations hold a substantial percentage of the maturing issues and might not want to hold an intermediate security, but it appeared to the Council that that situation could be met by the Federal Open Market Committee following a liberal policy of making the October and November 1951 notes available at around 1-1/2 per cent.

"There was a general discussion of the market effect of an intermediate issue and Chairman McCabe asked the Council's view on the action of the Open Market Committee in allowing the short-term rate to move to a somewhat higher point. Members of the Council indicated that the increase was desirable because it put the banks in a position where if the Board should raise reserve requirements the banks could obtain additional reserves through the sale of short-term securities only at a penalty rate which had had a restrictive influence on the extension of bank credit. President Brown stated

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"that the apprehension of the Council had been that the increase in the short-term rate above 1-1/2 per cent would result in sales of long-term securities, particularly restricted issues, and that he did not see how the rate could go above that level at this time without serious unsettling effects on the long-term market.

"In response to an inquiry by Chairman McCabe as to whether an intermediate refunding issue would tend to put pressure on the short-term rate and to freeze that rate, President Brown said that he did not want to say that the short-term rates should never be permitted to move higher, that it might be desirable to examine that question at a later date, that he disagreed with the policy of the Treasury and the Board that the long term 2-1/2 per cent rate should be supported, and that he felt that the price on long-term securities should be permitted to go below par.

"In a discussion of these points, Mr. Eccles stated that the purpose of System's actions was to restrict credit, that he did not feel that the actions taken up to this point had accomplished that objective, and that the issuance by the Treasury of an intermediate security in connection with the December and January refunding would only tend to reduce flexibility in the market because a further increase of the short-term rate would cause the new issue to go below par. In these circumstances, he thought the current refunding should take the form of a one-year certificate and that the short-term rate should be permitted to go just as high as possible without putting continuing pressure on the long-term 2-1/2 per cent rate.

"At the conclusion of the discussion, Chairman McCabe stated that yesterday he had conferred with the Treasury with respect to the December and January refunding and that he did not feel free to tell the Council what the recommendations of the Federal Open Market Committee had been. However, he said, in the discussion that had taken place at this meeting with the Council, he could not detect any area of disagreement.

"President Brown stated that the next meeting of the Federal Advisory Council would be on February 18-20, 1951, and that, if it were found to be desirable to have a meeting of the executive committee of the Council with the Board in the interim, the date for such a meeting could be fixed later."

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Returned to Mr. Phillip Thomas

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4-4-71

OPEN MARKET OPERATIONS

TECHNICAL ASPECTS AND MONEY MARKET EFFECTS

Your discussion leader has indicated that you are interested in the mechanics and techniques as well as the money market aspects of Federal Reserve Bank open market operations. As you know, the term "open market operation" has reference to the purchases, sales and redemptions of various credit instruments by the Federal Reserve Banks under the statutory authority of the Federal Reserve Act and in accordance with regulations and directions of the Federal Open Market Committee. Since open market operations are for all practical purposes currently concerned almost wholly with United States Government securities, it has seemed best to start these remarks with a short review of the more salient facts with respect to Treasury debt -- its size, growth and principal features. I shall follow this with comments on the structure and operational mechanics of the market in which United States Government securities are traded. This will give a convenient point of departure for a more detailed look at the operations themselves and a clearer picture of the techniques and problems involved in their execution.

I. NATURE OF THE PUBLIC DEBT

Growth and Importance

United States Government debt is one of the most significant features of American economic life. In the past decade the total United States interest-bearing debt has increased six-fold. At the end of 1929 it amounted to $18 billion or 9 per cent of outstanding private debt*; by the close of 1939 it was $50 billion or 32 per cent of private debt*. At $256 billion#, the Federal debt now exceeds the total private debt* of the nation; it is about equal to the gross national product and several times the value of all stocks on the New York

* Including state and municipal obligations.
\# Including matured and non-interest bearing debt.

FOR FILES
L. McColloch

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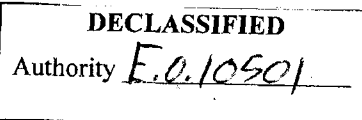
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Stock Exchange. Clearly, as a result of its phenomenal growth over the past decade, it has assumed a wholly new place in our national economy. It has become the principal readily shiftable investment medium for most financial institutions and individuals and as such exercises a dominant force in the determination of monetary and credit developments.

Form

The public debt is the most frequently cited aspect of the postwar monetary problem, because of the size, broad ownership and its acceptance as a liquid or readily shiftable asset. Of major importance also but less frequently emphasized as an important problem in determining debt management and credit policies, is the form and structure of the debt. The composition of the debt as of February 28, 1950 is given in the attached Table No. 1.

Marketable Treasury obligations amount to some $154 billion or 61 per cent of total interest-bearing debt, with Treasury bonds ($103 billion) predominating. These are composed of bank-eligible taxable and partially tax-exempt bonds and ineligible restricted bonds, having maturities running from several months to seventeen years and nine months (call date for the 2 1/2's of December 1967-72). Certificates of Indebtedness (maturities of twelve months or less) rank second in size at $24 billion, followed by Treasury notes (maturities of one-to five-years) at $15 billion, and Treasury bills (maturities of ninety-one days or less) at $12 billion. At present rates, the return on marketable Treasury obligations ranges from 1.15 per cent on ninety-one day Treasury bills and 1.17 per cent on nine-month certificates* to 2.35 per cent on the longest term Treasury bonds (a differential of 1.18 per cent for seventeen years). Rates on these issues rise as the maturity

* Longest maturity outstanding.

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increases thus forming a well-defined and fairly smooth curve of yields, the level and slope of which is subject to constant change, depending on the particular influences at work at any given time.

Although our interest lies mainly in marketable debt, there should be cited here the Treasury's exposure, as a borrower, to the uncertain claims of holders of some $65 billion of Savings Bonds and Savings Notes because these obligations are an element of great potential significance with a direct bearing on the marketable segment of the debt. They are held chiefly by the non-professional investing public and while they are not negotiable, they are redeemable and, to that extent, constitute a demand obligation of the Treasury. The fixed terms of these issues, with their penalties for premature redemption, are closely related to the going market rate so that the stability of their ownership depends, among other things, upon the prevailing rate structure of the marketable debt. Fixed redemption provisions are scaled so that redemption before maturity is penalized by a smaller interest return while a reward for non-redemption increases with the passage of time. In this way ownership tends to be encouraged and a wider area is created for fluctuations in market rates before the redemption of non-market securities becomes profitable. Leaving aside the element of psychology and viewing the matter purely in terms of the arithmetic of the redemption schedule, it would probably take an appreciable increase in the going market rate on comparable maturities to discourage sales and invite shifts out of non-market into market debt or into cash.

Non-market debt has increased modestly in the postwar years due to the Treasury's efforts to promote ownership in those issues. Any reversal of this trend would mean that the Treasury would have to draw on its cash balances to meet redemptions and, under present budgetary conditions, market borrowing

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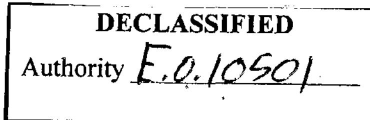

for cash through the banking system would be necessary to meet the public's cash claims. It is evident then that while these bonds and notes require no direct market support, continuity of ownership is related in part to the action of intermediate and long maturities of marketable Treasury bonds. They can thus be a limiting influence on basic rate changes on the marketable debt and a factor to be reckoned with by those with a direct or indirect administrative responsibility for market conditions in United States Government securities.

Maturity Distribution and Ownership

A classification of Treasury marketable debt, according to maturity or first-call date, shown in attached Table No. 2 provides some idea of the term structure of the debt and points up the concentration of maturities in the next five years. In the next year alone the Treasury must refund eight separate issues totaling $32 billion (exclusive of weekly roll-overs of Treasury bills, outstanding in the amount of $12.3 billion).

Investment needs of investor groups vary widely and their combined influence on supply and demand shapes the general character of the market and creates a set of sub-markets within the whole. Although investors have come to regard United States Government securities generally as little different from cash, there still exists a well-defined set of divergent maturity preferences which influence the ownership and trading activity in different areas of the market and conditions the whole debt management problem for which the Treasury and the System have a joint responsibility.

The general maturity and rate structure of the debt at any given time have a direct bearing on ownership distribution and hence on volume and the character of market activity. To the extent that rates and types of issues are not kept in conformity with the interests and requirements of investors, elements of instability in ownership are created. Of course, the positions of

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various investor groups are constantly changing and portfolio adjustments are a normal daily occurrence. But shifts in ownership, if carried too far in too short a space of time, may lead to disorderly markets and may thus force the System to undertake open market operations for market stabilization purposes with a limiting influence on their effectiveness as a credit control weapon. The major investor groups which, in the broad sense, constitute the market for United States Government securities, and their general maturity preferences are indicated in the attached Table No. 3.

These few facts provide a rough idea of the character of the Treasury debt and suggest some of the ramifications of the debt management problem. The existence of a fairly broad and homogeneous body of Government debt provides an effective medium through which open market operations can be used in the expression of central banking policy. At the same time, the form of the debt is such that the Treasury, faces a formidable and complicated problem of refunding successfully maturing issues, both marketable and non-marketable, in the next three years; this problem will tend to place limits on the System's range of operations in its efforts to carry out appropriate and effective credit policies. The future scope for open market operations will depend to a large extent on the need for the System "to make a market" for Treasury obligations at the expense of credit considerations. This need, in turn, will depend on the supply of and demand for investment funds and whether refunding offerings meet the requirements of the market.

It seems appropriate at this point to examine the market in which the vast body of Government debt is traded and the mechanics that exist for effecting ownership changes.

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II. STRUCTURE OF MARKET FOR UNITED STATES GOVERNMENT SECURITIES

Over-the-counter-Market

The market for United States Government securities is known as an "over-the-counter" market. There is no formally organized central meeting place or exchange in the sense that there is for stocks, bonds and commodities. The market exists and is given substance through the operations of a relatively small group of security dealers specializing in the purchase and sale of Government securities. While only one element in the market, they perform a unique function in creating and maintaining an active market over an extensive network of telephones and private wire systems thus providing a focal point of activity. It has been suggested that a more apt name would be the "over-the-telephone" market since the bulk of the business is done by telephone calls between security dealers and customers. Trading is centered in the hands of a relatively small number of dealers and dealer-banks. It is the function of these dealers to bring together buyers and sellers and facilitate ownership changes by standing ready to match the demand and supply at a given price. While it is true that a market for Treasury bonds exists on the New York Stock Exchange, it is little more than a pale reflection of the over-the-counter market for trading and even on active days turnover on the Exchange is a microscopic fraction of the volume of trading in the unlisted market.

All the larger dealers have their principal offices in New York City and Chicago but they do business of a national scope partly through the medium of branch offices, representatives or other security firms. Many local investment firms throughout the country handle Government security business which they pass on to the large Government security houses for a commission. These

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dealer and investment house facilities are materially supplemented by the activities of many bank institutions throughout the country with trading departments. Many other banks encourage their correspondent banks and other clients to place orders through them. All of the facilities existing outside of New York City for trading in Government securities are operated on the basis of the New York market, both with respect to quotations and breadth. Except for a small amount of orders which are matched off by bank and investment firms in local markets, the trading is done ultimately with or through the offices or branches of the Government security dealers and dealer-banks in New York City and Chicago.

The dealers' main activity is to maintain a liquid market for outstanding securities. In carrying out this function dealers engage in three operations - buying, selling and the maintenance of a portfolio. Unlike a broker, the dealer does not restrict his operations to buying and selling on orders of customers although under special circumstances the dealer may confine his activities largely to an order business. At any given time, a dealer is generally long certain issues and short certain others and, in this way, obtains some protection against changes in the general average of Government security prices. Usually, however, he is either net long or short depending on his judgment of the future course of the market.

A dealer creates a market when he is prepared both to buy and sell at the prices he quotes; he maintains a market when he continues over a period of time to state prices at which he is ready and willing to buy and sell. He maintains a substantial holding (position) in a variety of issues and normally stands ready to buy and sell in size. The size of his market is determined by many factors, including his total position, the condition of the market, the issue in question, his capital and borrowing capacity. The dealer makes his

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regular income by selling at a higher price than he buys although he takes some income from the interest accrual on his portfolio in so far as it exceeds the cost of borrowing to carry his position. He also stands to have substantial capital gains or losses as a reflection of the effect of rises or declines in price on the securities in his position. At times the creation and maintenance of a market is a delicate task and can be done only by constant contact with investors, dealers and other segments of the market and estimates of current and prospective Government and Federal Reserve policy. The market trend is not determined by one dealer but by all dealers, who reflect their appraisal of demand and supply by the markets they make (their bid and offered quotations) and constantly refine through telephone calls from dealer to dealer.

Prices of Treasury bonds are quoted in multiples of 1/32 or 1/64 and usually the spread between bid and asked prices is 2/32 although at times it may widen to 1/4 of a point under abnormal conditions. This differential between bid and asked prices is "closed up" or reduced in actual trading when activity is reasonably well balanced. Most short-term issues (bills and certificates) are traded on a yield basis. Generally, transactions are for next day (regular) delivery and payment (although deferred or delayed deliveries are not uncommon), and payment is made in Clearing House funds unless otherwise specified. Cash transactions call for delivery and payment the same day. However, the Federal Reserve Bank always insists on payment in Federal funds* when it is a seller and similarly always makes payment in Federal funds when it buys. Where new issues of Treasury obligations have been offered for subscription but not yet issued, trading in such obligations is on a "when issued" basis. Most contracts are oral with written confirmation at the end of the day.

* i.e. Immediately available funds at the Federal Reserve Banks as contrasted with other types of balances such as Clearing House funds which in New York are not available until the day after their receipt in the form of checks or drafts on Clearing House banks.

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III. RELATIONSHIP OF FEDERAL RESERVE BANKS TO GOVERNMENT SECURITIES MARKET -- OPERATING STANDPOINT

The Federal Reserve System occupies a unique position in relation to the United States Government security market. This stems from its statutory authority but the changing features of the American economy, with the large growth in the public debt, have widened the responsibilities of the System and brought open market operations into a position of new prominence in meeting that responsibility. Under the law the Federal Reserve Banks are authorized to buy and sell in the open market a variety of credit instruments. Actual purchases and sales are confined in practice chiefly to obligations of the United States Government although at times bankers acceptances have played an important role in the System's operations. For present purposes only United States Government securities need to be considered. These transactions, known as "open market operations" are one of the major general instruments of credit control. By the terms of Section 12A of the Federal Reserve Act, as amended, the time, character and volume of all purchases and sales of United States Government securities in the market shall be governed with a view to accommodating commerce and business and with due regard to their bearing on the general credit situation of the country. With the changes wrought by the war open market operations have increased in significance and are now the most flexible and effective instrument in the Federal Reserve System's equipment for affecting the supply, the availability and the cost of credit. The active role played by open market operations in recent years is suggested by the fact that wartime operations in United States Government securities have brought total holdings of those issues from $2 billion at the end of 1941 to a peak of $24 billion on December 31, 1945. Subsequently holdings have declined to a current level of some $17 billion.

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Money Market Effects of Open Market Operations

Purchases of Government securities by the Federal Reserve Bank increase the supply of reserves available to the commercial banks while sales have an opposite effect.* To the extent that transactions are made in effect, from the portfolios of investors and corporations, deposits as well as reserve balances are affected as the funds involved are deposited in, or withdrawn from, their banks.

Open market operations are effective as an influence on the availability of credit (as distinct from the supply) by encouraging or discouraging lending activities of the member banks and indirectly other suppliers of credit. Through their effect on the supply of reserves and availability of credit, Federal Reserve Bank transactions in United States Government securities also influence interest rates on both public and private credit, either in limited areas or throughout the whole range of the money and capital markets. The character of this latter influence can also be varied by selling one class of Government securities and buying another without a change in the total holdings of the Federal Reserve Banks. Thus, because of their flexibility and the

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* As has been indicated earlier, securities which are bought and sold for the System Open Market Account pass through the hands of Government security dealers. These dealers maintain accounts with one or more local commercial banks which lend them the funds needed to finance their purchases and to carry positions. In some cases, the banks also act as clearing agents on their security transactions. In making and receiving payment on their transactions with the System Account, dealers arrange with their banks of account to make debits and credits to their respective bank's reserve accounts at the Federal Reserve Bank. For example, when a dealer delivers securities to the Federal Reserve Bank against payment, he instructs the Reserve Bank to credit payment to the Reserve Account of the member bank at which he keeps his deposit, and he receives from the Federal Reserve Bank a "certified credit advice" which he presents to that bank. Under certain circumstances, the dealer may prefer to receive payment by check on the Federal Reserve Bank in which case an officer's check is issued. Where a dealer picks up securities at the Federal Reserve Bank he must pay for them with Federal funds. To do this he may arrange with his bank to obtain either a debit to its Reserve Account or a check drawn by it on the Federal Reserve Bank. The debit to the Reserve Account will generally be in the form of a letter of authorization to the Federal Reserve Bank from the member bank to charge its Reserve Account.

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tendency for credit effects to reach out into all sections of the financial structure, open market operations have an important role in any cyclical credit policy calling for alternating programs of restraint, neutrality and ease. They also serve a useful purpose in smoothing or neutralizing seasonal or short-run influences affecting reserve balances, such as ordinary gold movements and changes in currency circulation, as well as float, as distinct from basic changes in the credit base.

How Federal Open Market Policies Are Determined and Carried Out

Over the years, open market operations have passed through a number of important evolutionary stages. Early in the life of the System they were employed as a means of building up earning assets of the Federal Reserve Banks, and the individual banks bought Government securities on their own initiative without System consultation. It was soon evident that this procedure ignored the requirements of the banking system for reserve funds and resulted in a disorganization of the United States Government securities market. It became obvious that there was need for greater coordination of these operations. This situation lead to the creation in 1922 of an Open Market Committee composed of five Governors of certain Federal Reserve Banks for the purpose of recommending policies and coordinating transactions. By the spring of 1923 this Committee was reorganized to give recognition to the interest of the Federal Reserve Board in open market operations, and some guiding principles for the conduct of open market operations were adopted. At this time, a System Open Market Investment Account was also set up, and policies were formulated by the Committee for review by individual Reserve Banks. In 1933 the name of the Committee was changed to Open Market Policy Conference and its membership was expanded further to include a representative from each Reserve Bank. Further changes of a statutory nature made in the Committee under the Banking Acts of 1933 and 1935, culminated

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in the present organizational arrangement. These developments in the control and use of open market operations reflected a growing recognition of their importance as an instrument of central banking policy and a recognition of the need to coordinate their conduct more completely with other policy actions and objectives.

The Banking Act of 1935, as amended, placed open market operations under the direction of the Federal Open Market Committee, composed of seven members of the Board of Governors, the President of the New York bank and the presidents of four other Reserve Banks chosen in rotation annually. The Committee meets at least four times a year and sets the general policy. It, in turn, appoints an executive committee (three members of the Board and two presidents of Reserve Banks), which meets frequently and acts to implement the broad policy laid down by the full Committee. The decisions of the Committee are final and participation can no longer be rejected by an individual bank as was the case prior to 1935.

The Federal Reserve Bank of New York as an agent for, and under direction of, the Federal Open Market Committee operates the System Open Market Account in which the twelve Federal Reserve Banks participate for the purpose of conducting open market operations in Government securities. The New York bank, subject to approval of the Federal Open Market Committee, appoints a Manager of System Open Market Account, who is responsible for translating Federal Open Market Committee policy into action, through System operations in the market.

It is through the Government security dealers* that the Federal Reserve System maintains a constant, close and intimate contact with, and influence over, the money and Government security markets. The actual purchases and sales of

* The New York Federal Reserve Bank deals only with a limited group of qualified dealers in U.S. Government securities under terms formalized by the Federal Open Market Committee. See 1944 Annual Report of Board of Governors - pp. 48-51.

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Government securities for System Open Market Account are executed in the trading room of the Securities Department of the Federal Reserve Bank of New York. From this room direct wires connect with leading dealer firms in New York City and it is through those firms that our primary market contact is established and maintained. It should be emphasized at this point that the Bank always deals with "the market"; by that is meant that transactions are confined to dealers and direct transactions with banks and with non-bank investors are avoided. The Bank tries to be the residual or marginal factor in the market dealing only with the gap between supply and demand. The satisfaction of normal selling and buying desires of investors is left to the dealers who match off buyers and sellers or increase or reduce their positions. In this way the volume of System Account transactions is minimized while their effects are magnified.

Guides to Day-to-Day Operations

The operations of these dealers are reported on a confidential basis to the Federal Reserve Bank of New York each day. Their reports cover long and short positions in the various classes of Government securities, the amount of securities borrowed and the amount of money borrowed to carry their portfolios. In addition, the volume of trading is reported by each dealer in terms of the total of purchases and sales for each class of security. At times when the Treasury is undertaking a financing operation in the market these dealers' reports are expanded to cover data regarding the dealer's own subscription to the new issue or issues, subscriptions purchased by him as well as purchase and sale transactions in the issues included in the operation. These data provide a continuous knowledge of the principal factors in the dealer market.

Another phase of the Federal Reserve Bank of New York's contact with the market consists of daily conferences prior to the opening of the market at

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10:00 A.M. between representatives of the "qualified" dealers and those officers directly responsible for the conduct of the open market operations. Since time does not permit a daily conference with a representative of all the leading dealers, the Manager of the Account will see two or three of them each day in a rotating schedule. At these conferences the representatives review the more important developments in the market, summarize their transactions, and pass on to us any comments they wish to make, or any suggestions that they have gathered in their conversations and contact with the investing public in general. In addition, during the course of each day various dealers are in touch with us as information comes into the market, or trading tendencies develop which a dealer believes should be brought to our attention. Moreover, the tone and characteristics of the market are continually being described to us through telephone conversation.

Apart from market contacts through the dealers, the officers make a practice of maintaining fairly close contact with the portfolio managers of the large local banks, a number of large out-of-town banks, insurance companies, and savings banks, as well as with smaller security firms. The information so obtained amplifies and checks the information which is constantly being received from dealers.

The Federal Reserve Bank of New York also follows closely each day the reserve position of the money market banks in New York City, watches the clearings and wire transfers involving such banks, keeps close contact with all money market developments, including current and prospective inflow and outflow of funds, and confers with the Treasury regarding decisions as to the scheduling of calls on Tax and Loan Accounts. It is thus in a position to measure the extent of the pressure and ease in the money market and adjust operations in accordance with the general credit policy being implemented.

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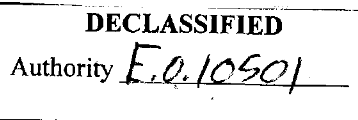

In spite of these varied sources of information, there are times when extraordinary developments upset the calculations and forecasts. In addition to the usual seasonal factors to be reckoned with on a short-term basis and the general Federal Open Market Committee policy being served, there are always a variety of political, economic and psychological elements affecting all security markets with which those connected with open market operations must deal. The job of handling transactions successfully is in reality a team operation in which all the talent and capacities of the System are needed and have an active, if varied, role to play. Those at the trading desk must be constantly in intimate touch with the market during the trading hours from 10:00 A.M. to 3:00 P.M. in order to determine first, whether System intervention is needed, and second, what form that intervention should take. They must also be continually prepared to adapt and re-adapt transactions in accordance with the requirements of a changing situation. There can, under these conditions, be no rigid or fixed technique to follow automatically. In fact, the operational procedures are seldom the same. A high degree of flexibility is required, for prompt action and a versatility of approach can add immeasurably to the effectiveness of policy refinements.

Execution of Transactions for System Open Market Account

As a general rule open market operations are accommodated to the different sections of the market and to the actions of investor groups which make up those sections, within the limitations of the general policy which the Bank is trying to express. Measured in terms of volume, open market transactions are predominantly in short-term Treasury obligations (one- to ninety-one day Treasury bills and three-to twelve-month certificates of indebtedness) which are largely held by commercial banks and which are the first issues to reflect a changing credit situation. Normally, activity in the Treasury bill and certificate

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markets will follow the ebb and flow of funds between banks and the general course of money market forces; in the short run, operations are conducted so as to moderate extremes in the swings of such forces -- at times anticipating developments, and at times waiting for them to be reflected in price and market pressures, depending on the magnitude and duration of the forces at work and the psychology which the Bank may want to create in terms of its general policy directive. More often than not, dealers take the initiative in extending bids and making offers to the System Account on transactions in short Treasury issues. They are especially active at times when their positions are expanding rapidly or, on the other hand, when their positions have been severely depleted. In these extreme situations, they are unable to meet the demands of their customers and will make offerings or bids to the Account which it, in turn, will accept or refuse in the light of the over-all situation and the general credit policy. Occasionally, one dealer will have only a limited view of the market and may be a seller at a time when another may be an active buyer, possibly on an order which he alone may have. Where the market interest is involved two dealers may be "put together" in a situation of this kind. There may be times when dealers have relatively large positions and projections forecast a considerable degree of money market stringency ahead. In such circumstances, it may be expedient to take the initiative and solicit offerings from "the market" to lessen the impact of the heavy selling expected later.

Handling maturing issues of Treasury bills and, to some extent, other maturing Treasury obligations, is a particularly important phase of open market operations under present conditions. In the case of Treasury bills, the System has a weekly decision to make as to the disposal of its holdings of the maturing issue. The Treasury normally makes a fixed offering of new Treasury bills for

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cash on a competitive basis on Friday of each week. Ordinarily tenders are received up until 2:00 P.M. on the following Monday and payment is made on the following Thursday in order to provide the Treasury with funds to meet the issue maturing on that date. The System is a large holder of Treasury bills and, depending on its maturity schedule, may either assume an active role in affecting reserve balances and influencing rates through the weekly bidding or, it may try to follow the judgment of the market. This it does by adjusting its exchange tenders as to price and amount in accordance with its appraisal of the market at the time and the basic decision as to whether its holdings of the maturing issue are to be replaced in full or in part, or redeemed, and the desired rate effect. If the System holdings of Treasury bills are redeemed in part or in whole at maturity, the money market effect is much the same as a market sale of an equivalent amount of Treasury obligations. Thus action of this kind provides a means by which some restraint can be placed on the reserves of member banks. Such a step leaves a larger amount of Treasury bills to be absorbed by the market in its bidding, since under usual conditions the cash offerings of Treasury bills are in the same amounts as the maturing issues.* It makes little difference whether the larger awards are made to the commercial banks at the expense of System holdings or whether dealers successfully bid bills away from the commercial banks and the System. In the latter case, dealers must, in turn, borrow from the banks to pay for their commitments on the payment date but in both cases funds move from the commercial banking system to the Federal Reserve Banks with a restrictive effect on reserves and a tendency for rates to rise if the shift is substantial and the money market is in anything but an easy condition.

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* System bids are adjusted to take account of differences, if any, between the amount of the bill maturity and bill offering in a given week.

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One of the problems with which we have had to contend since the war has been the insistence of most large banks on a policy of full investment and their consequent efforts to buy or sell for cash (or same-day delivery) in making necessary reserve adjustments. This occasionally causes rapid swings in the market for short-term Government securities. Despite the willingness of some banks to borrow for short periods, this investment policy places, at times, a considerable burden on the market facilities. Similarly, correspondingly greater demands are made on the System to meet these distortions in reserve positions and, in so doing, because of rate considerations to become "the market." The Federal Reserve Bank, within the limits permitted by rate effects, has resisted this practice and has refused to become a party to cash trading. However, dealers have been willing to do some of this business even on a no-profit basis for competitive reasons.

System operations in short-term Government securities must also take account of the inter-relationship between, as well as the level of, money market rates in order to maintain a smoothly functioning security market. Apart from capital funds, dealer positions are financed through loans from commercial banks. Rates on those loans vary with money market conditions. The dealers' willingness to carry positions in short Treasury obligations depends in part upon the relationship between these loan rates and the coupon or rate on the securities carried. Thus a high loan rate in a tight money market will be a deterrent to dealer borrowing and may affect the prices dealers quote to the point of forcing System intervention in a situation which might otherwise be self-correcting in the short run. To meet conditions of this kind arising out of temporary money market stringency where the need for an immediate injection of Federal Reserve Bank credit is indicated the Federal Reserve Bank of New York

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sometimes enters into repurchase agreements with qualified dealers rather than make outright purchases. These agreements may be defined as a means for making immediately available to the market, through the brokers and dealers in United States Government securities, Federal Reserve Bank funds at a fixed rate of interest under arrangements which involve the purchase by the Federal Reserve Banks of such securities subject to the seller's commitment to repurchase them at the same price within a specified period of time. All Federal Reserve Banks are currently authorized to enter into such agreements. They are, however, essentially a money market instrument to be used in close conjunction with open market operations.

In the case of Treasury bonds, where trading volume is less active and price movements somewhat larger than in short maturities, our operations must be handled with great delicacy because they are more susceptible of damaging misinterpretation and are instrumental in shaping the psychological climate of the whole securities market. The corporate and municipal bond markets are particularly sensitive to open market policies and usually respond readily to developments in the Treasury bond market. The level, as well as the direction, of rate movements for long-term Treasury bonds directly affects the volume and the character of private financing -- both new and refunding. In these circumstances the System's open market operations assume a particular importance in the day-to-day activities of the underwriters, general security dealers and the other professional elements in the market.

There are many ways in which System Open Market transactions in Treasury bonds may be handled. Those in charge may place an order for the purchase or sale of a block of securities (at the prevailing price or above or below that price) through one dealer or through several; they may buy and sell on an agency

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basis which means that the dealer acts as an intermediary between the System Account and the investor, receiving a commission for his services; they may buy and sell on a net basis in which case the dealer acts as principal, buying or selling for his own account at his quoted markets; they may wait upon the market and adjust trading operations to the situation disclosed by the firm bids and offers which dealers make on their own initiative; they sometimes use in market operations orders for Treasury investment accounts where authority permits, as an adjunct to System Open Market operations for stabilization purposes. As a general rule, they buy or sell on a commission basis,with the dealer acting as agent for the System Account as well as for his customer. In such a case, his position is unaffected. The choice between these various techniques depends on many factors, including for example, the level of dealer positions in the issues in which we may be operating, the strength of the investment demand and supply in the market, and market psychology. Finally, there are what have come to be known as "open mouth" operations. This is a term coined by the market to describe a situation in which official and semi-official statements are made with a view to encouraging certain inferences as to future policy or immediate objectives. It may also be applied to the use of moral suasion which can sometimes be exercised successfully over the market through the dealers for a given effect, in lieu of actual operations which the bank may be unable or unwilling to engage in at the time.

IV. WAR AND POSTWAR OPEN MARKET OPERATIONS - THE CONFLICT BETWEEN RATE AND CREDIT POLICIES

A quick historical look at open market operations over the past decade will emphasize how problems and objectives have varied with changing conditions and how responsibilities for a swollen public debt have come to wield such an

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important influence in the determination of open market policies. This should bring the current status of open market operations into a clearer perspective By the outbreak of the war in 1941 the role of open market operations had passed through three phases of development. Starting initially as a device to obtain earning assets for Reserve Banks, they were soon utilized to influence reserve balances for credit control purposes as a supplement to discount rate action. By 1937 their function was broadened to include preservation of orderly markets in Government securities. This concept was further expanded in 1939 as war in Europe developed.

In our war years this function was again extended and open market operations were actively employed in maintaining a pattern of rates as well as in the placement of new Treasury obligations with banks and others. When the United States entered the war in December 1941 the Board of Governors of the Federal Reserve System issued a statement with respect to war finance which included the following paragraph:

> "The System is prepared to use its powers to assure that an ample supply of funds is available at all times for financing the war effort and to exert its influence toward maintaining conditions in the United States Government security market that are satisfactory from the standpoint of the Government's requirements."

Bacause the Treasury was unable to raise, through taxation, all the funds needed to finance the war in amounts and at rates which kept pace with expenditures, extensive reliance was placed on borrowing. A large part of the Treasury borrowing in the years 1941 through 1945 was done outside the area of the banking system but the Treasury was nonetheless forced to lean heavily on the banks for its cash needs. It became the duty of the Federal Reserve System not only to maintain a stable market in which the Treasury could complete its financing operations but also to assure the success of Treasury loans in terms

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of subscription response. Through open market operations the System, therefore, took an active part in maintaining a fixed rate structure in the Government security market which was considered vital to the success of the war effort on the financial front in order that 1) a market would be available for Treasury securities at rates known in advance, 2) Treasury borrowing would be possible at steady rather than at rising rates, and 3) the incentive for investors to defer purchases of Government securities in the hope of rising rates would be eliminated. Large scale purchases of United States Government securities by the Federal Reserve System to prevent rates from rising (many of which were made at the fixed buying rate of 3/8 of 1 per cent posted on Treasury bills), provided the banks with the reserves needed to enable them to act as residual buyers of market debt, and to meet a rapidly expanding public demand for currency.

After the war the System endeavored to reorient its policies to the requirements of the peacetime problems. In the period 1946-48 the primary concern of the Federal Reserve System was the two-sided problem of combatting strong inflationary pressures and of maintaining an orderly and relatively stable market for United States Government securities. The war-time growth of public debt and its new financial significance as a repository of abnormally large war-time savings left the Federal Reserve System at the conclusion of the war with a heightened sense of peace-time responsibility for conditions in the Government security market, especially in view of the fluidity of holdings of much of the debt, post-war economic abnormalities and international commitments. The guiding consideration was credit restraint within the limits imposed by 1) the avoidance of action which might have an adverse effect on full production and employment, 2) the maintenance of conditions conducive to the successful refunding of maturing Treasury obligations. Rate stability required that the System act as a

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residual buyer of Government securities to maintain market liquidity and stabilize market values at a time when credit policy was directed toward restraint. As a result the successful administration of open market operations as a credit instrument was greatly complicated.

This basic conflict between rate and credit policy continues to dog the System but in less acute ways. The form in which that conflict has manifested itself and the problem it presented at any given time has varied. Different elements in the problem have received varying degrees of emphasis, depending on the market, the budget and the economic situation. In the various discussions of the problem the fundamental, central criticism leveled at the System has been the charge that over-emphasis on debt management responsibilities has made an arbitrary structure of rates the overriding criterion in the determination of open market operations, with a perverse effect on the supply of money. In this way, it was feared, an effective brake on the potential increase in the supply of money would be removed and the Treasury encouraged to handle its debt on the basis of interest costs rather than on monetary considerations.

In order to prevent support operations from resulting in net additions to Federal Reserve Bank holdings of United States Government securities and thereby providing a basis for a multiple expansion in commercial bank credit three steps were taken in the period 1946-48:

1. Utilization of Treasury cash balances and surplus to retire maturing debt with emphasis on the debt held by the Federal Reserve Banks, as inflationary forces grew.
2. Controlled increases in short-term rates on United States Government securities.

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3. An increase in discount rates and legal reserve requirements against demand deposits for member banks.

As a result the System was able to offset by redemptions and sales of short term Governments not only the effects on bank reserves of its own purchases of Government bonds but also the greater part of the effects of other factors such as an inflow of gold and a gradual reduction in currency circulation. Growth in the money supply first slowed and then reversed itself.

In 1949 the character of this open market problem changed and its seriousness temporarily lessened as inflationary pressures abated and deflationary tendencies assumed, for a while, greater relative importance. In view of the accumulating evidence of economic readjustment, the System first modified and later reversed the earlier policies adopted to combat post-war inflation by relaxing certain qualitative controls imposed over credit under Regulations T, U and W and later by reductions in reserve requirements of member banks. Open market operations also played a critical role in the implementation of this redirected policy through their influence over the supply, the availability and the cost of credit. The Federal Open Market Committee after consultation with the Treasury Department, reformulated policy with respect to open market operations along lines intended to increase their flexibility and to coordinate them more closely with other instruments of Federal Reserve policy. Toward this end the Federal Open Market Committee made the following statement on June 28, 1949:

> "The Federal Open Market Committee, after consultation with the Treasury, announced today that with a view to increasing the supply of funds available in the market to meet the needs of commerce, business, and agriculture it will be the policy of the Committee to direct purchases, sales, and exchanges of Government securities by the Federal Reserve Banks with primary regard to the

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> general business and credit situation. The policy of maintaining orderly conditions in the Government security market, and the confidence of investors in Government bonds will be continued. Under present conditions the maintenance of a relatively fixed pattern of rates has the undesirable effect of absorbing reserves from the market at a time when the availability of credit should be increased."

This statement represented a significant milestone in the development of a peacetime credit policy aimed at striking a fairer balance of interest between Reserve System responsibilities in the related areas of debt management and credit control. With the cooperation of the Treasury Department, short-term rates have been permitted to move more freely in response to market forces and System credit policies. Short-term rates moved sharply lower in the summer of 1949 in reflection of the easy money policy then in effect. Later as recessionary forces spent themselves rates again responded by hardening slightly. The Treasury Department recognized this market situation in the choice of terms used in its refunding operations.

The System has been moving as rapidly as circumstances will permit toward the restoration of a freer market. It has availed itself of every opportunity to relax the rigidities of the rate stabilization practices of the war and early post-war years in favor of a policy of guided flexibility in rates, the full expression of which has not yet been fully developed. The future role of the open market instrument will be determined by the measure of agreement that can be achieved between the System and the Treasury in coordinating actions in the separate areas of administrative responsibility.

What is involved in such coordination of action and the results that may reasonably be expected from it have been cogently stated in the following quotations from two speeches made earlier this year by Allan Sproul:

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"The primary role of the Federal Reserve System in promoting economic stability is in the field of monetary and credit policy, with which we must now always associate debt management. We will gain much, I believe, if we can achieve general recognition of the inherent interrelations between the two, and of the need for continually directing both, harmoniously, toward the objective of economic stability.***there cannot be a purposeful monetary policy unless the Federal Reserve System is able to pursue alternating programs of restraint, 'neutrality,' and ease, as the business and credit situation may require. Such programs must, as they accomplish an increase or contraction in the volume of credit and a tightening or loosening in the availability of credit, affect interest rates, not only for private credit, but for Government securities. The terms of Treasury offerings for new money, and for refunding issues, must be affected. Yet those effects will, at times, be inconvenient and burdensome to the Treasury in its management of the enormous public debt, and may conflict with otherwise praiseworthy efforts to minimize expenditures for debt service. This is a conflict which will continue to arise, in one form or another, so long as this public debt, huge in relation to our present national income, is with us. It is not a problem which can be solved by demanding more courage or independence on the part of the Federal Reserve System, nor by attacking indiscriminately the Treasury's understandable concern with the cost of servicing the public debt."

(Excerpt from remarks of Allan Sproul, President, of Federal Reserve Bank of New York, at the Conference of Chairmen of the Federal Reserve Banks and Directors of the Federal Reserve Banks of New York and Minneapolis and their branches, in Washington, D. C., on January 16-17, 1950.)

"***if a suitable permanent framework for the relations between debt management and monetary policy can be established, the tasks of monetary control and debt management will not be impossible. While the money market is not so sensitive to slight changes or disturbances as it was from 1946 through much of 1948, when large segments of the swollen public debt had not yet settled into firm hands, it is still sensitive to relatively small changes in the interest rate structure, and to any uncertainty concerning the future direction of rates created by such changes, in terms of its readiness to make funds available for expansion. Through judicious use of discount rates and flexible open market operations, it should be possible to make

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monetary policy reasonably effective without such abrupt and such wide changes in interest rates as used to be considered quite normal and a necessary part of central banking technique. Such a monetary program would be consistent with moderate fluctuations in the cost of servicing the debt (and it is important to remember that 'fluctuation' does not mean only decreases, or only increases, but changes which may 'average out' over time); nor would such a program contemplate (or require) large changes in the prices of outstanding Government securities."

(Excerpt from remarks of Allan Sproul, President, of Federal Reserve Bank of New York, at the Midwinter Meeting of the New York State Bankers Association, New York City, January 23, 1950.)

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Table 1.

STATEMENT OF UNITED STATES DIRECT AND GUARANTEED PUBLIC DEBT OUTSTANDING#

(In millions of dollars)

		Outstanding 2/28/50	Per Cent
Direct Debt			
Market Issues:			
Treasury Bills		12,336	4.9
Ctfs. of Indebt.		24,399	9.6
Treasury Notes		14,790	5.8
Treasury Bonds		102,796	40.5
Other Bonds		160	-
	Sub-total	154,481	60.8
Non-Market Issues:			
U. S. Savings Bonds (*)		57,217	22.5
Savings Notes		7,988	3.1
Investment Series Bonds		954	.4
2% Depositary Bonds		287	.1
Armed Forces Leave Bonds		325	.1
	Sub-total	66,771	26.2
Special Issues		32,871	13.0
Total Interest Bearing Debt		254,123	100.0

* Current redemption value

\# Reflects exchange of certificates due March 1 and bonds called for payment March 15, for new Treasury notes.

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Table 2.

SUMMARY OF UNITED STATES DIRECT
INTEREST-BEARING MARKET ISSUES OUTSTANDING FEBRUARY 28, 1950 #
CLASSIFIED BY YEAR IN WHICH ISSUES BECOME DUE OR CALLABLE

(In millions of dollars)

				Treasury Bonds				
				Part.	Taxable			
Year	Bills	Ctfs. of indebted.	Treasury Notes	Tax-exempt	Unrestricted	Restricted	Total	Cumulative Total
1950	12,336	19,026	3,596	1,186	7,574		43,718	43,718
1951		5,373	4,659	3,500	8,496		22,028	65,746
1952					17,013		17,013	82,759
1953				725			725	83,484
1954			4,675	681			5,356	88,840
1955			1,860	2,611			4,471	93,311
1956				982	5,272		6,254	99,565
1957								99,565
1958				919			919	100,484
1959						8,754	8,754	109,238
1960				1,485			1,485	110,723
1961				50*			50	110,773
1962						2,118	2,118	112,891
1963						2,831	2,831	115,722
1964						7,599	7,599	123,321
1965						5,197	5,197	128,518
1966						3,481	3,481	131,999
1967					2,716	19,656	22,372	154,371
Various				110*			110	154,481
	12,336	24,399	14,790	12,249	41,071	49,636	154,481	

* Wholly Tax-Exempt

Reflects exchange of certificates due March 1 and bonds called for payment March 15, for new Treasury notes.

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Table 3.

TREASURY SURVEY OF OWNERSHIP, NOVEMBER 30, 1949

SUMMARY OF INTEREST BEARING PUBLIC MARKETABLE SECURITIES

CLASS OF HOLDER	HOLDINGS AS A % OF MARKET DEBT OUTSTANDING	HOLDINGS BY CALL CLASSES AS A PER CENT OF TOTAL HOLDINGS					
			Due or first becoming callable				
		Total	In 1 yr.	1-5 yrs.	5-10 yrs.	10-15 yrs.	Over 15 yrs.
Commercial Banks	38.5	100.0	43.8	38.1	11.3	2.5	4.3
Mutual Savings Banks	6.9	100.0	4.2	10.1	18.3	27.2	40.2
Life Insurance Companies	9.4	100.0	1.3	5.6	6.5	25.8	60.8
Fire, Casualty & Marine Insurance Companies	2.5	100.0	25.3	19.5	19.5	16.5	19.2
U. S. Government Investment A/CS and Federal Reserve Banks	14.8	100.0	48.5	8.0	4.8	7.0	31.7
All Other Investors	27.9	100.0	45.3	13.4	8.1	7.6	25.6
TOTAL	100.0	100.0	37.7	21.3	9.7	8.8	22.5

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REC'D IN FILES SECTION
AUG 24 1949

August 24, 1949

Chairman McCabe — Money market prospects

Woodlief Thomas

The attached copy of a regular weekly table showing possible future changes in bank reserves in Federal Reserve market operations indicates the sort of situation that might be expected in this week and next.

The important aspect of this situation at present is that member banks hold a substantial amount of excess reserves--1384 million on last Wednesday, August 17. During the two weeks from that date, some 500 million dollars will be added to available reserves by the reductions in reserve requirements, but these will be more than offset by retirements of 700 million dollars of Treasury bills from the System account and further increases in Treasury balance at the Reserve Banks resulting from additional offerings of bills. As a result, member banks will need to draw down their excess reserves by a substantial amount.

Member banks could meet the entire drain by drawing upon excess reserves and still have an excess of over 800 million dollars. Since, however, most of the excess reserves are held by country banks, we cannot be certain how rapidly those funds will be put to use. As of Monday of this week country banks had over 800 million of excess reserves, which is some 300 million more than they have customarily held. Reserve city banks had on that date 266 million of excess reserves, which is approximately 100 million more than they ordinarily carry. Central reserve city banks also had somewhat more excess reserves on Monday than is customary.

It appears likely, therefore, that the money market may be relatively easy during the next week and the System may be called upon to buy some securities on Thursday or Friday, but on other days there may be sales by the System. We have allowed for net purchases in the coming week on the assumption that banks will be slow in drawing down excess reserves.

(Signed) WOODLIEF THOMAS

Attachment - R+S 200-32 filed statement
WT:rj
Cc: Governor Szymczak

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REC'D IN FILES SECTION
AUG 18 1949

August 12, 1949

Chairman McCabe — Recent developments

Woodlief Thomas

Money market

Money market developments in the first week after the announcement of the decrease in reserve requirements have been in some respects surprising. The first decrease was limited to country banks, and it was not until Thursday, the 11th, that city bank requirements were reduced. The two most striking developments have been the heavy demand for certificates rather than bills and the prompt decline in excess reserves at country banks.

As a result of the strong market demand for certificates, about 238 million dollars of certificates were sold from the System account in the week ending August 10. Treasury bills in the account, on the other hand, showed an increase for the week, reflecting purchases before the announcement of a reduction in reserve requirements and only moderate sales (59 million dollars) on Monday and Tuesday of this week. On Wednesday and Thursday, figures for which will appear in next week's statement, 116 million of certificates and 38 million of bills were sold, and 269 million of bills were redeemed.

In supplying certificates and bills, the New York Bank permitted only a small decline in rates for bills and practically none in rates for certificates. The margin between the rate on 3-month bills and 10-month certificates is only 6 basis points. Existing market pressures would tend to put the rate on certificates lower if it were not for System action in selling at the higher rate.

Two explanations may be offered for the heavier demand for certificates than for bills. (1) The reduction in reserve requirements to date has applied only to country banks, which generally prefer certificates to bills. (2) City banks, dealers, and perhaps other well-informed buyers expect that short-term interest rates will decline as a result of Board action and are anxious to buy certificates at present rates, as well as to hold on to those that they have. The bank statement for August 10 indicates that both factors were operative.

New York City banks increased their holdings of certificates in the week by 220 million dollars and Chicago banks showed an increase of 20 million. Both groups of banks reduced their holdings of bills, but this was probably the result of sales before the reduction in requirements was announced.

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The weekly statement also shows that country banks were quick to make use of their additional reserves. Estimated excess reserves of country banks for Wednesday, August 10, showed an increase of only 40 millions above the estimate of the preceding Wednesday before making allowance for the retroactive reduction in reserve requirements. In other words, the country banks utilized about 200 millions of the 244 millions released. It is not possible to know whether this represents a shift of funds that might have occurred in any event or whether it reflects quick action by the country banks in investing available funds. Because of the retroactive feature of the reduction in requirements, country banks could reduce their reserves for this week down to the level that will prevail next week. It is possible that some country banks have already taken advantage of this opportunity.

The policy of keeping up the rate on certificates has probably encouraged the market to buy certificates rather than buy bills or hold excess reserves. If the rate on certificates had been permitted to decline in response to market demands, the margin between bill and certificate rates might have narrowed to a point where bills would have been more popular. It may be said, on the other hand, that the policy followed is serving to effect a quick absorption of available excess reserves and may prevent a sharp decline in interest rates just prior to the announcement of Treasury financing and then a subsequent increase in rates. Establishment of coupon rates on new financing would be made more difficult by such fluctuations.

Another conclusion that is suggested by these developments is to cast some doubt upon the prevailing view that the nominal spread between the 1-year certificate rate and the 3-month bill rate should be 1/8 per cent. If banks and other investors prefer certificates to bills and indicate their preference in the market, then perhaps the System should not endeavor to prevent an adjustment in the relationship of these rates.

As for future developments, the situation in the current statement week may be somewhat different. About 400 million of additional reserves were made available to city banks on Thursday and another 400 million will become available to country banks on Tuesday, although the latter may be in part anticipated. In any event, there should be abundant funds in the market. Offsetting these funds are the maturities of bills in the System account yesterday (Thursday) amounting to 269 million dollars, together with the increase in bills sold and a call on war loan accounts of 100 million dollars. Dealers obtained about 330 million dollars of bills on Thursday and will want to dispose of these bills or borrow on them in order to hold out for the higher price (lower rate) that they expect will occur. This will exert some strain on the market. On balance, however, the market should be relatively easy this week.

For the following statement week, the Treasury has already announced an additional offering of 200 millions of bills for Thursday, the 18th, even though it does not need the extra money. There are also about 330 millions of maturities in the System account on that date.

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The decrease in reserve requirements becoming effective at city banks on the same date amounts to 250 million dollars. It is not unlikely that there may be some pressure on the market in that week if the System's holdings of bills are permitted to run off.

The same may be true in the next two weeks (ending August 31 and September 7), when the System's bill maturities amount to about 400 million each week and the decreases in reserve requirements to 250 million a week. There will also be a holiday currency demand in this period. If the Treasury should offer additional bills in those two weeks, the pressure would be increased somewhat. It is not unlikely that the System may be called upon to purchase securities in the market during the latter part of August and the first week of September, notwithstanding the reductions in reserve requirements becoming effective in that period. (Further details of prospects for future weeks are included in a revised statement with tables now being prepared.)

Another development of interest shown in the weekly statement is an increase in commercial loans at New York City banks of 38 million dollars and at Chicago banks of 6 million dollars.

The Treasury cash balance has continued to increase in excess of previous expectations. The total, excluding gold, was 2.5 billion on August 10. In view of this it is all the more surprising that the bill issue is being increased again next week. The Treasury has announced, however, that it will no longer pay interest for the elapsed period of the month for Series D notes purchased after the first of the month. This may have a mild moderating effect on current sales of these notes but should affect the distribution of sales within the month rather than the total volume.

The attached sheets give comments regarding various other economic developments concerning which we have recently obtained information.

(Signed) WOODLIEF THOMAS

Attachments
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With orig

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D IN FILES
JAN 23 1947

Carded

January 21, 1947

Mr. S. A. Miller
Assistant Vice President
Federal Reserve Bank of New York
New York 7, New York

Dear Sy:

Attached is a redraft of pages 4-6 of your Bill Statement, to follow after line 4 on page 4. There are no changes on pages 1 and 2. On page 3 we suggest changing the second paragraph to read as follows: "It is proposed, therefore, that the posted buying rate and repurchase option for Treasury bills be eliminated. The points that need discussion include:"

Best regards,

Richard A. Musgrave
Chief, Government Finance Section

Attachment
RAM:db RAM

P.S. Mr. Thomas has not yet seen our changes and will not be able to get around to it until Monday, but I thought you might like to have some comments in the meantime. I shall call you after getting his ideas.

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(2) If the posted buying rate and repurchase option on Treasury bills are eliminated, there is a choice between continuing the present volume of Treasury bills at higher rates and replacing them by certificates.

One possibility would be for the System to discontinue its purchase and sale of bills at the 3/8 per cent rate and permit the open market bill rate to rise toward the three months certificate rate, while continuing to refund maturing bills into new bills at the higher market rate. Or the bill rate could be pegged by the System at some lower level, just as the certificate rate is now pegged, by buying and selling in the market as the demand may arise.

The other alternative would be to eliminate or greatly reduce the amount of total bills outstanding to a level of about 5 billion. It is clear that so long as the certificate is supported at a fixed guaranteed rate, the bill will not have a market except as it becomes the equivalent, in rate, of a certificate of the same maturity. It can be argued, therefore, that there is little or nothing to be gained in having outstanding two competing instruments serving essentially the same purpose, that the bill mechanism of offerings and tenders is out of place, and that all short borrowing be done with certificates. To do this gradually, the posted rate and the repurchase option might be continued, but new issues of bills would be reduced and those of certificates increased. In effect, bills would be refunded into certificates and eventually bills would disappear from the market.

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(3) The large Federal Reserve holdings of government securities raise a problem of excess earnings. The aggregate level of System's Treasury security holdings is, for practical purposes, indefinitely frozen. The redemption of these holdings for cash is not feasible nor can any substantial net sales of Treasury obligations be made by the System pending gains in reserves from an inflow of gold or a return flow of currency in circulation, or from a cut in reserve requirements which, at this time, would be contrary to official policy. The excessive level of earnings would be increased further if the bill rate was raised or certificates were substituted for bills.

One proposal is that, on the assumption that Treasury bills will be offered on an exchange basis, the System would maintain the 3/8 per cent rate on only its own bill holdings, allowing the open market rate to rise on holdings of Treasury bills by others. This solution is simple but by itself inadequate, as it would not solve the problem of excessive earnings which exists even at the present bill rate.

A second possibility is that a substantial part, say, 12 billion dollars out of the 15 billion dollars of bills held by the Federal Reserve Banks, might be exchanged for a demand or short-fixed maturity Treasury certificate bearing a low-fixed rate of interest (say 1/8 per cent or 1/4 per cent). To meet objections of "direct purchase" the exchange of maturing Treasury bills could be effected by a Treasury offering to all investors of special certificates at a low rate payable on demand. Any bills held outside the Federal Reserve Banks probably would not be exchanged because of the low rate and would be redeemed at maturity.

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Conversion of 12 billion dollar holdings of Treasury bills by the System into special 1/4 per cent certificates of indebtedness would mean a yearly reduction in Treasury interest payments and System earnings of 15 million dollars. If the special certificates were to carry a 1/8 per cent rate the reduction would be double that amount. The special certificate rate might have to be adjusted from time to time to meet changed earning positions of the Federal Reserve Banks. From the outset, some fractions of present bill and certificate holdings would be retained in marketable form and in addition provision would be made for the privilege of exchanging the special certificates into marketable bills or certificates when open market policy so requires.

Another proposal is to impose a franchise tax with which to absorb the increase in earnings due to holding of bills at a higher rate or to exchange bills against certificates. Without a franchise tax, conversion of all bills into 7/8 per cent certificates or a corresponding increase in the bill rate would result in an annual increase in the carrying charges on the public debt in the neighborhood of 65 million dollars to 85 million dollars most of which, under existing conditions, would accrue to the Federal Reserve Banks. This increase in Treasury costs and Federal Reserve earnings would be offset or more than offset by reimposition of a franchise tax on Federal Reserve Bank earnings. While a franchise tax would not prevent an increase in interest charges it would provide an offset on the receipt side.

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It would appear to be desirable for the System to be currently appraised of the investment policy of banks and of the reasons for past and prospective changes in such policy. Such information would be particularly helpful to me in studying current developments in the Government security market, and I should think it would also be helpful to the officers and directors of the Federal Reserve Banks. In the recent past, commercial banks were generally lengthening their portfolios, and this policy had an important influence in strengthening the market for 2 per cent bonds and in resulting in a substantial supply of bills and short-term certificates. There is some evidence now that banks are either in a transition phase or are beginning to shorten their portfolios.

Developments of this nature have an important bearing in the planning of open market operations and of Treasury financing. In this respect, it is useful to know not only past trends as reflected in reported figures but to have some indication of future trends. In connection with open market operations, it is helpful to know what securities the System is likely to purchase or to sell in the near future. Such information would be particularly useful in the post-war period in the event that the System should find it desirable to modify or gradually to abandon the maintenance of a pattern of rates.

In connection with Treasury financing, it is useful to know not only recent trends involving shifting from one group of securities to another but also what trends may be expected in the future. If, for example, there is considerable evidence that banks are anxious to decrease their holdings of 2 per cent bonds, this fact should be an important consideration in the determination by the Treasury regarding offerings of such securities. Specifically, I should like to suggest that the System contemplate a study of these questions somewhat along the following lines:

1. A tabulation by each Reserve Bank for each weekly reporting member bank in its district of such significant figures as holdings of each of the five classes of Government securities, deposits, loans, other investments, and reserve balances.

2. A tabulation of a sample of other banks obtained from the call reports. It would not be necessary to tabulate all of the smaller banks, but a carefully chosen sample of such banks in each district should indicate current trends.

3. A study of trends at each of the banks for which figures are tabulated. This study would indicate banks that are receiving an inflow of funds and the disposition made of those funds into reserve balances, loans, or investments in Government securities by classes. It would indicate for banks that are losing funds the type of asset that is being reduced. Finally, it would indicate for banks having little or no change in total funds available any shifts that they might be making among their assets.

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4. After studying the trends of individual banks, it would be helpful for an officer of the Reserve Bank to interview the investment officers of these banks, particularly the banks whose figures indicate some change in policy. In these interviews, the Reserve Bank officer would discuss the recent changes and attempt to obtain information as to the reason back of the changes and as to future investment policy. It would also be helpful to ascertain what type of securities each bank would prefer to purchase in a future Treasury offering.

5. Each Reserve Bank would make such use of this information as might be desired by the officers and directors of the Bank. In addition, it would be of value to the Board if the Reserve Banks would send a periodic report of the results of their studies and interviews. It is contemplated that such reports would not be in great detail but might cover general trends in the recent past and any changes in trend that banks may contemplate for the future, together with such suggestions regarding future Treasury financing as the banks may have to offer.

6. It would probably be desirable for the committee to outline a general program and method of approach, in order to bring about uniformity among the twelve Banks in developing this study and the interviews.

7. If this program proves to be successful, it might be helpful to expand it to include insurance companies, mutual savings banks, and other important groups of investors in each district.

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IN FILES SECTION
JUN - 8 1943

June 7, 1943.

Mr. Albert C. Agnew,
General Counsel,
Federal Reserve Bank of San Francisco,
San Francisco, California.

Dear Mr. Agnew:

Please accept my thanks for your very kind letter of June 2, 1943, enclosing for my information a copy of a letter which you addressed to the Assistant Attorney General of California under date of May 27, 1943, on the question whether surplus funds of the State of California may be invested in Treasury bills issued by the Treasury of the United States.

I have read your opinion on this with much interest and feel that there can be no doubt about the correctness of the conclusion which you have reached. Even if Treasury bills were not technically bonds they would at least be included in the broad term "obligations * * * for which the faith and credit of the United States are pledged" in the section of the California law quoted on page 1 of your letter.

You refer to the opinion which I addressed on October 27, 1942, to Mr. Eccles in his capacity as Chairman of the Federal Open Market Committee, relating to the limitation on the amount of obligations of the United States which may be acquired directly from the United States; but you did not say whether or not you agreed with my conclusions. If you care to express any views on that subject I would be interested in receiving them.

With all best wishes and kindest personal regards, I am

Cordially yours,

Walter Wyatt,
General Counsel.

Copies FOMC - Genl (ref to 10/27/42)

WW:aad

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

REC'D IN FILES SECTION
MAR 26 1943

Office Correspondence

Date ~~March 17, 1943~~

To Board of Governors

Subject: Treasury financing.

From Ronald Ransom

CONFIDENTIAL

Cardex

Sometime ago I asked for a chart showing the extension through 1944 of the pattern of securities then being issued by the Treasury. Of course this could be nothing more than a forecast, but I thought it might be helpful to see where we would come out by that time if we continued to follow the then existing program. Copies were sent to all Board Members.

I asked Mr. Goldenweiser to have Miss Burr take one copy of this chart and insert actual results for the four months November 1942-February 1943. On the attached chart the changes indicated in red are the actual results rather than the forecasted results. Also attached is a memorandum from Miss Burr, dated March 13, commenting on these changes. This may be interesting to members of the Board and is being circulated with the request that it be returned to me.

Attachments 2

Chart retained in Mr. Ransom's office.

FOR CIRCULATION

First to Mr. ...

Mr. Ransom ✓
Mr. Szymczak ✓
Mr. McKee ✓
Mr. Draper ✓
Mr. Evans ✓
Mr. Clayton ✓
Mr. Morrill ✓
Mr. Bethea ✓
Mr. Carpenter ✓
Mr. Thurston ✓
Mr. ...
Mr. ...
Mr. ...

Please note and return

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MAR 26 1943
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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 15, 1943

To Mr. Goldenweiser
Subject:
From Miss Burr

On the attached schedule of monthly issues and redemptions of public marketable securities through December 1944 prepared last October, there have been inserted the actual results for the four months November 1942-February 1943. Comparison of actual results with the schedule brings out the following points:

Chart returned to Mr Parsons office.

1. The monthly distribution of offerings was greatly changed as a result of the December Victory Drive, the idea of which was at a very preliminary stage when the schedule was prepared. Three-quarters of the net change in securities took place in December.

2. The net increase in marketable securities outstanding was about $3½ billion less for these four months than shown by the schedule. Nevertheless the net increase in dollar bills and in certificates outstanding has been somewhat larger than shown by the schedule and the net increase in outstanding long-term bonds sold to investors has been smaller than shown by the schedule.

Net increase in public marketable securities
November 1942-February 1943
(in billions of dollars)

	As shown by October Schedule	Actual
Bills	2.0	3.1
Certificates	4.4	4.9
Notes	3.3	(-)0.2
Bonds—short-term	4.0	3.1
long-term	3.5	2.8
TOTAL	17.2	13.7

Considering the fact that this schedule showed by the end of 1944 a very substantial increase in bills and certificates, you might well be concerned that offerings have run ahead of the schedule.

3. The volume of savings bonds and tax notes appears to have changed during the four months about as estimated, although

Copy filed
Cap. mkts. + Bus. Fin.
Security mkts.
Sec. Issues + Retirements
General
All Memo 3/17/43

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F. S. Fitzgerald

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the savings bonds appear to have run a little behind the expectations of September and the tax notes a little ahead.

Revision of this schedule to December 1944, to take account of the periodic Victory Drives and the issuance of short-dated bonds, might give some interesting results, especially if the revision were made after the results of the April drive are known.

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Governor

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SEP 30 1942

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date September 29, 1942

To Board of Governors
Subject: Lowering Discount Rates

From Gov. Szymczak

I am sure you will find the attached memorandum of interest. It relates to the subject we discussed yesterday with the Presidents at the Open Market Committee meeting.

I am quite aware of the fact that there will not be much borrowing and we should not encourage Banks to go into debt over a long period of time. However, having so realistic a presentation of the long range program by Drs. Goldenweiser and Williams, we must be aware of the fact that we shall be compelled to rely more and more upon Open Market operations and less and less on reduction of reserve requirements.

The job ahead of us is tremendous. It is only common sense, therefore, that urges us to provide rediscount facilities for member Banks at a rate which will make it possible for them to borrow, if and when reserve conditions in individual member Banks are such as to make this advisable and part of our long range program on the subject of reserves and Government deficit financing.

I don't think, ~~in fact, I am convinced~~, that rediscounting can be expected, nor should be expected, to provide any major share of the new reserves needed. However, lowering the general rediscount rate is highly advantageous for member Banks, which may find themselves in a tight reserve position, to avail themselves of the rediscount facilities for which the Federal Reserve Banks were created.

The attached memo concentrates on the subject discussed yesterday, namely, general versus preferential rediscounting.

Attachment

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BOARD OF GOVERNORS
OF THE
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REC'D IN FILES SECTION
AUG 16 1940
333

Office Correspondence

Date August 12, 1940

To Files

Subject:

From Mr. Morrill

Government bond market

During a meeting of the Board on August 9, 1940, Mr. Draper distributed copies of the attached memorandum relating to steps which might be taken to improve the relations of the Federal Reserve System to the Government security market and it was agreed that the matter should be considered at a conference to be held on Monday, August 12, 1940.

Messrs. Eccles, Ransom, McKee, Davis, Draper, Morrill, Carpenter, Thurston, Wyatt, Goldenweiser, and Piser met in the Board Room on Monday, August 12, for that purpose, at which time Mr. Draper stated that his reason for requesting that consideration be given to the advisability of making the changes suggested was that he felt the present arrangement was not working satisfactorily and that some program should be worked out which could be discussed and adopted by the Federal Open Market Committee.

The draft of program was considered in the light of its possible effects on the Government security market, the inability of the System to control the causes of the present money market situation, and the suggestion that possibly the most important element in the solution of the problem was the selection of a manager of the System open market account who would report directly to the executive committee of the Open Market Committee rather than to a Federal Reserve Bank.

With reference to the large amount of Treasury financing that would be necessitated by the defense program, Mr. Goldenweiser stated that Messrs. Parry and Piser were working on a memorandum covering that matter which would be submitted to the members of the Board for consideration prior to the next Treasury financing operation, and Chairman Eccles said that between now and December of this year the Board might well make a complete study of the Government fiscal policy as it relates to monetary and credit conditions and thereafter express its views with respect to the effect of that policy on the credit situation.

Mr. Draper suggested that a committee be appointed to consider and report to the Board on the advisability of selecting

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a well-qualified expert to make a study of the functioning of the Government bond market and submit a report containing recommendations as to the methods, if any, by which the present organization and functioning of that market could be improved.

This suggestion was discussed and it was decided that between now and the first meeting of the Federal Open Market Committee after March 1, 1941, Mr. Draper would consult with members of the staff for the purpose of formulating a program which he would be prepared to recommend with a view to the consideration by the members of the Federal Open Market Committee in Washington of the desirability of placing it upon the docket of the first meeting of the Committee after March 1, 1941.

SRC:sbm

FOR APPROVAL

First to Mr. Draper

Mr. Ransom ....
Mr. Szymczak ....absent
Mr. McKee ....
Mr. Davis ....
Mr. Draper ....
Mr. Clayton ....Absent

Please note, check and return to Mrs. Fitzgerald.

This memo
not entered in minutes
of Federal Reserve Board

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AUG 16 1940

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Foreword

The scope of this suggested program is not broad. In fact, it is so restricted that it is a fair question as to whether the changes suggested herein are worth making at all.

However, this is the problem that faces us:- If in a meeting of the Open Market Committee we are to discuss a definite plan for better control of government bond dealers, it seems essential that we present a united front at that meeting. With this aim in mind, we might as well be realistic and admit now that it is probably impossible for all of us to agree upon a program which to some of us might seem too far-reaching. On the other hand, a modest program which we could all support might be considerably more effective than no program at all. Also, such a program would have 3 distinct advantages:

First. It would give some of us a clearer insight into the problem as a whole.

Second. It would educate our staff into a better familiarity with actual working technique.

Third. It would serve as evidence to all concerned that while we believed present conditions could be improved, we had decided to proceed in a cautious and reasonable way, to which no fair-minded person could take exception.

MINUTES ON
JUL 1940

MINUTES ON
AUG 9 1940

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Suggested Program

With these facts in mind the following program is suggested:-

1 - The System should control within limits the portfolio of dealers. We know that this is taking place to some extent at present but there is evidence to show that the methods used are neither very definite nor very strict. We also receive no regular reports on just what is being done.

2 - Individual Reserve banks should provide to member banks and small investors a service of buying and selling government securities at existing New York quotations.

Transactions under this plan should be limited to those involving not more than $200,000.00 of government bonds in any one transaction.

All transactions of this character should be carried on by each individual Reserve bank keeping in touch with us here in Washington and having its orders executed through us rather than directly with the New York bank. Our staff here in Washington, in turn, would keep in touch with the New York market by receiving hourly quotations in ordinary times or 30 minute quotations in times of crisis. From our point of view, the advantages of having all this small business clear through our staff here in Washington are obvious.

3 - The System should engage in more frequent swap transactions in order to keep the market as non-rigid as possible.

4 - Over-the-counter quotations should be made public at regular and frequent intervals during the day. This could be accomplished

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by providing the Dow Jones Ticker Service with quotations on a selected list of the most active bonds every hour in ordinary times and every 30 minutes in time of crisis.

5 - The New York Stock Exchange should be used more freely than at present. This could be done by putting in bids and offers at more frequent intervals. It might be worth the effort to try and build up a larger amount of business on the Stock Exchange.

6 - A dealer's confirmation should indicate whether the transaction was executed on a dealer or a broker basis.

7 - Bank supervisors should be instructed to be more critical of those banks which are continually trading in and out of the market.

8 - The dealers, both recognized and unrecognized, should be encouraged to form an association for the purpose of improving trading practices in the market. If such an association were brought into being, and proper regulations adopted, it would give added strength to reputable dealers and to us in thwarting the efforts of those who attempt to raid the market or act in other ways prejudicial to decent public and private standards.

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Mr. Morrill ✓

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AUG 16 1940

Some Thoughts On The Suggested Program
Relating To The Government Bond Market

E.G.D.

1. So far as small orders are concerned, the present procedure is an artificial one. New York is not the money market for all types of money. It is the money market for big money. The money markets for small money are west of the Hudson River.

2. From a management standpoint the present method of handling orders is inefficient in that, regardless of the location of the buyer, these orders are executed in New York whereas many of these orders could have been executed in the districts in which they originate.

3. Under this proposed plan New York would still execute all orders, both large and small, originating in its own district. Only those orders originating in other districts would be serviced direct.

4. The present arrangement of subservience by other banks to New York is an unhealthy one, particularly in a regional central banking system such as ours. If we were a purely central bank, such as some of the foreign central banks, the situation would be different. But we are not.

5. In these days when the System itself is so relatively free from burdensome problems, any move of this nature should help to revitalize the System's regional activities without in any sense injuring the basic functions of the Open Market Committee setup in New York.

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6. As to the freedom of action of the dealers under the present setup, this state of affairs is fraught with danger, particularly under future potentialities in the world situation. If, in the future, our record shows that we have not even made a modest effort to strengthen this setup, we are certainly laying ourselves open to criticism that could have been easily avoided by a little extra foresight now. Even if this suggested program, or a similar one, is rejected by the Open Market Committee, at least the record will show that we are aware of the dangers involved and that we tried to do our best to meet them.

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First. It would give some of us a clearer insight into the problem as a whole.

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8 - The dealers, both recognized and unrecognized, should be encouraged to form an association for the purpose of improving trading practices in the market. If such an association were brought into being, and proper regulations adopted, it would give added strength to reputable dealers and to us in thwarting the efforts of those who attempt to raid the market or act in other ways prejudicial to decent public and private standards.

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MAY 10 1940
323

May 9, 1940.

Mr. George L. Harrison, President,
Federal Reserve Bank of New York,
New York, New York.

Dear Mr. Harrison:

I wish to thank you for your letter of May 7 relative to the outcome of the experiment of a regular reporting service from a representative group of investment banking firms.

The copy of letter sent to each firm in the group, referred to in your letter as being enclosed therewith, was evidently omitted inadvertently. When it is received, I will circulate your letter to the other members of the Board for their information.

Sincerely yours,

(Signed) Chester C. Davis

CCD:CSP

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FOR FILES
E. L. McKnew

FOR FILES
Carol Piper

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FILES SECTION
DEC 27 1949
333.

December 22, 1949.

Mr. John K. Langum, Vice President,
Federal Reserve Bank of Chicago,
Chicago 90, Illinois.

Dear John:

In accordance with your request of December 20 we are enclosing three copies of the document entitled, "A Proposal for a New Type of Long-Term Government Bond." The proposal shares authorship rather widely. As I remember it Win Riefler was the prime mover originally, but the thing has been worked over by several others here at the Board including Ralph, Woody, Al Koch, Tom Smith and myself. Al was largely responsible for the idea of the prospectus for presentation, although again this responsibility is shared by others.

12/18/49

I am sorry that I forgot to wire you regarding the table in the December Bulletin. At any rate, your students at the Wisconsin School will have something to work on from the December leading article.

Merry Christmas.

Sincerely yours,

(Signed) Richard Youmgdahl

Richard Youngdahl, Chief,
Government Finance Section,
Division of Research and Statistics.

Enclosures 3.
RY:mww

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FEDERAL RESERVE BANK OF CHICAGO
CHICAGO 90

December 20, 1949

Mr. C. Richard Youngdahl, Chief
Banking Section
Division of Research and Statistics
Board of Governors of the
Federal Reserve System
Washington 25, D. C.

Dear Dick:

12/18/49

Thank you for the document entitled "A Proposal For a New Type of Long-Term Government Bond". I would appreciate receiving two or three additional copies of this proposal if they are available. By the way, who prepared the proposal?

Sincerely yours,

John K. Langum

John K. Langum
Vice President

FOR FILES
Richard Youngdahl

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12/18/49

A

PROPOSAL FOR A NEW

TYPE OF LONG-TERM

GOVERNMENT

BOND

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THE PROPOSAL

To offer a new type of Government bond that would be:

Long-term
Repaid, with interest, in equal instalments
Nonmarketable
Redeemable at owner's option
Available on tap

WHY THE PROPOSAL?

During the next three years the Government faces the problem of refunding or refinancing a major portion of its debt:--

45 billion dollars of bills, certificates, and notes are now outstanding.

45 billion dollars of bonds will become callable.

Basic considerations regarding the maturity distribution and form of the Government debt:--

Too large a floating debt creates refinancing problems for the Treasury and greatly restricts the flexibility and scope of monetary action.

Too large a volume of long-term, marketable securities presents problems of maintaining orderliness in the market for such securities.

It would be in the public interest if a significant proportion of the refinancing required in the next few years would come from an offer of long-term, nonmarketable bonds that would appeal strongly to institutional investors.

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FEATURES OF PROPOSED BOND

1. Denominations:

   $1,000, $5,000, $10,000.

2. Price:

   100 per cent

3. Semi-annual interest and instalment repayments of principal:

   $25 per $1,000

   First semi-annual payment would be approximately 1/2 interest and 1/2 repayment of principal; thereafter a decreasing proportion of each semi-annual payment would be interest and an increasing proportion, repayment of principal, for the outstanding principal would gradually be declining.

4. Period of repayment:

   28 years

5. Redemption privilege:

   At owner's option

6. Yield:

   When held to final maturity--2.52 per cent

   When redeemed prior to maturity--approximately equal to the yield that might be obtained by investing for a corresponding maturity in the present Government securities market.

7. Amount which may be held:

   Available for subscription at any time in unlimited amounts.

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PAYMENTS AND YIELD OF BOND

Semi-annual payments made on a $1,000 bond of the proposed type at the end of the years noted would be as follows:

End of:	Total payment	Interest	Repayment of principal
First year	$25.00	$12.44	$12.56
Fifth year	25.00	11.12	13.88
Tenth year	25.00	9.27	15.73
20th year	25.00	4.79	20.21
28th year (maturity)	25.00	.31	24.69

The bond would yield the following percentage return if held for the period indicated:

Period held:	Redemption value at end of period indicated:	Yield to redemption	Additional yield if held from end of period indicated to maturity:
One year	$960.55	1.10%	2.65%
Five years	814.70	1.41	3.14
Ten years	654.81	1.84	3.67
20 years	324.68	2.33	5.14
To maturity (28 years)	--	2.52	--

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WHO MAY OWN?

Nonbank investors only, except that savings deposits of banks may be invested on a formula basis.

The bond should appeal particularly to:

- Life insurance companies
- Fire, marine, casualty, and surety insurance companies
- Fraternal benefit insurance companies and organizations
- Banks with savings deposits
- Savings and loan associations
- Trust funds
- Pension funds
- Endowment funds
- College and university funds
- Foundations
- Religious organizations
- Trade unions
- Credit unions

It would also be available to individual investors, but would be most attractive to those with large accumulated savings.

No limitation on amounts that could be purchased or held.

General Comment:--

Ineligible for commercial bank investment, except for a specified proportion of savings deposits. The bond would be an attractive form in which to hold some of the commercial bank funds now invested, for liquidity reasons, in bills and certificates. In such investments, however, heavy redemptions and new purchases would be a burden on the Treasury and a source of confusion in the money market.

Once seasoned, the bond should command a growing market with portfolio investors, institutional and individuals.

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ADVANTAGES TO INVESTORS

The bond would be particularly attractive to institutional investors because:

(1) It would be safe

(2) It would yield a comparatively high return

(3) It would be liquid

(4) It would provide a staggered series of principal repayments and offer good opportunity to carry out a flexible investment policy in accordance with changing market conditions.

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ADVANTAGES TO THE TREASURY

The bond would assist the Treasury in:

(1) Obtaining long-term money at low cost.

(2) Moving toward a more balanced debt structure, particularly as to maturity.

(3) Placing an additional and significant portion of the long-term debt in permanent hands because of the high additional yield investors have to forego if they redeem the bond prior to maturity.

(4) Mitigating debt management problems of the type that have prevailed thus far in the postwar period. Our monetary and debt management authorities have recognized the need for maintaining an orderly market for long-term marketable Government securities during this perbd, but this tended to offset the effects of other measures taken by them to promote economic and monetary stability.

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ADVANTAGES TO THE FEDERAL RESERVE

(1) Reduce possibility of need for support operations.

(2) Increase the flexibility of credit policy.

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ADVANTAGES TO THE PUBLIC

Issuance of this bond in a significant amount helps to assure the public that:

(1) Monetary and credit policies appropriate for maintaining stable economic progress will be more flexibly and promptly adopted.

(2) The Treasury is prepared to put some part of its debt on a regular retirement basis. Funds for debt retirement might be considered a part of the Federal budget, and a semi-automatic method of debt reduction be adopted.

(3) A freer, yet orderly, Government securities market will continue to be an objective of national financial policy.

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SUPPORTING

MATERIAL

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IMPORTANCE OF FEDERAL DEBT IN THE ECONOMY

The Federal debt now is:

Approximately equal to the gross national product

In 1939, it was less than 1/2

In 1929, it was less than 1/5

About 1 1/2 times the size of the money supply

In 1939, it was 5/6

In 1929, it was 1/3

About 60 per cent of all public and private debt

In 1939, it was 1/4

In 1929, it was 1/10

The Federal debt backs:

3/5 of our total deposit and currency supply.

1/3 of our life insurance reserves.

All of our postal savings.

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THE CURRENT STRUCTURE OF THE GOVERNMENT DEBT

As of August 31, 1949, the total Federal debt was:

256 billion dollars

This total was made up of 254 billion dollars of interest-bearing, and 2 billion of matured or non-interest bearing, securities.

The interest-bearing debt was made up of the following types of securities:

Marketable securities				$156 billion
Bills, certificates and notes			45	
Bonds			111	
Eligible for banks to own		61		
Partially or wholly tax exempt	15			
Fully taxable	46			
Restricted as to bank ownership		50		
Nonmarketable securities				65
Series E savings bonds		33		
Series F and G savings bonds		21		
Savings notes		7		
Investment bonds		1		
Other bonds		3		
Special issues				33
Total				254

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PATTERN OF DEBT INSTRUMENTS USED IN WAR FINANCE

During the five year period ending December 31, 1945 the Treasury obtained 377 billion dollars to finance the war. This total included 149 billion from taxes and 228 from borrowing.

Type of Security	Amount issued (In billions of dollars)			Purchased mainly by:-
Marketable debt			157	
Bills, certificates, and notes		69		Banks, other institutional investors, and large corporations for liquidity
Bonds		89		
Eligible for banks to own	36			Banks and other institutional investors for income
Restricted as to bank ownership	52			Institutional investors and individuals for income
Nonmarketable debt			56	
E bonds		31		Individuals with low or medium incomes for high return and price stability
F and G bonds		14		Individuals with high incomes and institutional investors for high return and price stability
Savings notes		8		Corporations for liquidity and price stability
Other		3		
Special issues			15	Government agencies and trust funds for income and price stability
Total			228	

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WAR EXPERIENCE WITH THE PRINCIPAL TYPES OF GOVERNMENT SECURITIES

Marketable debt

Bills, certificates, and notes

Purchased in large volume at low yields during the war period, principally by banks, other institutional investors, and large corporations.

Investor needs for liquidity were glutted by an over supply of these securities and many holders tended to shift from these securities to marketable Government bonds in large volume in the early postwar period, thereby necessitating large-scale open-market operations in Government securities by the Federal Reserve System and the Treasury's trust funds to maintain orderly markets.

Bonds

Purchased in large volume by investors during the war period, but with large-scale, short-run purchases to obtain capital gains.

Much shifting of existing eligible bonds to banks.

In the postwar period, large-scale shifting by investors, particularly institutions like life insurance companies, out of long-term marketable Government bonds into higher-yielding private obligations, mainly corporate bonds and mortgages, thereby augmenting the inflationary pressures of the time.

Nonmarketable debt

Savings bonds

Purchased in large volume by investors, mainly individuals, during both the war and postwar periods.

Total holdings of savings bonds were maintained and expanded during the postwar period.

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THE CURRENT OWNERSHIP OF THE GOVERNMENT DEBT

As of August 31, 1949, the debt is estimated to have been held as follows:

Held by:	Amount (in billions of dollars)		Composition of holdings:-
Banks		84	
Commercial banks	67		About 45 billion, or 3/4, of all bank eligible bonds; and 19 billion, or over 40 per cent, of all bills, certificates, and notes outstanding
Federal Reserve Banks	18		About 8 billion of bonds, 5 billion ineligible for commercial bank ownership; and nearly 10 billion of bills, certificates, and notes
Nonbank investors		133	
Individuals	69		About 49 billion, or 7/8, of all savings bonds outstanding; and about 17 billion of other bonds, mostly marketable.
Insurance companies and mutual savings banks	32		About 31 billion of bonds, 24 billion ineligible for commercial bank ownership
Business corporations, associations, and State and local governments	32		About 11 billion of bonds, and 21 billion of bills, certificates, and notes, including 6 billion of savings notes
U. S. Government agencies and trust funds		39	About 33 billion of special issues of bonds, and 6 billion of other securities, mostly bonds ineligible for commercial bank ownership
Total		256	

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MATURITY DISTRIBUTION OF THE U. S. GOVERNMENT DEBT

As of August 31, 1949, the total Federal debt comprised the following maturities or first call dates:

Type of debt and maturity:-	Amount (In billions of dollars)		General Comment:-
Marketable debt		156	
1949 - 1950	61		Includes 16 billion of bonds
1951 - 1952	29		
1953 - 1955	4		
1956 - 1958	7		
1959 - 1962	12		
1963 - 1967	42		
Nonmarketable debt		67	
Savings bonds, savings notes, and investment bonds			All redeemable at option of investor. Shown as if held to maturity
1949 - 1950	2		
1951 - 1952	15		
1953 - 1955	25		
1956 - 1958	17		
1959 - 1962	4		
1963 - 1967	1		
Other	3		Matured and other debt redeemable at option of holder
Special issues		33	Government trust funds by law must invest excess receipts in Federal securities. Net redemptions are unlikely for many years, barring a depression.
Total		256	

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MISC. 136 25M 10-38
FEDERAL RESERVE BANK
OF NEW YORK

INTEROFFI[CE]
ROUTE SL[IP]

add to
Gr H. letter

TIME ________ A. M. / P. M.   DATE 5/10/40

TO Secretary to
Hon. Chester C. Davis   DEPARTMENT / DIVISION / SECTION

REMARKS The attached is copy of letter which should have been enclosed in letter of 5/7/40 to Gov. Davis from Mr. George L. Harrison

FROM Norman P. Davis - Manager
Security Loans Department.   DEPARTMENT / DIVISION / SECTION

N. B. USE THIS FORM INSTEAD OF OFFICE ENVELOPE WHEN POSSIBLE.
TO INSURE PROMPT AND ACCURATE DELIVERY ALL COMMUNICATIONS SHOULD BE DISTINCTLY LABELED.

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REC'D IN FILES SECTION
MAY 10 1940

FEDERAL RESERVE BANK
OF NEW YORK

May 7, 1940.

Dear Mr. Davis:

Under date of April 6, 1938, I wrote to you concerning our plans to inaugurate a regular reporting service from a representative group of investment banking firms. For the information of yourself and the other members of the Board, I enclose herewith copy of a letter which I am sending today to each firm in the group giving notice of the discontinuance of the weekly reports with respect to underwriting commitments and inventory positions. As you will note from the letter, we have not found these reports to be of sufficient value to justify the trouble and expense of their compilation by the reporting firm or of their analysis by ourselves.

Faithfully yours,

George L. Harrison,
President.

Hon. Chester C. Davis,
Board of Governors of the
Federal Reserve System,
Washington, D. C.

Enc.

FOR CIRCULATION
First to Mr. Dana
Mr. Ransom
Mr. Szymczak
Mr. McKee
Mr. Davis
Mr. Draper
Mr. Clayton
Mr. Morrill
Mr. Bethea
Mr. Carpenter
Mr. Noell
Mr. Smead
Mr. Goldenweiser
Mr. Parry
Counsel
Please note, check and return to Mrs. Fitzgerald.

FOR FILES
E. H. McKnew

FOR FILES
Carol Piper

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C
O
P
Y

May 7, 1940

Mr. Harold Stanley,
Morgan Stanley & Co., Inc.,
2 Wall Street,
New York, N. Y.

Dear Mr. Stanley:

You will recall that I wrote to you under date of April 6, 1938, and subsequently discussed the participation of your firm, and other investment banking firms, in a confidential reporting service which would help to keep us informed concerning the functioning of the new issues market, and which might also prove helpful to the market.

Through the cooperation of a representative group of firms, the reporting service was established about two years ago. It has been of distinct value to us, not only because it has improved our knowledge of the methods and processes by which new issues are underwritten and distributed, but more particularly because of the intangible, but nevertheless very real, benefits which my associates and I have obtained from personal contact with you and your associates. At the present time, however, the use which we can make of the weekly reports submitted to us by your firm, and the other firms, does not seem to us to justify the effort of their preparation by you, and of their compilation and analysis by us. We, therefore, propose to discontinue this part of the service after this week.

As I am anxious that the discontinuance of the weekly reports at this time be not construed as an abatement of our interest in the functioning of the new issues market, and as I anticipate that there will be numerous occasions when we shall desire to obtain specific information with respect to particular issues or general conditions in the market, I hope that I and the officers of this bank, who have been heretofore functioning in a liaison capacity with your firm, may feel free to call upon you for such information. I should also be grateful if your firm would continue to furnish us, as heretofore, with periodic statements of financial condition.

I renew my expression of sincere gratitude for the cooperation which you have given in this undertaking.

Faithfully yours,

George L. Harrison,
President.

NPD:AS:am

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AUG 31 1949
322.

Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 29, 1940

To Dr. Goldenweiser

From Emile Despres

Subject: The principles of open-market policy reconsidered

The principles governing open-market operations were developed at a time when the short-term money market occupied a strategic place in our banking framework. Federal Reserve policies operated in the first instance upon the short-term money market, and the broader effects of these policies upon the economy were communicated through that channel. In other words, that market was the principal point of contact between the Federal Reserve System, on the one hand, and the banks and the whole economy, on the other. Through its operations in short-term Treasury securities, the System was able to increase or decrease the volume of member bank rediscounts, and the banks responded to the variations in their indebtedness by altering the terms upon which they placed funds in the money market.

Now, however, member banks, instead of having to borrow from time to time in order to keep their reserves at the required level, have excess reserves in an amount which is more than double the System's security portfolio; meanwhile, the supply of most kinds of short-term paper has been reduced to a mere fraction of its volume in the Twenties. There is little likelihood that it will be possible to restore the mechanism of the Twenties, even if such a development were desirable.

It is clear that open-market operations no longer possess the sort of significance which they had in the past. Since the principles which were developed under the conditions of the Twenties do not furnish satisfactory guidance today, there is need for a new appraisal of the functions of open-market operations in the light of today's conditions.

It is generally acknowledged that the final objective of central bank policy in its relation to economic activity is to influence the volume of expenditure in the markets for goods and services. The influence of the central bank upon expenditure is only indirect, however, and operates through the market for loanable funds. By influencing the cost and avail-

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ability of funds to those who wish to borrow and spend, the central bank can exert a retarding or stimulating effect on the volume of such expenditure. The central bank's influence is confined to the supply side of the loan market, and the actual amount of borrowing is dependent, of course, on a variety of other factors as well. Nevertheless, the volume of expenditure is never wholly independent of the cost and availability of loanable funds, and the central bank's influence over the flow of expenditure and income derives from this fact.

The focal point of Reserve System control during the Twenties was, as noted earlier, the short-term money market. This control could be exercised because the Reserve System was able to influence the volume of member bank indebtedness through open-market operations and to determine the cost of this borrowing through rediscount rates. With these instruments at its disposal the System had power to produce rapid and substantial changes in the level of open-market short-term rates, and these rate movements led to much smaller movements in the yields of long-term securities and in money rates outside the principal financial centers.

The System sometimes regarded its function as one of influencing the money and capital markets, and sometimes as one of influencing the volume of bank deposits. Under the circumstances then prevailing, it made little difference, in practice, which interpretation was adopted. Today, however, the distinction is an important one, and it is therefore worth pointing out that it is through the money and capital markets that central bank policies, and changes in the money supply, exert an influence on economic activity. Apart from its effects on the interest rate structure, [and on availability of funds] a change in money supply has little economic significance. In principle any volume of expenditure in the markets for goods and services can be financed from any quantity of money. All that is necessary is that the volume of turnover be sufficiently rapid or slow. Of course, this principle can be pushed to absurd lengths, but, within the limits of practicality, all degrees of prosperity or depression can exist whatever the quantity of money may be.

Open-market operations during the Twenties operated through their effects on the lending or investment policies of banks. For example, by selling securities in sufficient

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volume, the System was able to check an expansion of bank loans and investments, and bank deposits, or could even produce a contraction in bank assets and deposits.1/ The rise in money rates tended to draw domestic nonbanking funds, as well as foreign funds, into the money market. Thus, as banks withdrew from the loan market, bank depositors exchanged their deposits for the short-term assets previously held by banks. The decline in deposits was accompanied by a transfer of earning assets from banks to their depositors. Clearly, a shift in asset holdings from cash to nearby substitutes for cash need not have any effect on the volume of expenditures for goods and services. The statement frequently made that the Reserve System can influence the volume of deposits but not their rate of turnover is, therefore, not quite accurate. Any central bank action which tends to expand or contract the volume of deposits ~~has~~ an opposite effect on their rate of turnover. It is only in so far as ~~the effect on the volume of deposits~~ outweighs ~~its offsetting effect on the rate of turnover~~ that central bank policy can influence the flow of expenditure and income.

In practice, of course, central bank policies influence not only the volume of deposits but also, to a much smaller extent, the flow of expenditure and income. In other words, their effect on the volume of deposits is not completely nullified by their effect on the rate of turnover. But it is because money and interest rates are raised by restrictive policies, and lowered by expansive policies, that the volume of spending for goods and services is influenced by central bank action.

Let us assume, for example, that as the result of open-market sales by the Reserve System, commercial banks bid somewhat less actively for short-term paper. Treasury bill rates rise from 3 to 4 per cent, call money advances from 4 to 6 per cent, and similar, though generally smaller, movements occur elsewhere in the interest rate structure. As a result of the rise in rates corporations and institutional investors decide to exchange a part of their bank deposits for earning assets previously held by banks. Thus, a particular industrial corporation which formerly held $10,000,000 in bank deposits may now hold only $3,000,000 on deposit, with, say, $4,000,000 in call loans and $3,000,000 in Treasury bills. The fact that the corporation is

1/ The relationship of Federal Reserve policies to movements of foreign funds, and the resulting limitations on System action, will be left out of account in this analysis.

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now earning a higher rate of return on its financial assets may lead it to postpone certain types of optional expenditure, such as for inventory or plant and equipment. More important, the increased costliness of borrowing may lead to some reduction in the amount currently borrowed and, therefore, in the stream of expenditure for goods and services. Thus, the influence which central bank policies exert on the volume of expenditure for goods and services is exerted through their effect on money and interest rates; changes in the volume of bank deposits affect spending and economic activity only indirectly, through the market for loanable funds.

This point has been so fully developed because it is not generally understood and because it is of particular significance under present conditions.

The present large supply of cash is accompanied by an extremely small supply of short-term assets which represent nearby substitutes for cash. The change in the composition of assets other than cash has operated to increase greatly the demand for cash. Prior to 1933, banks were customarily "loaned up" to the limit of their available reserves and they frequently went into debt to the Reserve banks for shorter or longer periods. They held, however, large secondary reserves in the form of open-market paper, and of their remaining assets a considerable portion consisted of customers' loans, secured or unsecured, which were at least nominally short term. Today the secondary reserve of open-market short-term assets has declined, customers' loans are greatly diminished, and holdings of longer-term assets, largely Government securities, have increased. Excess reserves are truly "excess" only in the legal sense. In an economic sense, they meet the banking system's demand for liquidity which was formerly met by its holdings of short-term assets. The willingness of banks to hold their present portfolios of Government securities at existing yields is dependent on the present supply of excess reserves.

For bank depositors the story is virtually the same. The bulk of the growth in deposits relative to predepression levels has been in the deposits of financial institutions, trust funds, and well-to-do individuals. For them cash has taken the place of earning assets and the demand for cash has been heightened by the dearth of nearby alternatives in the form of short-term paper. The popularity of savings bonds

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among institutional investors and wealthy individuals is illustrative in this connection.

The demand for cash, besides being larger, is much more volatile than in the Twenties. Large investors, instead of being offered a wide range of assets of varying degrees of liquidity, are virtually confronted with the choice of holding cash or long-term securities. Uncertainty regarding the future price of such securities, i.e., the future level of interest rates, provides the principal motive for holding cash. Anyone would much rather hold an asset yielding, say, 2 1/4 per cent than hold cash, provided he were certain that the asset might be exchanged for cash at any time in the future for at least its original cost. But this certainty does not exist and speculative anticipations have free play in their influence on interest rates.

Several points emerge from this analysis. In the first place, open-market operations have significance not only because of their effect on excess reserves but also because of their effect on the bearish or bullish expectations of holders of high-grade securities. If the market believes that the System is prepared to furnish vigorous support to the Government security market, holders of high-grade securities will be less disposed to press their holdings on the market.

Second, it is just as truly deflationary for the System to refrain from buying Government securities when, owing to some unforeseen event, there is suddenly increased demand for cash on the part of holders of such securities, as it would be for the System to press its holdings on a previously stable market. Since the supply of funds is significant only because of its relation to the interest rate structure, the System is retreating from its essential task if it regards its job as that of determining the supply and allowing the level of rates to respond to the market's changing anticipations. The Reserve System should not try to avoid "taking a view" regarding interest rates.

Third, since the Reserve System was created to provide elasticity to the banking system, it has never had much power to check inflation. Its power today is greater than in the past, however, because it can exercise more direct control over long-term interest rates. It can influence not only the supply of money but also the ~~demand for cash in relation to~~ long-term assets. Merely by indicating that it regards interest rates

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as too low and is prepared to press its securities on the market, the System could produce a sharp marking up of bond yields. Conversely, by indicating that it is prepared to keep interest rates from rising otherwise than with extreme gradualness, the System could greatly increase the demand for securities at present yields.

Finally, a coordinated interest rate policy among Government agencies is greatly needed today. System open-market operations, Treasury debt operations, and the activities of Government lending agencies should all be brought within the scope of a unified policy. The Government as a whole has far more power to influence the cost and availability of funds to borrowers than in the past. This power should be effectively coordinated to promote expansion now and stability later.

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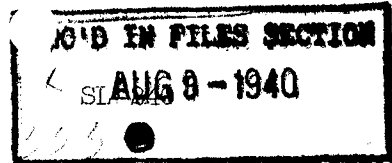

STRICTLY CONFIDENTIAL

March 11, 1940.

QUESTIONS FOR THE FEDERAL OPEN MARKET COMMITTEE

The System's open market operations, usually intended in the past to add to or to subtract from the reserves of the member banks, have been intended in recent years to influence the course of the market for Government securities -- with a view to preventing panic, minimizing disorder, or "exercising an influence toward maintaining orderly market conditions". The problems of the Federal Open Market Committee have accordingly become more numerous and more difficult. The purpose of this paper is to state some of these problems, to describe some of the proposed solutions, and to summarize with respect to each proposal the principal arguments both pro and con.

One of the difficult problems is that of formulating the objectives of contemplated operations with sufficient precision to make possible a real meeting of minds among the several members of the Committee. In the absence of such formulation, discussion is difficult to focus and decision is impeded. In addition there is the difficulty of transmitting proper instructions to the manager of the System Open Market Account and determining, both during and after the event, whether the purposes of the Committee are being effectuated. On the purely technical side, moreover, market operations designed to promote stability in the market must be broader in scope and more speedy and flexible in execution than market operations designed to influence the volume of member bank reserve balances.

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Three of the proposals for meeting the situation that have been made from time to time are discussed in this paper, each of which could be adopted either with or without the others: (1) changing the System agent selected by the Committee from an institution to an individual; (2) conducting open market operations at all Federal Reserve banks instead of at only one Reserve bank; and (3) having the System operate continuously instead of occasionally. At the end of this discussion, some proposals of a quite different order are enumerated and commented upon.

Proposal for changing the System agent selected by the Committee. - The first proposal is that the Federal Open Market Committee, instead of selecting as the System's agent either the Federal Reserve Bank of New York or any other Reserve bank, should select some individual, who would execute transactions in and manage the System Open Market Account, acting for all of the Federal Reserve banks collectively as the Federal Reserve Bank of New York does at present. He would not be on the payroll of a particular Reserve bank, however, and would not be on the payroll of the Board. He would be answerable to the Committee, but would have no more responsibility to any one member of the Committee than to any other member. A manager so appointed could be located in New York, or he could (if the Committee should so desire) be located in Washington, or the Committee could choose both a manager and an associate manager, with the idea that, taking turns, one of them might always be in Washington.

It may be argued in favor of the proposal that it would effect a clean-cut separation between policy-making personnel and operating

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personnel, thus eliminating one important source of misunderstanding, and that the agent-manager's contacts with the several members of the executive committee and of the full Committee would be much closer than they are now. This should facilitate both the formulation of open market policy and its execution, especially as the closer contacts should lead in due time to assimilation from the manager by all the members of the Committee of the technical lessons of market experience.

Possible arguments against the proposal are that for operations of such magnitude an institutional rather than an individual agent may be preferable as being more responsible, and that a manager of the account who had less independence of the Committee than the Committee's present agent and manager might fail to stand out sufficiently in the counsels of the Committee against any tendency in the Committee to undertake operations technically unsound. The arrangement would naturally be viewed with hostility in at least some parts of the financial community and might consequently be handicapped in maintaining the cooperation of dealers and dealer-banks which has always been cultivated by the officers of the New York Reserve bank and which has been found to be very valuable in connection with the acquisition of market information and helpful in connection with the floating of new issues of Government securities.

Proposal to provide for System dealings in Government securities at every Federal Reserve bank. - The second proposal is that, instead of confining System dealings in Government securities to the Federal Reserve Bank of New York, provision be made for dealings at every

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Federal Reserve bank.

The mechanics of the proposed arrangement would not involve decentralization of control. The general manager of trading for the entire System would probably continue to be the System's sole "trader" in New York, but he would in any case have under his supervision a district manager at every Federal Reserve bank. Under his supervision each district manager would be empowered to deal in Government securities for System account in his own district, on the basis of limited bids and offers decided upon by the general manager of System trading and communicated by him currently and continuously to all the district managers by teletype or otherwise. The transactions at outlying Reserve banks would be directed by the general manager according to a System plan, worked out along lines approved by the Federal Open Market Committee, that would cover such details as the amount of initiative that either the general manager or the district manager might be allowed to take, how frequently (as weekly or daily) any securities taken temporarily into the account of an individual Reserve bank should be carried to System account, and the size of the maximum individual transaction that might be handled by the district manager without having to consult the general manager.

In favor of the proposed arrangements it may be argued that they should enable the System to be more effective by dealing with disturbing liquidation "at its source", especially that arising far away from New York. Widespread dealings should add to the effectiveness of the outlying Federal Reserve banks in the counsels of the System by giving these Reserve banks increased opportunity for acquiring an intimate

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knowledge of the market. The service rendered to member banks might be much appreciated, especially by the smaller banks which are unable to hire their own "trader" in Governments to protect them in dealing in the open market. In past years, before the open market operations of the Reserve banks were completely centralized, there was some buying and selling by individual Federal Reserve banks, and even now the Reserve banks do in a small way something similar to this when they serve upon request as brokers (without commission) for member banks. There are in addition two further points, illustrated by incidents in September of last year, both of which relate to the emergency occasions when the market is unusually weak and the System is almost the only buyer: Large member banks outside New York City which have some selling to do for correspondents at such times feel unfairly treated because (1) instead of being able to sell directly to the System at its buying price they must sell to some middleman at a little lower price and (2) having to give up names of customers to dealers, as they had to do for a few days in September in order to make sales through the dealers to the System, meant giving up the names to competitors instead of to a Federal Reserve bank which is a semi-public institution.

In opposition to the proposal that System dealings be conducted at all Federal Reserve banks, it may be argued that the advantages might not be substantial enough to offset the added complexity and expense of management. In considering the contention in favor of having a ready market at each Federal Reserve bank for the member banks of the district, it may be affirmed that except in times of emergency, when the System is almost the only buyer, the market is already so well organized throughout the country as to bring a fairly ready market quite

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near to almost every member bank. It could be conceded that the proposed arrangement might help at times to halt "at the source" some liquidation by outlying member banks or other sellers, but it could still be contended that a market having the desired degree of stability can be achieved only by the System's operations in the larger transactions, most of which will continue to be in the central market at New York City.

Proposal for making System operations continuous. - The third proposal would make System operations in the Government securities market continuous instead of intermittent and would enlarge their scope in other ways. This proposal comprises three related suggestions: (1) that the System, instead of dealing actively only in periods when the market threatens to become disorderly, and then dealing only on one side, adopt the practice of dealing actively on both sides at all times or almost all times; (2) that the volume of the System's dealings be so enlarged, and their character so altered, as to make them at all times an important factor in the market; and (3) that the System, instead of confining its over-the-counter transactions to large dealers and large dealer-banks (member banks), extend its dealings to other dealers and other member banks, and possibly to other banks, to insurance companies, or even to the general public.

In favor of this proposal it may be argued that continuous and diversified dealing on a large scale would enable the System to have at all times, by direct observation and dealing experience and not (as at present) largely at second-hand, full information as to the state of the market and the size and run of transactions. This should simplify the problem of determining at any given time what the current trend of

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the market actually is and whether, in the light of established System policy, the trend is one that should be "bucked" and if so to what extent and by what type and magnitude of operations. The operations of the System "trader" should also be more effective, because professional dealers and other persons would become accustomed to seeing him trading extensively at all times on both sides of the market, now more and now less, sometimes for the System portfolio but often merely as middleman. They would consequently no longer be in so good a position to divine System policy by observing System operations, and in addition a variation in the amount of his activity in either direction would not be "news" as his entrance or withdrawal now is.

One of the objections to the proposal is that investors and traders, for some considerable time at least, would probably be very suspicious of a market in which the System would be known to be in position at any moment and without notice to exercise official influence. This might seriously impair the quality of the market. The arrangement would be at all times open to the accusation that the market is being manipulated in the interests of the Treasury and against the interests of the investing public. The proposed arrangement would be putting the Federal Reserve System into direct and formidable competition with dealers and could be viewed as likely in due time to put them completely out of business. If this view were to be widely held, and especially if it were to be shared by the Treasury, opposition to the proposed arrangement would be vigorous and prolonged. Another objection is that extensive operations to promote stability in the market cannot be combined with operations to influence bank reserves so that when the latter become practicable once more the former would have to be discontinued.

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Other proposals. - The proposals discussed have all related in one way or another to the management of System open market operations. In addition to these, mention should be made for the record of two proposals of a quite different order:

(1) It has been suggested that the New York Stock Exchange be encouraged and assisted to bring more of the trading in Government securities to the floor of the Exchange. The purpose would be to make to make the floor market, which is now very small, more representative, and in addition to bring a larger proportion of the total trading under the general supervision of the Exchange and under the Exchange's rules governing trading practices. The principal arguments against this proposal are that the obstacles in the way are very formidable. The trading in all kinds of bonds, not merely in Governments, is done mainly over the counter, and all efforts of the Exchange to bring much bond trading to the floor have heretofore failed to get anywhere at all. So far at least as trading in Government securities is concerned, an over-the-counter market has great technical advantages, largely because so many of the transactions are in large blocks, both outright and on swaps, and such transactions require negotiation and bargaining which are not possible on the floor.

(2) The suggestion has also been made that trading in Government securities should be brought under further regulation, either by extension of the present informal influence exercised over the trading positions of the six leading dealers by the manager of the Account or by bringing trading in Governments under "anti-manipulation" rules of the Securities and Exchange Commission that have been issued pursuant

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to the Securities Exchange Act of 1934. The powers of the Securities and Exchange Commission are extensive and the Commission could be requested to strike out of certain of its present "anti-manipulation rules" the present exemption -- indicated by the Securities Exchange Act of 1934 but not made mandatory by the statute -- for Government securities. The rules in question relate to the dissemination of information (whether true or false) to the effect that prices are likely to rise or fall because of the operations of some person -- e.g., the Federal Reserve System -- and to the effecting of transactions in series for the purpose of causing the market to be active or causing quotations to move and thus inducing other persons to buy or sell. In favor of proposals for more regulation it may be argued that it might reduce the amount of unstabilizing speculation that now results both from the trading of dealers and from that of other persons. Against the extension of the manager's informal influence, it may be argued that such regulation could not be carried very far without upsetting the very basis of the present arrangement. As to enlisting the Securities and Exchange Commission, it is probable that the Commission would be willing to remove the exemption only on the basis of an affirmative showing, which might be difficult, that such action is necessary "in the public interest or for the protection of investors". It may be said in general that in organized markets which have been under regulation for some time attempts to regulate trading seem to have done very little to make these markets steadier, especially on those occasions when mass psychology is a factor.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

FILED IN FILES SECTION
MAR - 9 1940
3330

Date February 29, 1940

To Members of the Board

Subject:

From Mr. Parry and Mr. Piser

Attached is a draft of the memorandum which we have prepared by request for submission to the members of the Federal Open Market Committee. Before putting it into final form for mimeographing, we should appreciate criticisms and suggestions.

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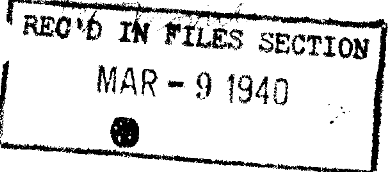

STRICTLY CONFIDENTIAL

February 28, 1940
CEP-LMP
(Second draft)

MANAGEMENT OF OPEN MARKET OPERATIONS

The System's open-market operations during the last few years have been directed in large part at new objectives and have necessitated the use by the Federal Open Market Committee of a technique of operation that is substantially different from that used in earlier years. These developments have made the Committee's problems of management more difficult. The purpose of this paper is to state briefly some of these problems, to describe several of the principal suggestions that have been made for solving them, and to summarize for the consideration of the Committee with reference to each proposal the principal arguments both pro and con.

Until a few years ago, open-market operations were usually intended to add to or to subtract from the reserves of the member banks, either by some definite amount or to the extent necessary to bring about measurable results on member bank borrowing, short-term money rates, etc., but in recent years this purpose has given way to another and in consequence these definite criteria have ceased to be applicable. The more recent purpose has been variously stated, upon occasion, in such general terms as preventing panic, minimizing disorder, or "exercising an influence toward maintaining orderly market conditions".

One of the most difficult of the new problems by which the Committee has been confronted is that of formulating the purpose or purposes of given operations with sufficient precision to make possible a real

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meeting of minds among the several members of the Committee. In the absence of such formulation, both debate and decision on matters of policy are impeded. In addition there is the difficulty of insuring that the full Committee and its executive committee will have the same understanding of a policy that has been agreed upon and the further difficulty of transmitting to the manager of the System Open Market Account instructions in such form that when carried out all parties concerned can determine, both during and after the event, whether the purposes of the Committee are being effectuated. Once a policy decision has been made, moreover, with a view to promoting stability in the market, the ensuing market operations must, on the purely technical side, be broader in scope and much more speedy and flexible in their details of execution than the operations that went with the older and less ambitious open-market policies.

Among the principal proposals that have been made from time to time for meeting the new situation, three that are among the most ambitious, each of which could be adopted either with or without the others, are discussed in this paper: (1) changing the agent acting for the Reserve banks from an institution to an individual; (2) making the System's operations continuous instead of occasional; and (3) arranging to have these operations take place at all Federal Reserve banks instead of at only one Reserve bank. At the end of this discussion, some less significant proposals are briefly touched upon.

Proposal for changing the agent selected by the Committee. - The first proposal has to do with the arrangements by which the policy

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decisions of the Federal Open Market Committee are translated into actual purchases and sales, at particular prices and in particular amounts, in the Government securities market. According to present arrangements, the general policies determined by the Federal Open Market Committee are translated into action by the executive committee through the agency of a Federal Reserve bank, the Federal Reserve Bank of New York, of which the President is a member of both the Committee and its executive committee and a Vice-President is the manager of the System Open Market Account. This arrangement, however conscientiously carried out by all participants, has inherent disadvantages, particularly at times when all the members of the executive committee are not in complete agreement with respect both to matters of general policy and to matters of trading policy. Unless there is complete agreement on these matters between the executive committee and the Committee's agent, rooted in the fullest understanding, both of these functionaries are likely upon occasion to find the relationship unsatisfactory -- as some members of the executive committee may feel that the Committee's policies and possibly even its instructions have not been carried out exactly, whereas there may be grounds from the point of view of the agent for charging the executive committee with having given faulty instructions.

A proposal that has been advanced for dealing constructively with this situation is that the Federal Open Market Committee, instead of selecting as the System's agent either the Federal Reserve Bank of New York or any other Reserve bank, should select some individual, who

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would execute transactions in and manage the System Open Market Account. The agent selected would act for all of the Federal Reserve banks collectively, as the Federal Reserve Bank of New York does at present, but would not be on the payroll of a particular Reserve bank and would be answerable, in practice as well as in theory, directly to the committee representing his principals. A manager so appointed and supervised could be physically located in New York or he could (if the Committee should so desire) be located in Washington; a refinement of this suggestion would be to have the Committee choose both a manager and an associate manager, with the idea that, taking turns but keeping in close touch, one or the other of them might always be in Washington.

It may be argued, in favor of an arrangement for an individual agent, that in managing the System account he would have no more responsibility to any one member of the Federal Open Market Committee than to any other member, and that in consequence the contacts of the manager of the account with the several members of the executive committee and of the full Committee would tend in all respects to be much closer than they are now. In course of time, his educating them with respect to market matters and being educated by them with respect to policy matters should reduce substantially the possibility of misunderstanding and correspondingly increase the efficiency of the System's operations.

One possible argument against the proposal is that for operations of such magnitude an institutional rather than a personal agent though not legally necessary may be desirable. Another is that the proposed arrangement might not insure a sufficiently high degree of technical competence on the part of the manager unless the Committee were willing

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both to stress technical competence in his selection, instead of adherence to its own economic philosophy, and to pay him according to New York standards instead of Washington standards. There is also the contention that the manager of the account, having less independence of the Committee than the Committee's present agent and manager, might fail to stand up sufficiently against the Committee in case the latter should be disposed at any time to undertake operations that were technically unsound. There is also the question whether there could be retained under the proposed arrangement -- since it would naturally be viewed askance in at least some parts of the financial community -- that co-operation of dealers and dealer-banks which has always been cultivated by the officers of the New York Reserve bank and which has been found to be most valuable in connection with the acquisition of market information and in connection with the floating of new issues of Government securities.

Proposal for making System operations continuous. - The second proposal, which is in some respects the most ambitious of all, would change the nature of System operations in the Government securities market by making those operations continuous instead of intermittent and enlarging their scope in other ways. This proposal comprises three related suggestions: (1) That the System, instead of dealing actively only in periods when the market threatens to become disorderly, and then dealing only on one side, adopt the practice of dealing actively on both sides at all times or almost all times; (2) that the volume of the System's

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dealings be so enlarged, and their character so altered, as to make the System operations at all times an important factor in the market; and (3) that the System, instead of confining its over-the-counter transactions to large dealers and large dealer-banks (member banks), extend its dealings to other dealers and other member banks, and possibly to other banks, to insurance companies, or even to the general public.

In favor of this proposal it may be argued that continuous and diversified dealing on a large scale would enable the System to have at all times, by direct observation and dealing experience and not (as at present) largely at second-hand, full information as to the state of the market and the size and run of transactions. It should consequently be less difficult than it is now to determine at any given time what the current trend of the market actually is and whether, in the light of established System policy, the trend is one that should be "bucked" and if so to what extent and by what type and magnitude of operations. The operations of the System "trader" should also be more effective, because professional dealers and other persons, being accustomed to seeing him trading extensively at all times on both sides of the market, now more and now less, sometimes for the System portfolio but often merely as middleman, would no longer be in so good a position to divine System policy by observing System operations, and in addition a variation in the amount of his activity in either direction would not be "news" as his entrance or withdrawal now is.

One of the objections to the proposal is that the time might come, sooner or later, when the System and its "trader" would be confronted by a dilemma. This might be at a time when -- possibly after

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the credit situation had been brought under control again by some such means as an increase in reserve requirements -- the System would desire to tighten the credit situation by selling a substantial volume of Government securities from its portfolio. Such an operation would be certain to become known quite soon to the market and might occasion vigorous selling which, unless counteracted by a reversal of System operations, might cause the market to become disorderly. Another objection is that investors and traders, for some considerable time at least, would probably be very suspicious of a market in which the System would be known to be in position at any moment and without notice to exercise official influence. The arrangement would be at all times open, moreover, to the accusation that the market is being manipulated in the interests of the Treasury and against the interests of the investing public. The proposed arrangement, furthermore, by putting the Federal Reserve System into direct competition with dealers, might arouse fear among them that they would be put completely out of business and might accordingly provoke vigorous criticism not only from them but also from other quarters.

By way of indicating possible answers to the objections that have been enumerated, a number of points may be briefly mentioned. The dilemma mentioned, involving a possible conflict at some time between operations designed to steady the market and operations designed to reduce bank reserves, is probably not imminent, since the use of open-market operations as an instrument of credit policy has been impractical for several years and may continue to be impractical for many years to come. It might fairly be asked, moreover, why System operations for reasons of credit control should be more unsettling under the proposed plan than under the present or any other plan. The contention concerning antagonism to the proposed

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plan would lose some of its force if the System were to go over to the proposed new procedure only gradually, and this antagonism might fairly be expected to die away in due time if and when the day-to-day operations of the System in the market were found by experience to be reasonable and sensible. The most effective answer to objections, however, if it can be substantiated, is that the newer objectives of the System's policies in the Government securities market are of such importance to the public welfare as to justify substantial extension of System enterprise into this field.

Proposal to provide for System dealings in Government securities at every Federal Reserve bank. - The third proposal is that, instead of confining System dealings to the Federal Reserve Bank of New York, provision be made for System dealings in Government securities at every Federal Reserve bank, or at every Reserve bank desiring to participate.

In working out the mechanics of the proposed arrangement, it would be necessary to recognize that any step toward decentralization of operations must not be accompanied by decentralization of control. The general manager of trading for the entire System would probably continue to be the System's sole "trader" in New York, but he would in any case have under his supervision a district manager at every Federal Reserve bank except possibly that he would himself serve in that capacity at the Federal Reserve Bank of New York. Under his supervision, each district manager would be empowered to deal in Government securities for System account in his own district, on the basis of limited bids and offers decided upon by the general manager of System trading and communicated

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by him currently and continuously to all the district managers by teletype or otherwise. The transactions at outlying Reserve banks would be directed by the general manager according to a System plan, worked out along lines approved by the Federal Open Market Committee, that would cover such details as the amount of initiative that either the general manager or the district manager might be allowed to take, how frequently (as weekly or daily) any securities taken temporarily into the account of an individual Reserve bank should be carried to System account, and the size of the maximum individual transaction that might be handled by the district manager without having to consult the general manager. Any such arrangement as that proposed would present difficulties to the general manager of trading for the entire System, but these could be surmounted, since a similar arrangement has been worked out by dealers.

It can be argued that the proposed arrangements might enable the System to be more effective by dealing with disturbing liquidation "at its source". It might add to the prestige of the outlying Federal Reserve banks in their own Federal Reserve districts and in addition increase their effectiveness in the counsels of the System because of their increased opportunity for acquiring an intimate knowledge of the market. The service rendered to member banks might be much appreciated, especially by the small banks which are unable to hire their own "trader" in Governments to protect them in dealing in the open market. It may be noted that in past years, before the open-market operations of the Reserve banks were completely centralized, there was some buying and selling by individual

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Federal Reserve banks, and that even now the Reserve banks do in a small way something similar to this when they serve upon request as brokers (without commission) for member banks. There are finally two further points, illustrated by incidents in September of last year, both of which relate to the emergency occasions when the market is unusually weak and the System is almost the only buyer. Large member banks outside New York City which have some selling to do for correspondents at such times feel unfairly treated because (1) instead of being able to sell directly to the System at its buying price they must sell to some middleman at a little lower price and (2) having to give up names of customers to dealers, as they had to do for a few days in September in order to make sales through the dealers to the System, meant giving up the names to competitors instead of to a Federal Reserve bank which is a semi-public institution.

In opposition to the proposal that System dealings at all Federal Reserve banks be authorized, it may be argued that the advantages that might flow from the proposed arrangement might not be substantial enough to offset the added complexity and expense of management. The contention that there should be provided by the System at each individual Federal Reserve bank a ready market for the member banks of the district has some force, but except in times of emergency, when the System is almost the only buyer, the market is already so well organized throughout the country as to bring a fairly ready market quite near to almost every member bank. It may be conceded that the proposed arrangement might perhaps help at times to halt "at the source" some liquidation by outlying member banks or other sellers, but it may still be argued that it is primarily by the System's operations in the larger transactions, most of which will continue to be in the central market at New York City,

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that a market having the desired degree of stability must be achieved.

Other proposals. - The proposals discussed have all related to the management of System open-market operations. In addition to these, there are a number of proposals for improving the character of the market for Government securities in one respect or another by other means, of which the principal ones are as follows:

(1) It has been suggested that the New York Stock Exchange be encouraged and assisted to bring more of the trading in Government securities to the floor of the Exchange, with a view to making the floor market, which is now very small, more representative, and also to bringing a larger proportion of the total trading under the Exchange's trading rules.

(2) The suggestion has also been made that the SEC be requested to strike out of certain of its "anti-manipulation rules" the present exemption -- indicated by the Securities Exchange Act of 1934 but not made mandatory by the statute -- for Government securities. The rules in question relate to the dissemination of information (whether true or false) to the effect that prices are likely to rise or fall because of the operations of some person -- e.g., the Federal Reserve System -- and to the effecting of transactions in series for the purpose of causing the market to be active or causing quotations to move and thus inducing other persons to buy or sell. It is probable that the Commission, if willing to remove the exemption, would be willing to do so only on the basis of an affirmative showing that such action is necessary "in the public interest or for the protection of investors".

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February 29, 1940

Members of the Board

Mr. Parry and Mr. Piser

Attached is a draft of the memorandum which we have prepared by request for submission to the members of the Federal Open Market Committee. Before putting it into final form for mimeographing, we should appreciate criticisms and suggestions.

No copies of the "Strictly Confidential" memorandum attached to original of memo 2/29/40 available for the files.

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Mrs. O'Hare:

After talking this over with Mr. Parry, Mr. Morrill had me change the covering memo to read as it does in the attached copy.

yd

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February [illegible], 1940

Members of the Board

Mr. Parry and Mr. Piser

Attached is a draft of the memorandum which we have been preparing by request for submission, by certain Board members of the Federal Open Market Committee, to the next meeting of the Committee. Before putting it into final form for mimeographing, we should appreciate criticisms and suggestions.

CEP/cls

No copies of the "Strictly Confidential" memorandum available for the files.

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FEB 12 1942
333

To: Mr. Carpenter.

From: Mr. Hammond. February 8, 1940.

333.-b-2

In a letter of July 18, 1924, from Governor Strong to Governor Crissinger there was apparently an enclosure of a copy of a letter then being addressed to all of the Federal Reserve banks in order to give effect to the action taken by the committee at its meeting in Boston on July 16. This letter to the banks is the subject of a memorandum by Mr. Stewart dated July 21, 1924, and also has other mention. The letter itself, however, is not in our files. It seems to me desirable that we have it, and I suggest that we ask New York for a copy. 333.-b-2

Attached is a copy of Governor Strong's letter in which the letter to the banks is mentioned.

Attachment.

BH

Filed

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November 1, 1939

Mr. Morrill:

Attached (rec'd 10/31/39) are 15 copies of Mr. Parry's memorandum on the Government securities market: one each for the Board members, one each for Messrs. Clayton, Thurston, Morrill, Bethea, and five extra copies.

Also to Messrs. Carpenter and Wyatt CW

From this office we have made the following distribution:

Mr. Goldenweiser
Mr. Piser
Mr. Smead
Mr. Dreibelbis
Mr. Parry
Mr. Bradley
Mr. Brown

F. C. O'Hare

Copies distributed 11/2/39
CW

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REC'D IN FILES SECTION
NOV 4 1939

November 4, 1939

10/31/39

The following distribution has been made of the attached memorandum:

15 copies to Mr. Morrill to be distributed: Mr. Eccles, Mr. Ransom, Mr. McKee, Mr. Davis, Mr. Draper, Mr. Szymczak, Mr. Morrill, Mr. Bethea, 5 extras, Mr. Clayton, Mr. Thurston

Distribution from this office: Mr. Goldenweiser
Mr. Piser
Mr. Smead
Mr. Dreibelbis
Mr. Parry
Mr. Bradley
Mr. Brown
Files
Mr. Thomas (Nov. 3, 1939)

FOR FILES
F. C. O'Hara

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FEB 15 1940
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CONFIDENTIAL

October 31, 1939.

TO: Board of Governors

FROM: See note 1/

Subject: Improving the Government Securities Market.

This memorandum, prepared at the recent request of the Board for an impartial discussion of certain proposals relating to the Government securities market, is intended for the attention of the Board alone and is on that understanding more outspoken in some places than it could otherwise have been.

Defining the problem. - The problem to be considered relates to the functioning of the market for Government securities. It has grown chiefly out of the conditions that have made that market increasingly speculative of late years and out of the experience of the System in attempting upon occasion, through operations guided by the Federal Open Market Committee, to make certain policies effective in that market for the purpose of minimizing disorder, officially expressed as "the purpose of exercising an influence toward maintaining orderly market conditions".

MINUTES ON FEB 13 1940

The market for Government securities has been more or less disorderly on several different occasions during recent years, infrequently on the up side but quite often on the down side -- as in the spring of 1937, the autumn of 1937, the spring of 1938, the autumn of 1938 (Munich), and the autumn of 1939 (European war). The evidence of disorder that was present on many of these occasions was quite apparent. It included the absence of bids, except as provided by the

1/ This memorandum has been written by Mr. Parry (who takes full responsibility for its language) in close collaboration with Mr. Piser. They both take responsibility for all views expressed. Others who have been consulted include Mr. Goldenweiser, Mr. Morrill, Mr. Smead, and Mr. Dreibelbis.

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System, or at least the absence of bids at levels close to the going market price; spreads wider than usual between the best bids in the market and the best offers; substantial price changes between a given transaction and the transaction immediately following; uncommonly wide price changes within the limits of a single day or a short period of consecutive days; and finally, the presence in the market of a good deal of excitement, evidenced for example by the ebb and flow of wild rumor, predictions that prices of Government securities would decline to specified low levels, and spirited discussion of these developments in financial circles and in the financial press. In the face of such evidence as this, there could be little difficulty in characterizing the market as disorderly; the heart of the administrative problem was to determine and appraise the degree of the disorder.

The efforts of the System to minimize disorder in declining markets, although they have unquestionably had substantial effect, have not in every instance prevented the disorder from becoming itself a material cause of weakness in the market and consequently contributing to the establishment in the market of a level of prices for Government securities, for a longer or shorter period, that was lower, at least in the opinion of some of the members of the Board, than was justified by a well balanced view of the underlying factors in the situation. In this interpretation, the essential point about the objective of the System's operations is not described merely in terms of an "orderly market", because that particular expression has too many different meanings, both as used in System discussions and as used in discussions "on the Street".

According to the foregoing analysis of the situation, the crucial questions in each instance of market instability are whose judgment

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of the degree of disorder is the one that shall be decisive in the determination of System trading policy and by what principles and methods, insofar as a sound judgment does not depend on such intangibles as "market sense", shall a sound judgment be arrived at and translated into terms of market technique.

It is with technique that this memorandum deals, but since a discussion of technique, in order to have real significance, must be concerned with means in their relation to selected ends, it will be worth while to identify some of the leading purposes for which market operations may be employed. Two of these are (1) emergency stabilization and (2) emergency stabilization plus ordinary stabilization.[2/] Operations directed at the first of these, sometimes described when used in a falling market as "preventing panic", would not only be limited to occasions upon which disorder threatened, either on the up side or on the down side, but would also be limited in their purpose by absence of concern on the part of the System with the actual level at which market prices would eventually be established after disturbance, provided only that this level were reached as the result of a market process <u>not itself accentuated</u> by unduly sharp and abrupt changes. Operations directed at the second of the enumerated market objectives would be conducted at any time, perhaps even at all times, and would aim not only at the dampening down of such fluctuations as occur in emergencies but also at the limitation in some degree of the minor fluctuations that occur at quite

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2/ A third possible purpose, which needs mention in this memorandum mainly because it has been mentioned elsewhere, would be to exercise, with intent and not merely incidentally, a measure of influence or control over the <u>level</u> of the prices of Government securities.

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short intervals even in a market that is reasonably normal -- but still without special System concern as to the level of the market. By way of emphasizing the point that any program of stabilization must be judged in the light of its purposes, it may be noted that possible purposes of a program of emergency stabilization plus ordinary stabilization might be (1) to curtail speculation in Government securities by making the market so steady that it would not be of much interest to speculators and so would lose some of its tendency to instability, or (2) to put the System in a position by virtue of the scope and nature of its ordinary operations and its experience in normal times to be more effective in emergencies than it is now.

Five proposals are discussed, largely in the order of convenience in exposition, but the first two proposals are more ambitious than the last two. The proposals relate to (1) management of the System's operations in the Government securities market; (2) making those operations continuous, etc; (3) having them take place in every Federal Reserve district; (4) regulation; and (5) bringing more of the trading to the floor of the Exchange, etc.

<u>Proposal for changing the management of System operations</u>. - The first proposal to be discussed has to do with the arrangements by which the policy decisions of the Federal Open Market Committee, whatever those may be, are translated into actual purchases and sales, at particular prices and in particular amounts, in the Government securities market. According to the arrangements that have been in effect for some years, the general policies determined by the Federal Open Market Committee are translated into action by the executive committee through the agency of the Federal Reserve Bank of New York, acting

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primarily through the President of that bank and the Vice-President who is the manager of the System Open Market Account. The President of the Federal Reserve Bank of New York is a member and vice-chairman of the Federal Open Market Committee and also a member and vice-chairman of the executive committee; he is at the same time the chief executive officer of the Federal Reserve Bank of New York, the agent of the Reserve banks selected by the Committee, and in this capacity the Vice-President who is the Manager of the System Account is primarily responsible to him.

This arrangement, however conscientiously carried out by all participants, has important disadvantages, particularly at times when the executive committee as a whole and its New York member are not in complete agreement with respect both to matters of general policy and to matters of trading policy. Unless there is complete agreement on these matters, and in addition mutual understanding and mutual confidence between the executive committee and the Committee's agent, both of these functionaries are likely upon occasion to find the relationship unsatisfactory: the executive committee may feel that its policies and even its instructions have not been carried out exactly or with sufficient vigor, whereas the men in New York may not only have the opposite opinion and be able to support it with technical details but they may in addition be able to advance reasons for charging the executive committee with vacillation, delay in making decisions, or a lack of precision in formulating and transmitting instructions.

There are those who consider such an arrangement as this to be inherently and incurably unsound. In any event, a proposal has been

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advanced for consideration that the Federal Open Market Committee, instead of selecting the Federal Reserve Bank of New York, select some other agent to execute transactions in and manage the System Open Market Account. The agent selected would act for all of the Federal Reserve banks collectively, as does the Federal Reserve Bank of New York now, but would not be on the payroll of a particular Reserve bank and would be answerable, in practice as well as in theory, directly to the Committee.

Under such an arrangement, the agent and manager of the System account would have no more responsibility to the Federal Reserve Bank of New York or to the New York member of the Federal Open Market Committee than to any other Federal Reserve bank or member of the Committee. A manager so appointed and supervised might be physically located in New York, as would seem to be desirable at least until some experience had been had under the new scheme, but he could (if the Committee desired) be located in Washington. A refinement of this suggestion would be to have the Committee choose both a manager and an associate manager, with the idea that, taking turns, one or the other of them might always be in Washington, where he could be educated by the executive committee and could educate the executive committee and the Board.

An important argument for the proposal that the Federal Open Market Committee select an agent other than the Federal Reserve Bank of New York to conduct the trading operations for all of the Federal Reserve banks would be that the contacts with the Board and its staff of a manager so chosen and so supervised would be so much closer than they are now, both in spirit and in fact, that the possibility of misunderstanding

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involving members of the Board would be substantially reduced.

Objections. - The proposal would be actively resisted by the Federal Reserve Bank of New York and by the New York financial community. One possible argument against it is that for operations of such magnitude an institutional rather than a personal agent (though not legally necessary) may be desirable. Another is that the proposed arrangement might not insure a sufficiently high degree of technical competence on the part of the manager unless the Committee were willing both to stress technical competence in his selection, instead of agreement with itself, and to pay him according to New York standards instead of Washington standards. There is also the contention that the manager of the account, having less independence of the Committee than the present manager, might fail to stand up sufficiently against the Committee in case the latter should be disposed at any time to advise operations that were technically unsound. Finally, there is the question whether there could be retained under the proposed arrangement, since it would be viewed askance in New York by reason of its not being identified with that community, the cooperation of dealers and dealer-banks which has always been cultivated by the officers of the New York Reserve bank and which has been found to be helpful in connection with the acquisition of market information by the New York bank and with the floating of new issues of Government securities.

If judged from any point of view except the special point of view of New York City, none of these objections except possibly the last seems to have much force. Certainly few of them can be taken very seriously by those who believe that one of the purposes of Congress in creating the Federal Open Market Committee as at present constituted,

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and endowing it with plenary powers, was to lessen substantially the influence in open-market matters of the Federal Reserve Bank of New York and to increase that of the representatives of the Government and the other Federal Reserve banks. Some of the cooperation now received from dealers would certainly be lost, but not that substantial part of this cooperation which has a fairly solid basis in the self-interest of the dealers and the dealer-banks.

Proposal for making System operations continuous, etc. - The second proposal to be discussed, which bears directly on the stabilization problem and is probably the most ambitious of them all, would change the nature of System operations in the Government securities market by making those operations continuous instead of intermittent and altering them in other ways. This proposal, according to one carefully considered view, would comprise three related suggestions: (1) That the System, instead of dealing actively only in periods when the market threatens to become disorderly, and then dealing only on one side, adopt the practice of dealing actively on both sides at all times (or almost all times); (2) that the volume of the System's dealings be so enlarged, and their character so altered, as to make the System operations at all times an important factor in the market; and (3) that the System, instead of confining its over-the-counter transactions to large New York dealers and large New York dealer-banks (member banks), adopt the practice of dealing in addition with other dealers, other member banks, other banks, insurance companies, and the general public.

The principal considerations in favor of this proposal may be briefly stated as follows:

(1) Continuous and diversified dealing on a large scale

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would enable the System to have at all times, by direct observation and dealing experience and not (as at present) largely at second-hand, full information as to the state of the market, the size and run of transactions, etc., from which it would be less difficult than it is now to determine at any given time what the current trend of the market actually is and whether, in the light of established System policy, it is one of those trends that should be "bucked" and if so, to what extent and by what type and magnitude of operations;

(2) The operations of the System would tend to benefit all banks and other investors by causing the market generally to be a "closer" market than it would otherwise be; and

(3) The operations of the System "trader" would be more effective, because professional dealers and other persons, being accustomed to seeing him trading extensively at all times on both sides of the market, now more and now less, would no longer be in so good a position to divine System policy by observing System operations, and in addition a variation in the amount of his activity in either direction would not be "news" (as his entrance or withdrawal now is).

Objections. - Among the objections to the proposal that have been advanced, probably the most important is that the time would be likely to come, sooner or later, when the System and its "trader" would be confronted by a serious dilemma. This might be at a time when -- possibly after the credit situation has been brought under control again by some such means as an increase in reserve requirements -- the System would desire to tighten the credit situation by selling Government

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securities from its portfolio. Such an operation, though conducted by the "trader" ever so cautiously, would be likely to cause the market to get the wind up and thus occasion some vigorous selling that might, unless counteracted by System buying, defeat the System's stabilization objective by causing the market to become disorderly.

This objection, if its premises be accepted, seems to be a very telling one. Upon careful consideration, however, reasons appear for doubting that it is so conclusive as it might seem to be at first sight. The contingency outlined might not arise for many years, possibly not so long as the country continues to have such an enormous volume of excess reserves. By the time that the indicated contingency did arise, conditions with respect to the volume of excess reserves, the size of the public debt, the general character of the market, etc., might well be so different from what they are now as to make the use of open-market operations as an instrument of credit policy entirely impractical. It has, in fact, been impractical for several years. At worst, moreover, it is hard to see why System operations for reasons of credit control should be any more difficult or unsettling under the proposed plan than they have been in the past, and there may even be some reason to believe that any disorder created by selling for purposes of credit control might prove to be lessened under the proposed scheme because of the market's being more accustomed to System dealing and because of the increased skill in the practice of his art acquired by the System "trader" through his more extended and active trading experience.

Another objection that has been advanced is that investors,

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for some considerable time at least, would probably be very suspicious of a market believed to be constantly under official control, never altogether "natural and free", and consequently unpredictable. The arrangement would be at all times open, moreover, it is said, to the accusation that the market is being manipulated in the interests of the Treasury and against the interests of the investing public. The proposed arrangement, furthermore, by putting the Federal Reserve System into direct competition with brokers, dealers, and dealer-banks, certainly in New York City and possibly elsewhere, might arouse fear among dealers that they would be put completely out of business and provoke vigorous criticism from many quarters.

Among the possible answers to such objections as these, the most effective, if it can be substantiated, is that the stabilization objectives of the System's policies in the Government securities market are of such importance to the public welfare as to justify substantial extension of System enterprise into this field. The initial antagonism, furthermore, might fairly be expected to die away in due time if and when the day-to-day operations of the System in the market were found by experience to be reasonable and sensible. In recognition of the force of these and other objections, however, it has been suggested that if the System should decide to adopt the proposed new procedure it should start in a small way and expand gradually, possibly by taking upon itself at the outset only a relatively small proportion of the total business or by confining its dealings to member banks or to some other selected segment of the market.

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<u>Proposal to provide for System dealings in Government securities at every Federal Reserve bank</u>. - All dealings in Government securities are now effected for the System Open Market Account by the Federal Reserve Bank of New York, acting as agent of the Committee and in behalf of all the Federal Reserve banks. They are effected almost altogether in the New York market, though small purchases or sales are at times made elsewhere, especially in Chicago. The proposal next to be discussed is that provision be made for System dealings in Government securities at each of the other Federal Reserve banks.

Before describing concretely just how the necessary arrangements might be made, the reasons that have been advanced for this proposal may be briefly stated. It is said that such arrangements might enable the System to be more effective by dealing with disturbing liquidation "at its source". It is said that as long as the Federal Reserve Bank of New York is the only one of the Reserve banks that is empowered to deal in Government securities, while no other Federal Reserve bank may buy or sell such securities even in its own Federal Reserve district, these other Federal Reserve banks are deprived of some of the prestige that they deserve in their own districts and perhaps also of effectiveness in the counsels of the System because of their lack of knowledge of the market. It is also said that if a Federal Reserve bank provides a market locally for the buying and selling of Government securities, the service will be appreciated by many of its member banks, especially

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the small banks which are unable to hire their own "trader" in Governments to protect them in dealing with ordinary dealers in the open market. There is the consideration that in past years, before the open-market operations of the Reserve banks were completely centralized, there was some buying and selling by individual Federal Reserve banks, and that even now the Reserve banks do in a small way something similar to this when they serve upon request as brokers (without commission) for member banks. There are finally two further points, illustrated by incidents in September of this year, both of which relate to the occasions when the market is weak and the System is the only buyer. Large member banks outside New York City which have some selling to do at such times feel unfairly treated because (1) instead of being able to sell directly to the System at its buying price they must sell to some middleman at a little lower price and (2) having to give up names of customers to dealers, as they had to do in September in order to make sales through the dealers to the System, meant giving up the names to competitors instead of to a Federal Reserve bank which is a semi-public institution.

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In considering the mechanics of the proposed arrangement, it is important to recognize that decentralization of operations must not be accompanied by decentralization of control. According to one carefully considered scheme, the general manager of trading for the entire System, whether or not the Federal Reserve Bank of New York continues to be the agent of the Federal Open Market Committee, would continue (like the present Manager of the Open Market Account) to be the System's sole "trader" in New York, but he would have under his supervision a district manager at every Federal Reserve bank except the Federal Reserve Bank of New York. Under his supervision, each district manager would be empowered to deal in Government securities for System account, in his own district, either with member banks only or with them and also with other investors. All trading everywhere would be on the basis of limiting bids and offers decided upon (or approximately decided upon) by the general manager of System trading and communicated by him currently and continuously to all the district managers by direct wire (using telegraph, telephone, or teletype). In planning the System's trading operations and in establishing the limiting bids and offers to be used throughout the System, the general manager would have at his disposal, in addition to the bid and asked quotations obtained currently by telephone from the New York Stock Exchange and corresponding data from leading dealers in New York, (1) the information acquired by him from his own System trading in the New York market, and (2) the information from all parts of the country with regard to bids, offers, and transactions transmitted to him currently by the district managers in all of the outlying Federal Reserve banks.

The transactions at individual Reserve banks would be directed

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by the general manager according to a System plan, worked out presumably by the Federal Open Market Committee, that would cover such details as the amount of initiative that either the general manager or the district manager might be allowed to take, how frequently (as weekly or daily) securities, if any, taken temporarily into the account of an individual Reserve bank should be carried to System account, and the size of the maximum individual transaction that might be handled by the district manager without having to consult the general manager.

A concrete example may help to show how such a scheme might serve to reconcile decentralization of operations with centralization of control. If the district manager at the Chicago Reserve Bank, for example, should receive from a customer an offer to sell $20,000 of 1960-65 bonds, the district manager at the Chicago bank would presumably buy the bonds immediately at a price not higher than the current bid price that had been already authorized by the general manager of System trading. If the offer were to sell as much as $5,000,000 of these bonds, however, the district manager at the Chicago Reserve Bank would take the transaction under advisement and discuss it with the general manager of System trading.[3/] The general manager would then decide whether the offer should be accepted by the Chicago district manager, and if so whether at a price as high as, or only at a price lower than, the bid already authorized. In making this decision, the general manager would consider any offsetting orders he might have from other districts to buy the same issue, any offsetting buying orders in other bonds of similar maturity, any buying orders in other

3/ The figures $20,000 and $5,000,000 are merely illustrative. The exact point at which the line between a "firm bid" and a "conditional bid" would be drawn, which would be likely in any given case to be somewhere between these two figures, cannot be determined in advance of experience.

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Government securities, the composition of the System inventory and all other factors bearing on the question. Once the decision had been made, it would be communicated to the customer by the Chicago district manager.

Objections. - The objections to the proposal that System dealings in Government securities at all Federal Reserve banks be authorized by some appropriate arrangement do not seem to be very substantial. Any such arrangement would present difficulties to the general manager of trading for the entire System, but these could be surmounted. It may well be doubted, however, whether the advantages that might flow from the proposed arrangement would be very substantial. The contention that there should be provided by the System at each individual Federal Reserve bank a "ready market" for the member banks of the district has some force, but except in times of emergency, when the System is almost the only buyer, the market is already so well organized throughout the country as to bring a fairly ready market quite near to almost every member bank. The proposed arrangement might perhaps help at times to halt "at the source" some liquidation by outlying member banks or other sellers, but it is primarily by the System's operations in the larger transactions, most of which will continue to be in the central market at New York City, that a close market (as well as a market having the desired stability) must be achieved.

Proposal for regulation of the trading in Government securities by professional dealers. - The next proposal to be considered belongs in a quite different category from the ones that have been already discussed. It relates not to trading operations by the System in the market for Government securities but to trading in that market by others, particularly by professional dealers, and to the regulation of that trading.

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The market for Government securities is very broad, but the price-making market centers at New York City and in that city not on the Exchange but in dealings over the counter, in which large dealers who specialize in such dealings play a leading part. There is a little trading in small lots on the Exchange every day, and all the transactions there are publicized by being reported on the ticker, but this trading is not by any means continuous and ordinarily amounts to little more than an inexact reflection of the trading over the counter.

In being a counter market, the market for Government securities does not differ essentially from the market for the bonds of important municipalities and large corporations, or from the market for British Government securities in London. All have counter markets, and for the same fundamental reasons -- that such securities belong in the main to large institutions which can afford to have professional "traders" of their own and which do most of their trading in large blocks. Such trading naturally goes to the counter because the counter, in contrast to the "floor", affords opportunities for the necessary privacy of negotiation, for bargaining, and for various economies that go with dealing on a large scale.

In other essentials, the market for Government securities is like other highly organized markets. The outsiders, the institutional and other holders of Government securities who buy and sell them from time to time, are the real "makers" of the market, their trades the ones for whom professionals compete. Given their interest and participation as buyers and sellers, the professional dealers, as in other organized markets, ordinarily make the market "close" and make the market "continuous" --

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close in the sense of making the spread at any given time between the highest bid and the lowest offer a narrow one, and continuous in the sense of making it possible for investors to buy or sell at any moment during any business day. To make a market "close" and "continuous" is a useful economic function, and this becomes evident to all when those who ordinarily perform this function quit doing so as all professionals in all highly organized markets commonly do in times of serious disturbance. At such times they "run away", usually to save their profits or their capital, whether they are jobbers on the London Stock Exchange or floor traders on the New York Stock Exchange or professional dealers in Government or other bonds over the counter. This contributes at times to instability, but as a general proposition the prevailing opinion among economist who have specialized in the study of highly organized markets is that the volatility of such markets arises far more from the multifarious influences that operate on and through mass psychology, including in particular the flow of market information, than it does from the defects of market mechanism or from the behavior of professional dealers of any kind.

If it is true, as the foregoing analysis affirms, that the market in Government securities is essentially like other highly organized markets that have been more thoroughly studied, then the possibilities of making it more stable through regulation and closer supervision of professional dealers must be quite limited. What is called for primarily is stabilizing operations along lines discussed elsewhere. It is nevertheless in order to inquire whether such unstabilizing influence as does arise from the activities of dealers could not be reduced by measures of regulation properly designed for the purpose.

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According to suggestions that have been made for this purpose, steps should be taken (1) to tighten the informal supervision of the trading by the large dealers that is at present exercised by the Federal Reserve Bank of New York and possibly (2) to bring all dealers, whether large or small, under certain regulatory provisions of the Securities Exchange Act of 1934.

The only direct control of any consequence that is now exerted over the professional dealers in Government securities is that which is exercised informally over the eight or ten leading dealers, on a so-called cooperative basis, by the Federal Reserve Bank of New York. This cooperation includes at the present time the making of highly confidential daily reports to the Reserve Bank which show, among other things, the size at the close of the day of the dealer's own "position" in each type of Government securities. On the basis of these reports -- and largely by reason of the fact that the Bank if so disposed could withhold valuable business from a non-cooperative dealer or, with Treasury approval, limit his subscriptions to new issues of Treasury securities -- the Bank has at times informed one dealer or another that his position was becoming so large as to make the market vulnerable and has advised him to reduce his portfolio to a more reasonable figure. There is evidence to show that the "moral suasion" thus exercised by the Bank has had a salutary influence and to indicate that it would be well for the Bank to make more frequent requests to dealers for reducing long positions or covering short positions when such action would appear desirable to give greater stability to the market. In the interests of efficiency and good understanding among all the members of the executive committee, reports of all such requests, which have not heretofore been made to the committee or to the Board, should be made to the committee currently and

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in detail.

The principal consideration in favor of the proposal is that the instrument of "moral suasion", if firmly and skillfully employed by the Federal Reserve Bank of New York, might contribute to the prevention of excessive and unstabilizing speculation on the part of the professional dealers and even have a little indirect effect on the speculation induced by them on the part of their customers. It probably could not be carried very far, however, without the likelihood of alienating the dealers and so upsetting the very basis of the present arrangement.

If further regulation of dealers in Government securities were desired, the trading in the Government securities market might be brough under certain of the "anti-manipulation" provisions of the Securities Exchange Act of 1934. Among these provisions, the principal ones which would seem relevant are those which prohibit (1) the dissemination of information (whether true or false) to the effect that prices are likely to rise or fall because of the operations of some person (e.g., dissemination of information to the effect that prices are likely to rise or fall because of operations of the Federal Open Market Committee), (2) the making of false or misleading statements as to any material fact, and (3) the effecting of transactions in series for the immediate purpose of causing the market to be active or causing quotations to move and the ultimate purpose of thus inducing other persons to buy or sell.

The trading in the Government securities market might be brought under these provisions, without new legilsation, by action of the Securities and Exchange Commission, which is the agency now authorized

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to make the necessary rules and regulations and to enforce the same. The Commission has issued rules relating to the provisions specified, but these contain, largely in consequence of statutory provisions that are not mandatory but are indicative, a specific exemption for Government securities (along with municipal securities). There is some reason to believe that the practices in question are employed to some extent by the professional dealers in the Government securities market, and if the Federal Reserve System were persuaded that these practices constitute "manipulation" the System could recommend to the Commission that it rescind the present exemption, so far as Government securities are concerned. The evidence to this effect that is at present in the Board's files, however, is rather scanty and probably not sufficient to convince the Commission. If so, an appeal either to the Commission or to Congress would have to be preceded by a special investigation of some kind.

On the whole, the proposal for attacking the problem of disorderly markets in Government securities by the method of regulation is not promising. Markets already regulated are far from stable -- including the grain futures markets regulated since 1922 and the stock market regulated since 1934.

Proposals for bringing more trading to the Exchange, providing the public with better information, etc. - The purpose of the proposals finally to be considered would be to bring to the support of Federal Reserve operations some changes in the organization of the market for Government securities. According to suggestions that have been made along these lines, steps should be taken (1) to induce and assist the New York Stock Exchange to bring more of the trading in Government securities to the floor of the Exchange and (2) to provide more and better market information for the public.

The principal reason for trying to bring more of the trading

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in Government securities to the floor of the New York Stock Exchange is in order to make that market in these securities, now little more than a small and intermittent (but widely publicized) echo of the over-the-counter market, more representative and consequently more efficient. A secondary reason is to bring a larger proportion of the total trading under the Exchange's trading rules. Doubtless measures for bringing more of the trading to the floor could be devised by the New York Stock Exchange and would be so devised by them if the Exchange were duly pressed or encouraged from Washington.[4/] The System could also help the cause along by having the Manager of the System Open Market Account make more use of the floor market than he does at present.

It has been further suggested that the Federal Reserve Bank of New York, partly in order to provide information that would be helpful in guiding System open-market operations, should request the more important dealers to include in their daily reports to the Reserve Bank, in addition to the aggregate amount of their purchases and sales of each type of Government securities (already being reported) certain additional information, to wit: the amount of each of the four principal types, long-term and short-term, bought from and sold to each of the principal classes of customers — such as dealers, insurance companies, savings banks, and commercial banks, with separate figures for New York City and out-of-town banks. These reports would serve to inform the System more fully

4/ Some measures that have been suggested include increasing the size of the trading unit in Governments on the Exchange from one bond to ten bonds, establishing a Government bond membership on the Exchange at a much lower price, and allowing transactions at closer differences such as 1/64th or (still better) 1/100th of a point (instead of 1/32nd as at present).

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with respect to just what is going on in the market, as indicated by the class of customers that is buying or selling on balance at any given time, either the long or the short maturities, and put the System in position to conduct its own stabilization (and other) operations more effectively. It should be noted in this connection that information similar to that described above has for many years been confidentially reported by dealers in the market for bankers' acceptances.

The proposed reports, in addition to being of use to the System, would provide figures for release to the public showing for each day, for the reporting group of dealers as a whole, the total volume of trading in each of the four principal types of Government securities. These data, if published daily, would give the public far better information as to the volume of trading in Government securities than the public now obtains through the reported (but substantially misleading) figure of the volume on the Stock Exchange. By another proposal designed to give the public essential market information, the Reserve Bank might put on the news ticker every hour, or even every half-hour, the consolidated average bid prices and offering prices that the Bank now computes at intervals for its own purposes on the basis of the dealers' quotations obtained by telephone.

The principal considerations in favor of such a program as has been outlined are: (1) to the extent that business should move to the floor of the Exchange, not only the Exchange market but also the market as a whole would become technically better; (2) to provide the trading public with more and better information would tend to have a similar effect; and (3) the System, having better information itself, could handle its own trading more efficiently.

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Objections. - The principal argument against the proposal is that the over-the-counter market for Government securities, technically considered, is so much better at present than the corresponding market on the floor of the Exchange that even extraordinary efforts by the Exchange might not succeed in moving much of that trading to the floor. This technical superiority of the over-the-counter market arises largely though not entirely from the much larger volume of the trading on that market. This makes it especially advantageous for trading in Government securities, because much of this trading is in large blocks, such as $1,000,000, $5,000,000, or even more. Another reason for this technical superiority, however, which is inherent in the essential difference between a counter market and a floor market, is that transactions in large blocks, especially when they involve "swaps" as many large transactions in Government securities do, require negotiation, which is not possible on the floor. For example, a dealer operating over the counter, before assembling a block of some particular issue of securities bid for by a customer, may work out (over the telephone or otherwise) a large number of intermediate transactions involving other dealers and other customers.

Concluding comments. - A few disconnected observations are appended here which seem to belong generally to the discussion but without belonging to any particular part of it.

In describing the different proposals, the intention has been to include only enough detail to make each proposal sufficiently concrete to be debated, not enough to serve as a basis for official action or to exhibit all the possible alternatives.

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The proposals discussed relate for the most part to different aspects of the problem and even those that relate to the same aspect are not in all cases to be considered mutually exclusive. For example, the proposal that the System trade continuously and the one that it trade at every Reserve bank might be viewed as supplementary.

Careful efforts have been made in writing this memorandum, whether or not they have been successful, to avoid bias, including any bias that might arise from prepossessions in favor of the Government in general and the Board in particular.

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October 31, 1939

(Draft to be polished for mimeographing)

To: Board of Governors

From: See note 1/

Subject: Improving the Government Securities Market.

This memorandum, prepared at the recent request of the Board for an impartial discussion of certain proposals relating to the Government securities market, is intended for the attention of the Board alone and is on that understanding more outspoken in some places than it could otherwise have been.

Defining the problem. - The problem to be considered relates to the functioning of the market for Government securities. It has grown chiefly out of the conditions that have made that market increasingly speculative of late years and out of the experience of the System in attempting upon occasion, through operations guided by the Federal Open Market Committee, to make certain policies effective in that market for the purpose of minimizing disorder, officially expressed as "the purpose of exercising an influence toward maintaining orderly market conditions".

The market for Government securities has been more or less disorderly on several different occasions during recent years, infrequently on the up side but quite often on the down side -- as in the spring of 1937, the autumn of 1937, the spring of 1938, the autumn of 1938 (Munich),

1/ This memorandum has been written by Mr. Parry (who takes full responsibility for its language) in close collaboration with Mr. Piser. They both take responsibility for all views expressed. Others who have been consulted include Mr. Goldenweiser, Mr. Morrill, Mr. Smead, Mr. Thurston, and Mr. Dreibelbis.

FO[illegible]ES
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and the autumn of 1939 (European war). The evidence of disorder that was present on many of these occasions was quite apparent. It included the absence of bids, except as provided by the System, or at least the absence of bids at levels close to the going market price; spreads wider than usual between the best bids in the market and the best offers; substantial price changes between a given transaction and the transaction immediately following; uncommonly wide price changes within the limits of a single day or a short period of consecutive days; and finally, the presence in the market of a good deal of excitement, evidenced for example by the ebb and flow of [rumor, sometimes] wild rumor, predictions that prices of Government securities would decline to specified low levels, and spirited discussion of these developments in financial circles and in the financial press. In the face of such evidence as this, there could be little difficulty in characterizing the market as disorderly; the heart of the administrative problem was to determine and appraise the degree of the disorder.

The efforts of the System to minimize disorder in declining markets, although they have unquestionably had substantial effect, have not in every instance prevented the disorder from becoming itself a material cause of weakness in the market and consequently contributing to the establishment in the market of a level of prices for Government securities, for a longer or shorter period, that was lower, at least in the opinion of some of the members of the Board, than was justified by a well balanced view of the underlying factors in the situation. In this interpretation, the essential point about the objective of the System's operations is not described merely [entirely] in terms of an "orderly market",

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because that particular expression has too many different meanings, both as used in System discussions and as used in discussions "on the Street".

According to the foregoing analysis of the situation, the crucial questions in each instance of market instability are (1) whose judgment of the degree of disorder is the one that shall be decisive in the determination of System trading policy, and (2) by what principles and methods, insofar as a sound judgment does not depend on such intangibles as "market sense", shall a sound judgment be arrived at and translated into terms of market technique, [and (3) through what channels and by what means shall a judgment, once arrived at, be carried into effect?]

It is with technique that this memorandum deals, but since a discussion of technique, in order to have real significance, must be concerned with means in their relation to selected [certain] ends, it will be worth while to identify some of the leading purposes for which market operations may be employed. Two of these are (1) emergency stabilization and (2) emergency stabilization plus ordinary stabilization.2/ Operations directed at the first of these, sometimes described when used in a falling market as "preventing panic", would not only be limited to occasions upon which disorder threatened, either on the up side or on the down side, but would also be limited in their purpose by absence of concern on the part of the System with the actual level at which market prices would eventually be established after disturbance, provided only that this level were reached as the result of a market process not itself accentuated by unduly sharp and abrupt changes. Operations directed at the second of

2/ A third possible purpose, which needs mention in this memorandum mainly because it has been mentioned elsewhere, would be to exercise, with intent and not merely incidentally, a measure of influence or control over the level of the prices of Government securities.

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the enumerated market objectives would be conducted at any time, perhaps even at all times, and would aim not only at the dampening down of such fluctuations as occur in emergencies but also at the limitation in some degree of the minor fluctuations that occur at quite short intervals even in a market that is reasonably normal -- but still without special System concern as to the level of the market. By way of emphasizing the point that any program of stabilization must be judged in the light of its purposes, it may be noted that possible purposes of a program of emergency stabilization plus ordinary stabilization might be (1) to curtail specu-

Insert (A) for page 4.

Five proposals are discussed, largely in the order of convenience in exposition, but the first two proposals are more ambitious ~~in substance~~ than the last two. The proposals relate to (1) management of the System's operations in the Government securities market; (2) making those operations continuous, etc.; (3) having them take place in every Federal Reserve district; (4) regulation; and (5) bringing more of the trading to the floor of the Exchange, etc.

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mittee are translated into action by the executive committee through the agency of the Federal Reserve Bank of New York, acting primarily through the President of that bank and the Vice-President who is the manager of the System Open Market Account. The President of the Federal Reserve

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Bank of New York is a member and vice-chairman of the Federal Open Market Committee and also a member and vice-chairman of the executive committee; he is at the same time the chief executive officer of the Federal Reserve Bank of New York, the agent of the Reserve banks selected by the Committee, and in this capacity the Vice-President who is the Manager of the System Account is primarily responsible to him.

This arrangement, however conscientiously carried out by all participants, has important disadvantages, particularly at times when the executive committee as a whole and its New York member are not in complete agreement with respect both to matters of general policy and to matters of trading policy. Unless there is complete agreement on these matters, and in addition mutual understanding and mutual confidence between the executive committee and the Committee's agent, both of these functionaries are likely upon occasion to find the relationship unsatisfactory [when things go wrong]: The executive committee [in Washington] may feel that its policies and even its instructions have not been carried out exactly or with sufficient vigor, whereas the men in New York may not only have the opposite opinion and be able to support it with technical details but they may in addition be able to advance reasons for charging the executive committee [in Washington] with vacillation, ~~indecision,~~ delay in making decisions, or a lack of precision in formulating and transmitting instructions.

There are those who consider such an arrangement as this to be inherently and incurably unsound. In any event, a proposal has been advanced for consideration that the Federal Open Market Committee, instead of selecting the Federal Reserve Bank of New York, select some other agent to execute transactions in and manage the System Open Market Account.

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The agent selected would act for all of the Federal Reserve banks collectively, as does the Federal Reserve Bank of New York now, but would not be on the payroll of a particular Reserve bank and would be answerable, in practice as well as in theory, directly to the Committee.

Under such an arrangement, the agent and manager of the System account would have no more responsibility to the Federal Reserve Bank of New York or to the New York member of the Federal Open Market Committee than to any other Federal Reserve bank or member of the Committee. A manager so appointed and supervised might be physically located in New York, as would seem to be desirable at least until some experience had been had under the new scheme, but he could (if the Committee desired) be located in Washington. A refinement of this suggestion would be to have the Committee choose both a manager and an associate manager, with the idea that, taking turns, one or the other of them might always be in Washington, where he could be educated by the executive committee and could educate the executive committee and the Board.

An important argument for the proposal that the Federal Open Market Committee select an agent other than the Federal Reserve Bank of New York to conduct the trading operations for all of the Federal Reserve banks would be that the contacts with the Board and its staff of a manager so chosen and so supervised would be so much closer than they are now, both in spirit and in fact, that the possibility of misunderstanding involving members of the Board would be substantially reduced.

Objections. - The proposal would be actively resisted by the Federal Reserve Bank of New York and by the New York financial community. One possible argument against it is that for operations of such

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magnitude an institutional rather than a personal agent (though not legally necessary) may be desirable. Another is that the proposed arrangement might not insure a sufficiently ~~so~~ high ~~a~~ degree of technical competence on the part of the manager [as the present arrangement] unless the Committee were willing both to stress technical competence in his selection instead of agreement with itself, and to pay him according to New York standards instead of Washington standards. There is also the contention that the manager of the account, having less independence of the Committee than the present manager, might fail to stand up sufficiently against the Committee in case the latter should be disposed at any time to advise operations that were technically unsound. Finally, there is the question whether there could be retained under the proposed arrangement, since it would be viewed askance in New York by reason of its not being identified with that community, the cooperation of dealers and dealer-banks which has always been cultivated by the officers of the New York Reserve bank and which has been helpful, particularly in the acquisition of market information by the New York bank and also in connection with the floating of new issues of Government securities, [and in some other connections.]

None of these objections except possibly the last, if judged from any point of view except the special point of view of New York City, seems to have much force. Certainly [most] few of them cannot be taken very seriously by those who believe that one of the purposes of Congress in creating the Federal Open Market Committee as at present constituted, and endowing it with plenary powers, was to lessen substantially the influence in open-market matters of the Federal Reserve Bank of New York and to increase that of the representatives of the Government and the other Federal Reserve banks.

[That] Some of the cooperation now received from dealers ~~mentioned~~ would be lost ~~is practically~~ certainly

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but not that substantial part of ~~it~~ this cooperation which has a fairly solid basis in the self-interest of the dealers and the dealer-banks.

Proposal for making System operations continuous, etc. - The second proposal to be discussed, which is probably the most ambitious of them all, would change the nature of System operations in the Government securities market by making those operations continuous instead of intermittent and altering them in other ways. This proposal, according to one carefully considered view, would comprise three related suggestions: (1) That the System, instead of dealing actively only in periods when the market threatens to become disorderly, and then dealing only on one side, adopt the practice of dealing actively on both sides at all times (or almost all times); (2) that the volume of the System's dealings be so enlarged, and their character so altered, as to make the System operations at all times an important factor in ~~"making~~ the market~~";~~ and (3) that the System, instead of confining its over-the-counter transactions to large New York dealers and large New York dealer-banks (member banks), adopt the practice of dealing in addition with other dealers, other member banks, other banks, insurance companies, and the general public.

The principal considerations in favor of this proposal may be briefly stated as follows:

(1) Continuous and diversified dealing on a large scale would enable the System to have at all times, by direct observation and dealing experience and not (as at present) largely at second-hand, full information as to the state of the market, the size and run of transactions, etc., from which it would be less difficult than it is now to determine at any given time what the current trend of the market actually is and whether, in the light

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(2) The operations of the System would tend to benefit all banks and other investors by causing the market generally to be a "closer" market than it would otherwise be; and

of established System policy, it is one of those trends that should be "bucked" and if so, to what extent and by what type and magnitude of operations;

3 (2) The operations of the System "trader" would be more effective, because professional dealers and other persons, [would be] being accustomed to seeing him trading extensively at all times on both sides of the market, now more and now less, ~~and consequently~~ a variation in the amount of his activity in either direction would not be "news" (as his entrance or withdrawal now is).

[(3) Since any bank or other person could obtain from the System at any time the System's buying and selling prices and many such persons would actually deal with the System directly, they] would no longer be in so good a [an unfavorable] position [in comparison with the large dealers and dealer-banks] to divine System policy [from direct contact with the] by observing System operations, and in addition

Objections. - Among the objections to the proposal that have been advanced, probably the most important is that the time would be likely to come, sooner or later, when the System and its "trader"[, because of their continuous concern with either ordinary or emergency stabilization,] would be confronted by a serious dilemma. This might be at a time when -- possibly after the credit situation has been brought under control again by some such means as an increase in reserve requirements -- the System would desire to tighten the credit situation by selling Government securities from its portfolio. Such an operation, though conducted by the "trader" ever so cautiously, would [[illegible]] be likely to cause the market to get the wind up and thus occasion some vigorous selling that might, unless counteracted by System buying, defeat the System's stabilization objective

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by causing the market to become disorderly.

This objection, if its premises be accepted, seems [at first sight] to be a very telling one. Upon careful consideration, however, reasons appear for doubting that it is so conclusive as it might seem to be at first sight. The contingency outlined might not arise for many years; or possibly [probably] [it would] not [arise] so long as the country continues to have such an enormous volume of excess reserves. By the time that the indicated contingency did arise, conditions with respect to the volume of excess reserves, the size of the public debt, the general character of the market, etc., might well be so different from what they are now as to make the use of open-market operations as an instrument of credit policy entirely impractical. It has, in fact, been impractical for several years. [Then, too, the time at which sales for purposes of credit control would become necessary would be very likely to be one in which general business was booming, Treasury receipts from taxation expanding, and the Government debt decreasing. In such circumstances, the market for Government securities might be sufficiently strong to absorb System sales with comparative ease -- but there are those who argue that at such a time the market might be weak because the banks, having to meet substantial demands for business loans, might be selling their Government securities.] At worst, moreover, it is hard to see why System operations for reasons of credit control should be any more difficult or unsettling under the proposed plan than they have been in the past, and there may even be some reason to believe that any disorder created by selling for purposes of credit control might [well] prove to be lessened under the proposed scheme because of the market's being more accustomed to System dealing and because of the increased skill in the practice of his art acquired by the System "trader" through his more extended and active trading experience.

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Another objection that has been advanced is that investors, for some considerable time at least, would probably be very suspicious of a market believed to be constantly under official control, never altogether "natural and free", and consequently unpredictable. The arrangement would be at all times open, moreover, it is said, to the accusation that the market is being manipulated in the interests of the Treasury and against the interests of the investing public. The proposed arrangement, furthermore, by putting the Federal Reserve System into direct competition with brokers, dealers, and dealer-banks, certainly in New York City and possibly elsewhere, might arouse fear among dealers that they would be put completely out of business and vigorous [and widespread] criticism from many quarters. [persons in other occupations who object on principle to such competition.]

Among the possible answers to such objections as these, the most effective, if it can be substantiated, is that the stabilization objectives of the System's policies in the Government securities market are of such importance to the public welfare as to justify ~~the~~ substantial extension of System enterprise ~~to~~ into this field. The initial antagonism, furthermore, might fairly be expected to die away in due time if and when the day-to-day operations of the System in the market were found by experience to be reasonable and sensible. In recognition of the force of these and other objections, however, it has been suggested that if the System should decide to adopt the proposed new procedure it should start in a small way and expand gradually, possibly by taking upon itself at the outset only a relatively small proportion of the total business or by confining its dealings to member banks or to some other selected segment of the market.

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Proposal to provide for System dealings in Government securities at every Federal Reserve bank. - All dealings in Government securities are now effected for the System Open Market Account by the Federal Reserve Bank of New York, acting as agent of the Committee and in behalf of all the Federal Reserve banks. They are effected almost altogether in the New York market, though small purchases or sales are at times made elsewhere, especially in Chicago. The proposal next to be discussed is that provision be made for System dealings in Government securities at each of the other Federal Reserve banks.

Before describing concretely just how the necessary arrangements might be made, the reasons that have been advanced for this proposal may be briefly stated. It is said that such arrangements might enable the System to deal with disturbing liquidation "at its source". It is said that as long as the Federal Reserve Bank of New York is the only one of the Reserve banks that is empowered to deal in Government securities, while no other Federal Reserve bank may buy or sell such securities even in its own Federal Reserve district, either for its own account or for System account, these other Federal Reserve banks are deprived of some of the prestige that they deserve in their own districts and ~~some of the~~ effectiveness ~~they deserve~~ in the counsels of the System. It is also said that if a Federal Reserve bank provides a market locally for the buying and selling of Government securities, the service will be appreciated by many of its member banks, especially the small banks which are unable to hire their own "trader" in Governments to protect them in dealing with ordinary dealers against having to pay somewhat more than the going market price when buying and having to take somewhat less

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when selling. There are the further points, illustrated by incidents in September of this ye[illegible], [illegible] those occasions when the market is weak and the System is the only buyer, [illegible] [illegible]mber banks outside New York City which have some selling to do feel unfairly treated when they cannot deal directly with the Federal Reserve System because (1) instead of being able to sell directly to the System at its buying price they must sell to some middleman at a little lower price and (2) having to give up names of customers in order to make sales to the System, as they had to do in September, they have to give the names to dealers who are competitors instead of to a Federal Reserve bank which is a semi-public institution and not a competitor. There is the final consideration that in past years, before the open-market operations of the Reserve banks were completely centralized, there was some buying and selling by individual Federal Reserve banks, and that even now the Reserve banks do in a small way something similar to this when they serve upon request as brokers (without commission) for member banks.

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In considering the mechanics of the proposed arrangement, it is important to recognize that decentralization of operations must not be accompanied by decentralization of control. According to one carefully considered ~~possible~~ scheme, the general manager of trading for the entire System, whether or not the Federal Reserve Bank of New York continues to be the agent of the Federal Open Market Committee, ~~who might or might not be located at New York,~~ would continue (like the present Manager of the Open Market Account) to be the System's sole ~~or principal~~ "trader" in New York, but he would have under his supervision a district manager at every Federal Reserve bank ~~including~~ except the Federal Reserve Bank of New York. Under his supervision, ~~the~~ each district manager would be empowered to deal in Government securities for System account, in his own district, either with member banks only or with them and also with other investors, institutions, etc. All trading everywhere would be on the basis of limiting bids and offers decided upon (or approximately decided upon) by the general manager of System trading and communicated by him currently and continuously to all the district managers by direct wire (using telegraph, telephone, or teletype). The transactions at individual Reserve banks, though directed by the general manager, would be according to a System plan, worked out presumably by the Federal Open Market Committee, that would cover such details as the amount of initiative that either the general manager or the district manager might be allowed to take, the size of the maximum individual transaction that might be handled by the district manager without his having to consult the general manager, how frequently (as weekly or daily) accounts, if any, taken temporarily into the account of individual Reserve banks should be carried to System account and ... In planning the System's trading operations and in establishing the limiting bids and offers to be used throughout the System, the general manager would have at his disposal, in addition to the bid and asked quotations obtained currently by telephone from the New York Stock Exchange and corresponding data from leading dealers in New York, (1) the information acquired by him from his own ~~the~~ System trading conducted in

Margin notes: "Tr. to p. 15"; "1 m?? bid. ?, "; "initiative"

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the New York market, and (2) the information from all parts of the country with regard to bids, offers, and transactions transmitted to him currently by the district managers in all of the outlying Federal Reserve banks. If securities were found to be coming in or going out in too large volume at any given time, taking transactions everywhere into account, this would be a reason for the general manager to alter his quotations, or to take some other appropriate step for bringing the trading at one or more Reserve banks within bounds.

A concrete example may help to show how such a scheme might serve to reconcile decentralization of operations with centralization of control work. If the district manager at the Chicago Reserve Bank, for example, should receive from a customer an offer to sell $20,000 of 1960-65 bonds, the district manager at the Chicago bank would presumably buy the bonds immediately at a price not higher than the current bid price that had been already authorized by the general manager of System trading. If the offer were to sell as much as $5,000,000 of these bonds, however, the district manager at the Chicago Reserve Bank would take the transaction under advisement and discuss it with the general manager of System trading.[3] The general manager would then decide whether the offer should be accepted by the Chicago district manager, and if so whether at a price as high as, or only at a price lower than, the bid already authorized. In making this decision, the general manager would consider any offsetting orders he might have from other districts to buy the same issue, any offsetting buying orders in other bonds of similar maturity, any buying orders in other Government securities, the composition of the System inventory and all other factors bearing on the question. Once the decision had been made, it would be communicated to the customer by the Chicago district manager.

[3] See attached

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Footnote for page 15.

~~3/ The figures $20,000 and $5,000,000 are merely illustrative. The exact point at which the line would be drawn between a "firm bid" and a "conditional bid", which would be likely to be somewhere between these two figures, cannot be determined in advance of experience.~~

3/ The figures $20,000 and $5,000,000 are merely illustrative. The exact point at which the line between a "firm bid" and a "conditional bid" would be drawn, which would be likely in any given case to be somewhere between these two figures, cannot be determined in advance of experience.

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Objections. - The objections to the proposal that System dealings in Government securities at all Federal Reserve banks be authorized by some appropriate arrangement do not seem to be very substantial. Any such arrangement would present difficulties to the general manager of trading for the entire System, but these could be surmounted. It may well be doubted, however, whether the advantages that might flow from the proposed arrangement would be very substantial. The contention that there should be provided by the System at each individual Federal Reserve bank a "ready market" for the member banks of the district has some force, but except in times of emergency, when the System is almost the only buyer, the market is already so well organized throughout the country as to bring a fairly ready market ~~fairly close~~ to ~~the door of~~ almost every member bank. The proposed arrangement might perhaps help at times to halt "at the source" some liquidation by outlying member banks or other sellers, but it is primarily by the System's operations in the larger transactions, most of which will continue to be in the central market at New York City, that a close market (as well as a market having the desired stability) must be achieved.

Proposal for further regulation of trading by dealers in Government securities. - The next proposal to be considered, ~~which~~ relates to the regulation of trading, belongs in a quite different category from the ones that have been already discussed. ~~It may be, as~~ The proposals for expanding the dealings of the System assume, that such a degree of stability ~~in the~~ market ~~as would~~ satisfy the Board can be attained only by System operations ~~in the market, by buying and selling~~ intended to offset unstabilizing influences and designed to do so in the desired degree, but this assumption requires examination. It implies

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Proposal for regulation of the trading in Government securities by professional dealers. - The next proposal to be considered belongs in a quite different category from the ones that have been already discussed. It relates not to trading operations by the System in the market for Government securities but to trading in that market by others, particularly by professional dealers, and to the regulation of that trading.

The market for Government securities is very broad, but the price-making market centers at New York City and in that city not on the Exchange but in dealings over the counter, in which large dealers who specialize in such dealings play a leading part. There is a little trading in small lots on the Exchange every day, and all the transactions there are publicized by being reported on the ticker, but this trading is not by any means continuous and ordinarily amounts to little more than an inexact reflection of the trading over the counter.

In being a counter market, the market for Government securities does not differ essentially from the market for the bonds of important municipalities and large corporations, or from the market for British Government securities in London. All have counter markets, and for the same fundamental reasons -- that such securities belong in the main to large institutions which can afford to have professional "traders" of their own and which do most of their trading in large blocks. Such trading naturally goes to the counter because the counter, in contrast to the "floor", affords opportunities for the necessary privacy of negotiation, for bargaining, and for various economies that go with dealing on a large scale.

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In other essentials, the market for Government securities is like other highly organized markets. The outsiders, the institutional and other holders of Government securities who buy and sell them from time to time, are the real "makers" of the market, their trades the ones for whom professionals compete. Given their interest and participation as buyers and sellers, the professional dealers, as in other organized markets, ordinarily make the market "close" and make the market "continuous" -- close in the sense of making the spread at any given time between the highest bid and the lowest offer a narrow one, and continuous in the sense of making it possible for investors to buy or sell at any moment during any business day. To make a market "close" and "continuous" is a useful economic function, ~~as~~ and this becomes evident to all when those who ordinarily perform this function quit doing so as all professionals in all highly organized markets commonly do in times of serious disturbance. At such times they "run away", usually to save their profits or their capital, whether they are jobbers on the London Stock Exchange or floor traders on the New York Stock Exchange or professional dealers in Government or other bonds over the counter. This contributes at times to instability, but as a general proposition the prevailing opinion among economists who have specialized in the study of highly organized markets is that the ~~ir~~ volatility of such markets arises far more from the multifarious influences that operate on and through mass psychology, including in particular the flow of market information, than it does from the defects of market mechanism or from the behavior of professional dealers of any kind.

~~[illegible] be the influence exercised by the professional dealers in the direction of causing instability in the Government securities market, it is nevertheless in order to inquire whether that influence could not be reduced by measures of regulation properly designed for the purpose.~~

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If it is true, as the foregoing analysis affirms, that the market in Government securities is essentially like other highly organized markets that have been more thoroughly studied, then the possibilities of making it more stable through regulation and closer supervision of professional dealers must be quite limited. What is called for primarily is stabilizing operations along lines discussed elsewhere. It is nevertheless in order to inquire whether such unstabilizing influence as does arise from the activities of dealers could not be reduced by measures of regulation properly designed for the purpose.

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According to suggestions that have been made for this purpose, steps should be taken (1) to tighten the informal supervision of the trading by the large dealers that is at present exercised by the Federal Reserve Bank of New York and possibly (2) to bring all dealers, whether large or small, under certain regulatory provisions of the Securities Exchange Act of 1934.

The only direct control of any consequence that is now exerted over the professional dealers in Government securities is that which is exercised informally over the eight or ten leading dealers, on a so-called cooperative basis, by the Federal Reserve Bank of New York. This cooperation includes at the present time the making of highly confidential daily reports to the Reserve Bank which show, among other things, the size at the close of the day of the dealer's own "position" in each type of Government securities. On the basis of these reports -- and largely by reason of the fact that the Bank if so disposed could withhold valuable business from a non-cooperative dealer or, with Treasury approval, limit his subscriptions to new issues of Treasury securities -- the Bank has at times informed one dealer or another that his position was becoming so large as to make the market vulnerable and has advised him to reduce his portfolio to a more reasonable figure. There is evidence to show that the "moral suasion" thus exercised by the Bank has had a salutary influence and ~~reason~~ to ~~believe~~ indicate that it would be well for the Bank to make more frequent requests to dealers for reducing long positions or covering short positions when such action would appear desirable to give greater stability to the market. ~~If further regulation of~~ In the interests of efficiency and for the information of the Board, full reports of all such requests, which have not heretofore been made to the Board, should be made to the Board.

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The principal consideration in favor of such action is that the instrument of "moral suasion", if firmly and skillfully employed by the Federal Reserve Bank of New York, might contribute to the prevention of excessive and unstabilizing speculation on the part of the professional dealers and even have a little indirect effect on the speculation induced by them on the part of their customers. It could not be carried very far, however, without the likelihood of alienating the dealers and so upsetting the very basis of the present arrangement.

If further regulation of dealers in Government securities were desired, the trading in the Government securities market might be brought under certain of the "anti-manipulation" provisions of the Securities Exchange Act of 1934. Among these provisions, the ones which would seem most relevant are those which prohibit (1) the dissemination of information (whether true or false) to the effect that prices are likely to rise or fall because of the operations of some person (e.g., dissemination of information to the effect that prices are likely to rise or fall because of operations of the Federal Open Market Committee), (2) the making of false or misleading statements as to any material fact, and (3) the effecting of transactions in series for the immediate purpose of causing the market to be active or causing quotations to move and the ultimate purpose of thus inducing other persons to buy or sell.

The trading in the Government securities market might be brought under these provisions, without new legislation, by action of the Securities and Exchange Commission, which is the agency now authorized to make the necessary rules and regulations and to enforce the same. The Commission has issued rules relating to the provisions specified, but these

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contain a specific exemption for Government securities (along with municipal securities). The Federal Reserve System could recommend to the Commission that it rescind this exemption, so far as Government securities are concerned and if the Commission should do so the effect would be to bring under the Commission's rules all dealings in Government securities including those of the professional dealers. There is some reason to believe that the practices that might be thus forbidden are engaged in to some extent by the professional dealers in the Government securities market, but the evidence to this effect that is at present in the Board's files is rather scanty and probably not sufficient to convince the Commission to take the suggested action and assume responsibility therefor. If so, the appeal would have to be to Congress.

On the whole, the proposal for attacking the problem of disorderly markets in Government securities by the method of regulation is not promising. Markets already regulated are far from stable, - including the grain futures markets regulated since 1922 and the stock market regulated since 1934.

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bring to the support of Federal Reserve operations some changes in the organization of the market for Government securities. According to suggestions that have been made along these lines, steps should be taken

<u>Proposals for bringing more trading to the Exchange, providing the public with better information, etc.</u> - The purpose of the proposals finally to be considered [(most of which were put forward in more detail in Mr. Piser's memorandum to the Board of December 9, 1938)] would be to

a small and intermittent (but widely publicized) echo of the over-the-counter market, more representative and consequently more efficient. A secondary reason is to bring a larger proportion of the total trading under the Exchange's trading rules. Doubtless measures for bringing more of the trading to the floor could be devised by the New York Stock Exchange and would be so devised by them if the Exchange were duly pressed or encouraged from Washington.[3] The System could also help the cause along by having the Manager of the System Open Market Account make more use of the floor market than he does at present.

It has been further suggested that the Federal Reserve Bank of New York, partly in order to provide information that would be helpful in guiding System open-market operations, should request the more important dealers to include in their daily reports to the Reserve Bank, in addition to the aggregate amount of their purchases and sales of each type

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3/ Some measures that have been suggested include increasing the size of the trading unit in Governments on the Exchange from one bond to ten bonds, establishing a Government bond membership on the Exchange at a much lower price, and allowing transactions at closer differences such as 1/64th or (still better) 1/100th of a point (instead of 1/32nd as at present).

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of Government securities (already being reported) certain additional information, to wit: the amount of each of the four principal types, long-term and short-term, bought from and sold to each of the principal classes of customers -- such as dealers, insurance companies, savings banks, and commercial banks, with separate figures for New York City and out-of-town banks. These reports would serve to inform the System more fully with respect to just what is going on in the market, as indicated by the class of customers that is buying or selling on balance at any given time, either the long or the short maturities, and put the System in position to conduct its own stabilization (and other) operations more effectively. It should be noted in this connection that information similar to that described above has for many years been confidentially reported by dealers in the market for bankers' acceptances.

The proposed reports, in addition to being of use to the System, would provide figures for release to the public showing for each day, for the reporting group of dealers as a whole, the total volume of trading in each of the four principal types of Government securities. These data, if published daily, would give the public far better information as to the volume of trading in Government securities than the public now obtains through the reported (but substantially misleading) figure of the volume on the Stock Exchange. By another proposal designed to give the public essential market information, the Reserve Bank might put on the news ticker every hour, or even every half-hour, the consolidated average bid prices and offering prices that the Bank now computes at intervals for its own purposes on the basis of the dealers' quotations obtained by telephone.

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The principal considerations in favor of such a program as has been outlined are: (1) to the extent that business should move to the floor of the Exchange, not only the Exchange market but also the market as a whole would become technically better; (2) to provide the trading public with more and better information would tend to have a similar effect; and (3) the System, having better information itself, could handle its own trading more efficiently.

Objections. - The principal argument against the proposal is that the over-the-counter market for Government securities, technically considered, is so much better at present than the corresponding market on the floor of the Exchange, that even extraordinary efforts by the Exchange might not succeed in moving much of that trading to the floor.

Concluding comment. - It is not the purpose of this memorandum, in view of the terms of reference to which it is subject, to make any recommendations to the Board as to whether the proposals discussed herein, or any of them, should be adopted. Attention may be called, however, to the fact that the different proposals are so related that none of them either depends upon or conflicts with any of the others. Consequently any one of them -- such as the most urgent or the least controversial -- (either without the others or before or after any of them) could be adopted separately, any desired continuation could be developed, or all of them could be combined into a single program.

The technical superiority of the over-the-counter market arises largely though not entirely from the much larger volume of the trading on that market. This makes it especially advantageous for trading in Government securities because much of this trading is in large blocks, such as $1,000,000, $5,000,000, or even more. Another reason for this technical superiority, however, which is inherent in the essential difference between a counter market and a floor market, is that transactions in large blocks, especially when they involve "swaps" as many large transactions in Government securities do, require negotiation, which is not possible on the floor. For example, a dealer operating over the counter, before assembling a block of some particular issue of securities bid for by a customer, may work out (over the telephone or otherwise) a large number of intermediate transactions involving other dealers and other customers.

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Concluding comments. - A few disconnected observations are appended here which seem to belong generally to the discussion but without belonging to any particular part of it.

In describing the different proposals, the intention has been to include only enough detail to make each proposal sufficiently concrete to be debated, not enough to serve as a basis for official action or to exhibit all the possible alternatives.

The proposals discussed relate for the most part to different aspects of the problem and even those that relate to the same aspect are not in all cases to be considered mutually exclusive. For example, the proposal that the System trade continuously and tha one that it trade at every Reserve bank might be viewed as supplementary.

Careful efforts have been made in writing this memorandum, whether or not they have been successful, to avoid bias, including any bias that might arise from prepossessions in favor of the Government in general and the Board in particular.

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OCT 26 1939

October 21, 1939

Mr. Parry and Mr. Bradley

Mr. Grinioff

Index of U. S. Government Bond Prices, etc.

The Treasury for some time has compiled and published two indexes dealing with long-term Government bonds which also appear in the Federal Reserve Bulletin and in the daily letter of the Federal Reserve Bank of New York.

One index deals with yields, the other with prices. Both of these indexes were revised in November 1938 (see "Bulletin" for December 1938, p. 1045). The revision changed the composition of both indexes by including only the bonds which were not due or callable for twelve years or more. Previously, the index included bonds not due or callable for eight years or more. The reason for this revision is that in 1935 a significant difference in yield developed between medium and long-term bonds, whereas previously the difference had been relatively small.

The published yield figures cover the period 1919 to the present on a monthly basis (average of daily figures). From 1931 to the present, figures are available weekly (on Wednesdays). In addition, current daily figures appear in the letter of the Federal Reserve Bank of New York and presumably back figures on a daily basis could be obtained from the Treasury if needed.

The index of bond prices consists of a simple arithmetic average of the prices of the same bonds used in calculating yields. Published figures, on a revised basis, cover the period 1931 to 1937 monthly (average of daily figures), and the period 1937 to date weekly (Wednesday figures). Daily figures appear in the letter of the Federal Reserve Bank of New York. This price index has performed in a manner quite different from the yield index. Whereas the yield index has shown a long-term downward trend and yields in the summer of 1939 were the lowest on record, the index of bond prices has failed completely to reflect the long-term downward trend. The reason is that new issues replacing the callable issues bore coupon rates near to the current market yield and consequently the prices of the new issues were near par. The result is that the price index has a large downward bias and should not be used for long-term comparison. A warning to this end appeared in the release covering the issue of the new index ("Bulletin" for December 1938, p. 1045):

"In using the price averages it should be noted that the comparability of the figures may be affected by changes in the issues included. For example, the price average was the same in September 1938 as in March 1934 although average yields had declined by 5/8 of 1 percent in the interim. Since 1931, there have been 13 changes in the issues included in the average.

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The largest change occurred in October 1933, when the 4-1/4's of 1947-52, which were then selling at 114-1/2, were removed from the average; this elimination reduced the average by 3.2 points. The aggregate effect of the 13 changes has been to lower the average by 10.7 points. The price series is more useful for comparing market fluctuations over short periods which do not involve differences in the issues included than for comparisons over a long period of time."

At this point, one might ask -- given an adequate long-term yield index -- is there use for a price index since both essentially express the same thing? The answer is that it is largely a question of personal choice, although there are situations when one might be preferable to the other. It must be borne in mind that a given change in yield does not produce percentagewise the same change in the price of a bond. For instance, the change in yield from 2 per cent to 4 per cent of a 3 per cent 16-year bond (a change of 100 per cent) changes the price from 113.6 (at a yield of 2 per cent to maturity) to 88.3 (at a yield of 4 per cent to maturity) -- a change of about 22 per cent. Consequently, if it is desired to compare, say the movements of bonds and stocks on a single grid, a bond price index might be preferable to the yield index. If a yield index is used, as sometimes has been done, the construction of a chart showing bond yields and stock prices creates the problem of relative scales. Ordinarily the bond yield scale is so adjusted that yields fluctuate about as much as prices of the bonds would if they were plotted instead of yields. Since such yields are usually plotted on an inverted scale, it shows that the real purpose of such charts is to make yield movements simulate price movements.

With this difficulty in mind, a new price index was constructed for the period 1931 to date[1/] in the following manner: The average yields as published were converted into corresponding prices of a hypothetical bond having a coupon rate of 3 per cent and 16 years to maturity. The resulting series was then converted into relatives with 1926=100. The resulting series shows, as a per cent of the 1926 level, approximately the most probable price at which the Treasury at a given moment could sell a 3 per cent 16-year bond -- "all other things being equal".

The 3 per cent coupon rate and 16 years to maturity represent approximately an average of coupon rates and of time to call -- or to maturity of all of the outstanding Treasury bonds -- not due or callable for twelve years, for the period 1931-1939. The time to call was used because during this period bonds were called and not allowed to mature,

1/ For selected weeks only.

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hence it was the time to call and not to maturity which had the greater influence on the price of the bonds. The average yields as published in the index were also computed to call date and not to maturity date (when the bonds sold over par).

The process of averaging coupon rates and years to maturity leads to some complications and loss of reality. It can be proved mathematically that of two bonds of equal coupon rate, but of unequal maturity (or time to call date), the price of the one having the longer time to run will fluctuate more percentagewise per unit change in yield than the one having the shorter time to run, "all other things being equal". Secondly, of two bonds of equal term, but of unequal coupon rate, the price of the one having the lower coupon rate will fluctuate more percentagewise than the price of the one having the higher coupon rate, "all other things being equal". Consequently, it is important to select the proper coupon rate and the term of the bond to be used as the new index as the shape of the curve depends on these two factors once the yield is given. The new index (in fact a hypothetic bond) represents the actual fluctuations of existing bonds most accurately during the periods when the actual, and average, coupon rates and years to call date were the closest. In statistical language, when the dispersion of the universe about the mean (Standard deviation) was small.

In individual issues, the highest coupon rate was 4½ per cent, the lowest 2¾ per cent. The longest term was 21 years and the shortest 13 years. This universe is represented by a bond of 3 per cent coupon rate and 16 years term to call date. Given below are the average yields and years to call date, for the period for all outstanding issues, by years:

All Treasury bonds not due or callable for 12 years of more

Date	Average coupon rate	Average number of years to call date
June 30, 1931	3.78	16
" " 1932	3.63	15
" " 1933	3.53	14
" " 1934	3.63	15
" " 1935	3.31	17
" " 1936	2.94	15
" " 1937	2.83	15
" " 1938	2.83	16
" " 1939	2.83	17
Average	3.26	15.6
Sept. 30, 1939	2.78	18

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This means that the index will understate by a very small amount the fluctuations in the actual bonds for the recent period, since the coupon rates of actual bonds are smaller and term is longer. Since the actual average coupon rate for the period 1931-1939 is about 3.2 per cent, the coupon rate of 3 per cent represents a compromise between understating by a trifle the price fluctuations in the few recent years, and overstating somewhat the fluctuations in the past years.[2/]

On Chart No. 1, the old and the new indexes of Government bond prices are plotted. Both indexes are on a comparable base, 1926=100. It is seen that the old index completely fails to reflect the steady decrease in yields and the consequent increase in price whereas the new index increases in price steadily. The old index (when not on a 1926=100 basis but on a dollar basis) is of some value to show the actual dollar price of long-term Government bonds. As a long-term retrospective index, it is absolutely incorrect. The new index gives proper weight to the increase in yields, but does not reflect actual dollar prices of the bonds.

The principal use to which this index can be put -- the purpose for which it was designed -- is its use in connection with the Standard Statistics Company indexes of stock prices, which are on a 1926=100 basis.

This is shown on Chart No. 2. On this chart, the following indexes are plotted, all on a 1926=100 base: stock prices, new index of

---

2/ To show the influence of change in coupon rate and term the following example is offered. When the yield of Government bond was 2.10 the price (as per cent of 1926) of a:

3 per cent 16 yr. bond is	122.4	(the bond used in the index)
3 per cent 18 yr. bond is	124.8	
3¼ per cent 16 yr. bond is	121.8	
3¼ per cent 18 yr. bond is	124.1	

In the Cleveland Trust Bulletin for June 1939, there appeared an attempt to derive a price index from the published yield figures for the period 1919-1939. The method used was simply to capitalize the yield at 3 per cent (by dividing the yield into 3) without any allowance for maturity dates or call dates. In other words, the result is the derived price of a perpetual bond -- not of a bond with a definite maturity. Consequently, the method used in the Bulletin is not a correct one for the purpose on hand because the Treasury bonds have a definite maturity. As has been mentioned in the text, bonds of longer term fluctuate more than bonds of shorter term and perpetual bonds will have the widest possible swings -- "all other things being equal".

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U. S. Government bond prices, preferred stock prices, and corporate bond prices. The purpose of this chart is to show conveniently in one place, the relative movements and levels of various kinds of securities. It shows that on September 20, 1939 stock prices were slightly below their 1926 level, while corporate bond prices[3] were slightly below stock prices. U. S. Government bond prices and preferred stock prices were about 12 per cent above their 1926 level.

The chart is useful to show graphically how disturbances are sometimes localized in one type of security only, and sometimes spread to the entire security market.

Chart No. 3 was constructed for the purpose of showing conveniently in one place bond yields and stock prices. To avoid confusion, two panels are used -- bond yields in the upper panel, stock prices in the lower. This, however, does not solve the problems of relative scales. I have used the ratio of one per cent change in yield to equal ten per cent change in price. After using it, I learned that Miss Burr, Mr. Piser, and Mr. Dirks, working independently, have also decided to use the same ratio. Charts as described above are used by Dr. Goldenweiser and Miss Burr. This chart is useful in showing changes in yield in the different grades of bonds. In 1937-1938, for instance, Baa bonds and stocks declined drastically, but Government bonds and high-grade corporate bonds declined by a very small amount.

In addition to showing bond yields, I have also plotted yields on high-grade industrial preferred stocks. The yield index of preferred stocks is useful in measuring fluctuations in these stocks. It should be used with care, however, if a direct comparison as to levels is attempted between bond yields and preferred stock yields. The yield on bonds is a yield to maturity whereas the yield on preferred stocks is a current yield. The preferred stocks in this index (Standard Statistics Company) are mixed, some not being of sufficiently high grade to eliminate the element of risk. The call factor

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3/ The index of corporate bonds plotted on the chart is the index of 45 corporate bonds compiled by the Standard Statistics Company. It contains approximately an equal amount of bonds of each rating ranging from "Aaa" to "Baa" (Moody's ratings). The prices of Aaa bonds have behaved differently from prices of Baa bonds and pooling the two together makes the index difficult to interpret -- unless a general cross-section of the bond market is required. It might be better to use an index of high-grade corporate bonds -- of medium-grade bonds -- separately, not combined. The combined index was used simply because it had been used before. If a wall chart is to be constructed, it would be desirable to use an index which embodied bonds of one grade only.

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is also present in some of these stocks.(4) Consequently, the yield index of preferred stocks should not be used except in a general manner in comparing actual rate of yield on bonds and preferred stocks. The peculiarities of the preferred stock index were more fully discussed in a memorandum of November 7, 1938, entitled "Preferred Stock Price Index in Bulletin" by Messrs. Brown, Dembitz, and Grinioff.

In the panel showing stock prices, the new index of Government bond prices was also plotted. This index, as mentioned before is derived from yields. It is on a 1926=100 base and as such is directly comparable with stock prices, as to relative levels and amplitude of fluctuations, whereas the yield index in the upper panel is not directly comparable. It was for this additional convenience that the price index was added to the chart.

In view of the above discussion, Chart No. 3 appears to be the logical candidate to replace the existing wall chart entitled "Prices of Bonds and Stocks" because it gives usuable information more directly. Secondly, it might be recommended that consideration be given to the deletion of the published price index of Treasury bonds from the Bulletin.

4/ Another complicating factor is that the yield index of preferred stocks is obtained by a method which amounts to taking a harmonic mean of the yields instead of an arithmetic mean, and a harmonic mean is always smaller than the arithmetic mean. In this case, however, as the range of the data is small, the harmonic mean and the arithmetic are very close together.

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Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

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APR 22 1941
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Office Correspondence

Date September 26, 1939

To Mr. Szymczak

Subject:

From Henry Edmiston

FOR FILES
A. M. Stone

This is in answer to your question of this morning as to the proportion of trading in securities, other than Governments, which is transacted by dealers at net prices.

The large majority of sales of corporate and municipal bonds are executed at net prices through dealers in the over-the-counter market. This is because the transactions of banks and other institutional investors, which bulk large in the total, are handled through dealers. Even where a commission house obtains an order from a customer, it is likely to be executed through a dealer on a net basis and the customer is charged a commission by the broker. In such cases, however, there is often an agreement to put the sale through on the Exchange so that the customer will be able to see a record of the transaction. This method means adding slightly to the net price previously agreed upon in order to cover the seller's commission (the seller in this example is, of course, the dealer).

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September 26, 1939

Mr. Szymczak

Henry Edmiston

Securities trading in Proportion of ...

This is in answer to your question of this morning as to the proportion of trading in securities, other than Governments, which is transacted by dealers at net prices.

The large majority of sales of corporate and municipal bonds are executed at net prices through dealers in the over-the-counter market. This is because the transactions of banks and other institutional investors, which bulk large in the total, are handled through dealers. Even where a commission house obtains an order from a customer, it is likely to be executed through a dealer on a net basis and the customer is charged a commission by the broker. In such cases, however, there is often an agreement to put the sale through on the Exchange so that the customer will be able to see a record of the transaction. This method means adding slightly to the net price previously agreed upon in order to cover the seller's commission (the seller in this example is, of course, the dealer).

HE/jh

FOR FILES
Leroy M. Piser

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Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date September 2, 1939

To Mr. Goldenweiser

Subject:

From Mr. Thomas

STRICTLY CONFIDENTIAL

The Board members have been in the habit of meeting at 8:30 every morning to consider open market policy at the time of the opening of the market. At the meeting this morning (Saturday, September 2), Mr. Harrison and Mr. Leach attended, making it a full meeting of the Open Market Executive Committee. Board members present were Eccles, Szymczak, Draper of Executive Committee, and Davis.

The situation was that the market had declined by exactly one point yesterday, the quoted prices being the bid prices of the System Account, there being no other bids in the market. Declines had been gradual, being about 1/8th of a point at each step and the System had purchased about $54,000,000 of bonds in the market and had taken over early in the morning about $62,000,000 of all sorts of Government securities from the dealers' portfolios.

Another development of interest yesterday was that the corporate bond market had declined much more sharply than the Government security market.

The System bid at this morning's opening was 1/8th below last night's close. There were offerings in the market. At about 10:30 it was reported that the New York Bank had purchased about $3,700,000 of bonds for System Account and had lowered its bid by another 1/4th of a point, making a total decline since yesterday's close of 3/8ths.

Board members present immediately raised the question about lowering the bid by a full 1/4th of a point with such a small amount of purchases. Mr. Sproul explained over the telephone that the reason for this action was the tendency for arbitrage between corporate bonds and Government bonds because of the sharper decline in the former, and feeling among responsible bankers and dealers with whom he had consulted was that the Government bond market should be permitted to fall somewhat further before outside buying support could be reached. Some of the Board members took the position that the action followed was not consistent with the instructions of the Committee. Mr. Davis indicated that he had no particular objection to the action but felt that the reasoning was not consistent. Mr. Draper objected to the action. The Chairman stated that there was a question as to whether the Government bond market should decline to the level of the corporate market or the corporate market should rise.

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Woodlief Thomas

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It was implied, although not expressed in any such definite terms, that one of the purposes of support to the Government bond market was support for the entire securities market, and since it was not possible for the System to buy corporate bonds, its only way of supporting that market was through the Government security market.

Mr. Sproul had also indicated that he thought it might be desirable to lower the price by another 1/4th before the end of the day. Instructions were given not to lower the price unless he received a flood of offers and then to consult the Committee before taking that action. In the meantime the Account had purchased about $10,000,000 of securities and by 11:30 another $5,000,000 had been purchased. At that time it was reported that the Federal Reserve bids were topped on the Exchange on three bonds. It is difficult to know now what brought about this change since there had been a slight shift in market psychology on the basis of efforts at conciliation abroad, resulting in some selling of the war stocks that had been in considerable demand.

The issue that arose was vigorously discussed with Mr. Harrison saying that those in the market could not be criticized in view of the fact that the total decline had been only 3/8ths, the others indicating that they were satisfied with the decline of as little as 3/8ths, but felt that buying should be more vigorous before any further decline was permitted. There was also some discussion as to whether anyone not close to the market could determine policies under such conditions. Mr. Leach supported the views of the members of the Board that there should be more vigorous buying before any further decline was permitted.

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R-496

STATEMENT BY THE FEDERAL OPEN MARKET COMMITTEE

For release in morning newspapers
of Friday, June 30, 1939.

June 29, 1939

As a result of a reduction in holdings of Treasury bills, this week's statement of condition of Federal Reserve banks shows a decline of $13,378,000 in the System Open Market Account. This is in accordance with action taken by the Federal Open Market Committee on June 21, 1939. For some time past, Treasury bills have been purchased for the System's account at or near a no-yield basis and the account at times has had difficulty in replacing its maturing bills. It was decided that it would serve no useful purpose to continue full replacement of maturing bills, the supply of which is not always equal to the market demand. This action is in response to technical conditions in the bill market and does not represent a change in general credit policy.

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Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

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JUN 2 1939
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Office Correspondence

Date May 22, 1939

To Board of Governors

Subject: Open market operations by the Treasury

From Mr. Wyatt, General Counsel

It is reported in the Wall Street Journal for May 20, 1939 that, under an amendment to the Social Security Act agreed to by the Committee on Ways and Means of the House of Representatives on Friday, May 19, the Treasury will be authorized to use the Old Age Pension Reserve Fund to purchase obligations of the Federal Government in the open market.

For the Board's information in this connection there is quoted below a statement regarding open market purchases of Government bonds by the Treasury which was made by Professor Harley L. Lutz, of Princeton University, in an address before the New Jersey Bankers Association on May 19, 1939. This was published in the American Banker for Saturday, May 20, 1939.

> "In fact, I am prepared to go so far as to say that I regard the authorization to the Treasury to engage in open market operations as dangerous and undesirable under all circumstances. It presents too great an opportunity, and often too strong a temptation, to manipulate the market for the Government paper. The same sort of practice, when engaged in by individuals, is called 'wash selling'. The English language has hardly been powerful enough in invective to satisfy those who have condemned wash sales; yet substantially similar operations are entirely lawful, when resorted to by the Treasury for the purpose of supporting the public debt."

Eccles ✓
Ransom ✓
Thurston ✓

Respectfully,

Walter Wyatt

Walter Wyatt,
General Counsel.

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FEB 27 1939

FEDERAL HOME LOAN BANK BOARD
WASHINGTON

OFFICE OF
T. D. WEBB
VICE CHAIRMAN

February 23, 1939

Mr. Lawrence Clayton,
Assistant to Chairman,
Federal Reserve Board,
Washington, D. C.

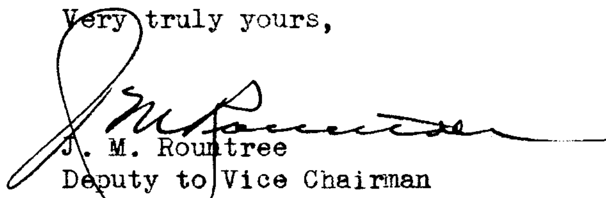
Dear Larry:

Your letter of the 18th in answer to my inquiry of January 27th received.

Thank you very much for this information. I am sure it will be helpful to the Vice Chairman to whom I am handing your letter.

If I can be of personal service to you at any time, kindly advise me.

Very truly yours,



J. M. Rountree
Deputy to Vice Chairman

JMR:KSP

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F. G. Ritter

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February 18, 1939.

Mr. J. M. Rowntree,
Deputy to Vice Chairman,
Federal Home Loan Bank Board,
Washington, D. C.

Dear Jim:

I have your letter of January 27 with regard to the control of open-market operations in the Federal Reserve System.

In the Federal Reserve System open-market operations are conducted in accordance with procedure prescribed by the Federal Reserve Act as amended by the Banking Act of 1935. Under the provisions of this Act, authority to determine open-market policy is vested in the Federal Open Market Committee, which is composed of the seven members of the Board of Governors and five members selected by the combined directorates of five groups of Federal Reserve banks. The law states that the time, character, and volume of all purchases and sales of United States Government securities by the Federal Reserve banks shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country. Participation in the open-market operations as directed by the Committee is mandatory upon all Federal Reserve banks. At the present time, therefore, the boards of directors of the regional Federal Reserve banks have no direct voice in the determination or execution of the System's open-market operations. Their influence is limited to the selection of five of the twelve members of the Federal Open Market Committee.

You may be interested in a brief review of the development of control over open-market operations. I will omit the period of the World War, and immediately thereafter, when the operations of the System were necessarily closely geared to the Treasury's general financing program.

Under the original provisions of the Federal Reserve Act there was no central control over open-market operations. Late in 1920 and in 1921, during the period of general liquidation, member banks paid off a substantial volume of indebtedness at the Reserve banks which had been built up during the post-war expansion. As a consequence, earning assets

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see memo - 1/30/39
See letter 2/23/39

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of the Federal Reserve banks declined and a number of the Reserve banks, early in 1922, began to purchase Government securities mainly for the purpose of restoring their earnings. These purchases resulted at times in disturbance in the Government security market. Purchases by interior Reserve banks, moreover, placed funds in the New York market, which were used to pay off indebtedness of New York City banks to the local Reserve bank. In this way purchase of Government securities by one group of Reserve banks resulted in reducing the discounts of another group of Reserve banks, leaving the earning assets of the System as a whole unchanged.

It became apparent, therefore, that operations of the several Federal Reserve banks in United States Government securities should be coordinated. In the spring of 1922 an informal Committee of four Governors of the Reserve banks was appointed for this purpose. This Committee, which was later enlarged to five Governors, functioned for about one year. During that time it became more clearly understood that at times when there is a considerable volume of indebtedness to the Federal Reserve banks purchases of Government securities by the Reserve banks, by placing funds at the disposal of member banks, result in a reduction of this indebtedness, while sales of Government securities by the Federal Reserve banks, by withdrawing funds from the market, result in a corresponding increase in member bank indebtedness. Indirectly these purchases or sales also tend to ease or tighten credit conditions by making banks feel inclined or disinclined to lend or invest money. The greater the banks' indebtedness the less willing they are to extend credit.

Recognizing the importance of open-market operations as an instrument of monetary policy, the Federal Reserve Board in 1923 suggested that the informal Committee be reorganized and given official status. The new Committee was called "The Open Market Investment Committee for the Federal Reserve System", and its duty was to make recommendations in regard to open-market policies. The Board stated that open-market policy should be based on the same principle as the discount rate policy, namely, to accommodate commerce and business, with due regard to the general credit situation. In the years that followed, open-market operations by the System were on a substantial scale. In 1930 the Committee was enlarged to include all twelve Governors of the Federal Reserve banks and in 1933 this Committee was recognized in the law under the name "Federal Open Market Committee". As mentioned above, the present Committee was created by the Banking Act of 1935.

Prior to 1935, as you can see, authority over and responsibility for open-market operations was diffused. A committee of Governors initiated the policy; these recommendations were submitted for approval or disapproval to the Federal Reserve Board, and if approved, the boards of directors of the individual Reserve banks had ultimate power to decide whether or not to participate in the operations. As Chairman Eccles pointed out in his testimony on the Banking Bill of 1935, this machinery was better adapted to obstruction and delay than to the efficient formulation and execution of policy.

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With reference to your specific problem it appears that neither of the two major reasons which led to the coordination of the Government security operations of the Federal Reserve banks apply to the Home Loan Banks. The magnitude of your purchases and sales would probably not be sufficient, except under extraordinary circumstances, to create undue disturbance in the Government security market. And they would not affect the total volume of reserve funds available to commercial banks and, therefore, would not be related to national credit policy.

Although the Federal Reserve experience may not be particularly helpful to you as a precedent, you may find it desirable on other grounds to follow a System policy requiring approval by the Home Loan Bank Board of purchases and sales of Government securities by the individual Home Loan Banks.

As I understand the main purpose of the Federal Home Loan Bank Act, the Federal Home Loan Banks were established primarily to serve as reservoirs of funds for member institutions engaged in home mortgage financing. The operations of these banks as a system rather than as individual banks would seem to be of major importance. The coordination of their operations under the Federal Home Loan Bank Board provides a means of equalizing the distribution of mortgage credit throughout the country by shifting funds to those localities where they are most needed. Provision was made for this in the law by permitting or requiring individual Home Loan Banks to rediscount the notes held by other Home Loan Banks or to make deposits with other banks. Since the Home Loan Bank Board has power to require the individual banks to place their idle funds at the disposal of other banks in the interest of the efficient operation of the Home Loan System as a whole, it would seem to follow that the investment of such idle funds in Government securities should also be a matter of System policy, to be coordinated and approved by the Board so that the banks will not work at cross-purposes with each other.

In addition, the Home Loan Bank Board may find it desirable to have control over the distribution by maturities and otherwise of the funds of the Home Loan Bank System taken as a whole. The total amount invested in Government securities by the Home Loan Banks and the maturity distribution of these securities has a bearing on the amount of funds that is available for immediate use as well as on the extent of losses through price declines at times when it became necessary to obtain funds through the sale of securities.

Very truly yours,

(Signed) Lawrence Clayton

Lawrence Clayton,
Assistant to Chairman.

SSB W. T. [illegible]
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FEB 27 1939

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 7, 1939

To Mr. Edmiston

Subject:

From Miss Anderson

Could something similar to the following paragraph be used in your letter?

"In contrast to the various functions of the Federal Reserve banks, the Federal Home Loan banks were established for one primary purpose which is to serve as reservoirs of funds for member institutions engaged in home mortgage financing. The operations of these banks, as a system rather than as individual banks, are of major importance in carrying out the main purposes of the Federal Home Loan Bank Act. The coordination of their operations under the Federal Home Loan Bank Board provides a means of equalizing the distribution of mortgage credit throughout the country by shifting funds to those localities where they are most needed. This is done by permitting or requiring the Home Loan banks to rediscount the discounted notes held by other banks, to purchase bonds issued by other banks, or to make deposits with other banks.

"In view of this, it appears to me that certain operations of individual Home Loan banks, such as the purchase or sale of U. S. Government securities, which would affect the supply of available credit for the Home Loan System as a whole, should be coordinated and approved by the Federal Home Loan Bank Board."

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Mr Goldenweiser

I believe that such a reply could best be prepared in your division. The distinctions involved are of course the important matter to be covered but it seems to me it also requires some care. Incidentally this is another small illustration of diffusion of influence among Gov. agencies.

[illegible]

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F. G. Ritter

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date January 30, 1939

To Mr. Morrill

From Mr. Clayton

Subject:

Mr. Rountree is a friend of mine and called me on the telephone to say that the attached letter was written at the instance of Mr. Webb, Vice Chairman, with the thought that some of the reasons underlying the policy of the Federal Reserve Open Market operations would assist the Federal Home Loan Bank Board in taking a position with their regional banks. What they want, in other words, is ammunition for a system policy. This might involve reference to the legislative history of our own Federal Open Market Committee. Will you please suggest who should draft the reply.

LC

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F. G. Ritter

Ans letter 1/27/39
Ans letter 2/18/39

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FEDERAL HOME LOAN BANK BOARD
WASHINGTON

Carded

January 27, 1939.

OFFICE OF
T. D. WEBB
VICE CHAIRMAN

Mr. Lawrence Clayton,
Assistant to Chairman,
Federal Reserve Board,
Washington, D. C.

Dear Larry:-

Will you please let me know the policy of the Federal Reserve Board as to authority of directors of a Federal Reserve Bank in buying or selling Government securities?

The question arises in this way:

As you know, we have twelve banks, and they now have in their portfolios $45,000,000. of Government securities. Some of the directors feel they should have the right to sell these securities on the market as they desire and buy on the market when it becomes necessary.

What I wish to know is the policy of the Federal Reserve Board toward the directors of the Federal Reserve Banks in such matters.

Regards.

Very truly,

J. M. Rountree,
Deputy to Vice Chairman.

See memo 1/30/39
See memo 2/7/39
See ans 2/18/39 See letter 2/23/39

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JAN 3 1939

R-377

STATEMENT BY THE FEDERAL OPEN MARKET COMMITTEE

For release in morning newspapers
of Saturday, December 31, 1938

December 30, 1938

The Federal Open Market Committee announced, following a meeting today, that weekly statements of the total holdings in the Federal Reserve System's Open Market Account may at times show some fluctuation depending upon conditions in the market affecting the Committee's ability to replace maturing Treasury bills held in its portfolio. The volume of Treasury bills available on the market has declined materially during the year and, owing to the large and increasing demand, such bills are already selling either on a no yield basis or at a premium above a no yield basis. It has, therefore, become difficult and in some weeks impossible for the System to find sufficient bills on the market to replace those that mature. Short term notes are also selling on a no yield basis and longer term notes have at times been difficult to obtain. In these circumstances, it may be necessary from time to time to permit bills held in the portfolio to mature without replacement, not because of any change in Federal Reserve policy but solely because of the technical situation in the market. Because no change in Federal Reserve policy is contemplated at this time, maturing bills will be replaced to the extent that market conditions warrant.

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
Division of Research and Statistics

GOVERNMENT SECURITY MARKET

AND THE

SYSTEM OPEN MARKET ACCOUNT

Leroy M. Piser

See MINUTES ON JAN 10 1939

See MINUTES ON FEB 2? 1939

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December 9, 1938

See MINUTES ON JUN 30 1939

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ACKNOWLEDGMENT

In preparing this memorandum the writer has discussed the questions considered with Mr. Goldenweiser, Mr. Parry, Mr. Thomas, and Mr. Edmiston and is indebted to them for many suggestions.

L. M. Piser

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SUMMARY

The following suggestions are advanced for improving the Government security market:

1. More definite and continuous supervision of dealers' portfolio positions by informal contacts through the New York Reserve Bank.
2. Removal of the exemption of Government security dealers from the "anti-manipulation" provisions of the Securities Exchange Act.
3. Daily reports from the principal dealers, to be made public in total, showing the amount of their transactions and the high and low price in each issue.
4. Weekly confidential reports from dealers showing purchases and sales by types of issue and classes of holders.
5. Certain changes in Stock Exchange procedure designed to bring more trading to the floor.

The following suggestions are advanced for improving Federal Reserve security operations:

1. Adoption of regulation empowering each Reserve bank to deal in Government securities.
2. Revision of published statement to exclude breakdown of the composition of the Government security account by bonds, notes, and bills, and to show fewer maturity groups.
3. Legislative authority to buy Government securities directly from the Treasury.

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PRESENT ORGANIZATION OF THE MARKET

History of the Government security market

At the present time trading in Government securities is carried on principally over the counter. The only Government securities listed on the Stock Exchange are Treasury bonds. Trading in notes and bills is entirely over the counter, and transactions in bonds on the floor are a negligible proportion of total Government bond transactions.

This has not always been the case. During and shortly after the World War the amount of trading in Government bonds on the floor was considerably larger than at present and was a much larger proportion of total transactions in Government bonds. At that time a large part of the outstanding amount of Government bonds was held by individuals. Each transaction was for a relatively small amount, and few transactions involved a swap from one issue to another.

During the 1920's the ownership of important amounts of Government bonds shifted from individuals to institutions, such as banks and insurance companies. Transactions of these institutions are large, and frequently involve swaps out of one issue into another. These institutions have employed skilled and experienced traders to handle their trading and have found that their transactions can usually be executed to better advantage over the counter than on the floor.1/

There are several reasons why this is true. First, on swaps, if buying and selling orders are placed simultaneously on the floor, the broker may complete one side of the transaction and fail to complete the other. Second, on

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1/ It is understood that similar developments have occurred also in London with respect to securities of the British Government.

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a single order for perhaps 200 bonds it may be possible to effect a transaction for only one bond. Third, trading over the counter can be carried on in 1/64's as against 1/32's on the floor. Fourth, large transactions can be kept more confidential over the counter, whereas a large bid or offering on the floor would alter the price against the institution. Finally, large institutional transactions frequently have to be worked out over a period of time through negotiation, and such negotiation would be hampered if bids or offers were given on the floor, even though the broker took his time.

Functions of the dealers

The primary functions of Government security dealers are (1) to provide a mechanism for the distribution of new Treasury issues and (2) to provide a ready market for outstanding Treasury issues. At the present time dealers play a more important role in distributing Treasury bills than in distributing new issues of other Government securities. Dealers bid for a substantial portion of each new bill issue and sell the bills (a) to investors who do not bid because of unfamiliarity with the bill market and (b) to the Federal Reserve banks, who are not allowed by law to bid. Dealers also aid in the conversion of maturing issues by purchasing them from holders who might otherwise present them for redemption in cash.

In normal times dealers provide a ready market for outstanding Treasury issues by themselves buying and selling moderate amounts of Government securities at current quotations and by working out larger orders for customers. It is in this respect that dealers perform their most important function. In the Government security market trading activity is small in relation to the total amount of debt outstanding. It would be difficult, therefore, to find ready buyers and sellers for large blocks of securities without working through dealers.

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On large orders and swaps dealers through their contacts with important investors are able to effect at prevailing market prices exchanges which it would be difficult or impossible to make on the Stock Exchange. Before assembling or selling a block of securities a dealer may work out a number of intermediate transactions involving other dealers and customers. If a dealer does not have a ready buyer or seller, he may take an offering into his portfolio temporarily or may provide issues in demand by borrowing the securities. Dealers thereby aid in maintaining a market that is orderly and liquid in normal times. This is obviously advantageous both to the Treasury and to investors in Government securities.

Defects in the market mechanism

There are times when the Government security market, which ordinarily is an unusually orderly and liquid market, loses these characteristics. This situation is inherent in all markets. It has been accentuated in the Government security market by the growth in the importance of dealers, who contribute at times to disorderly conditions by themselves speculating in the market. This is to be expected. No dealer, bank, or other investor whose actions are motivated by profit considerations can be expected to engage in transactions to preserve an orderly market when he feels certain that such transactions will result in a loss. Such conditions can be remedied only by adequate transactions by the Federal Reserve System and the Treasury.

There are five principal defects in the Government security market. First, changes in dealers' portfolios at times accentuate price movements. Second, at times of heavy liquidation dealers do not make firm bids to customers. Third, in periods of inactive trading dealers vary their quotations on Government securities for the purpose of attracting buying or selling in the market and

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thus inducing activity. Fourth, through market letters and direct contacts dealers attempt to increase activity by trying to persuade customers to buy or sell. Fifth, the public is informed as to the amount, price, and sequence of current transactions only for the relatively insignificant amount of trading on the floor.

It is believed that an attempt should be made to eradicate these defects as far as possible. It is further believed that such an attempt should seek at the same time to preserve as far as possible the existing mechanism of the market. In the following paragraphs there are discussed two general procedures for solving the problem: (1) by increased regulation of dealers' activities and additional reports from dealers and (2) by attempting to increase trading on the Stock Exchange.

METHODS OF IMPROVING THE MARKET

Portfolio fluctuations

Changes in dealers' portfolios frequently accentuate rather than lessen price movements, since dealers are likely to increase their portfolios at times of sharply rising prices and to decrease their portfolios at times of sharply falling prices. During the decline in the market in March 1937, for example, dealers reduced their portfolios of Treasury bonds by $50,000,000, until at the bottom of the market around the first of April they had a small short position. They also acquired a short position in Treasury bonds during the brief periods of unsettlement in early September 1937 and again in March and early April 1938. On the other hand, they added $60,000,000 to their bond portfolio in the second half of April 1938 in a rising market. It is to be noted, however, that during the decline in September 1938 dealers generally maintained their position and did not contribute to the weakness in the market.

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In most of these instances, dealers were doing in a small way what investors were doing in a large way. Fluctuations in dealers' portfolios are small in comparison with fluctuations in bank portfolios. In March 1937, for example, while dealers reduced their total position by $60,000,000, reporting member banks sold $500,000,000.

At the New York Reserve Bank the position of each Government security dealer is carefully watched. Whenever any individual dealer acquires a long position which is believed to be of such substantial proportions as to make the market vulnerable, the New York Reserve Bank advises the dealer to reduce his portfolio to a more reasonable figure. This is handled informally and is done without specific authority, except that the New York Reserve Bank could refuse to do business with any dealer who failed to cooperate. Dealers' subscriptions to new bond and note issues have also been limited. Dealers have generally cooperated in these efforts. As a result fluctuations in dealers' portfolios have been to some extent reduced.

More definite and continuous supervision of dealers' portfolio positions, however, might be advisable. This supervision could continue to be exercised informally by direct contact with dealers through the New York Reserve Bank, but with more frequent requests to dealers for reducing long positions or covering short positions when such action would appear to give greater stability to the market. Such matters require trained market judgment and cannot be reduced to a formula. Portfolios should be sufficiently large and flexible for each dealer to meet the normal requirements of his customers, but no dealer should be permitted to accumulate so large a speculative position that its accumulation would be an important factor in a rising market or its liquidation an important factor in a weak market.

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Regulation of this type might first be extended by soliciting informally the voluntary cooperation of the dealers, since this would arouse less antagonism. In case this was not forthcoming, legislative authority to enforce adherence might be sought. In any event the New York Reserve Bank, in addition to being given general instructions, should be asked to report to the Board all instances in which they request changes in dealer positions.

At times of heavy liquidation dealers do not make firm bids to customers. At these times dealers take all selling orders subject to their finding a buyer. The same situation exists at all times with regard to large orders. It also exists at times in all markets.

Although Government security dealers often do not make a market at times when it is especially important that they do so, such a procedure is necessary for the dealers' own protection, since their capital would be quickly wiped out during a period of rapid decline in the market. This defect in the market can be lessened by regulating portfolios. It would not be affected by eliminating dealers. Ultimate responsibility for maintaining an orderly market during periods of liquidation rests with the Federal Reserve System and the Treasury, and no other holder of Government securities can be expected to buy when prices are declining and look as though they will decline further.

Removal of exemption from Securities Exchange Act

In periods of inactive trading dealers vary their quotations on Government securities for the purpose of attracting buying or selling in the market and thus inducing activity. This is a relatively minor abuse, however, and it is difficult to see how it could be eradicated without entirely eliminating dealers. For reasons to be given later this would create major new problems in the process of attempting to solve a minor one.

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Through letters and direct contacts dealers attempt to persuade customers to buy or sell in order to stimulate activity in the market. The same thing is done by investment services, but in the latter case is more likely to reflect their best forecast of the market, since they have no interest in stimulating activity. It is to the long-run interest of dealers also to give correct advice, since repeated attempts on the part of any individual dealer to induce activity by making a poor forecast would lose customers. This is probably not a serious situation, however, since most customers either use their own judgment before buying or selling or check with other investors, such as correspondent banks. Moreover, legislation to prevent the soliciting of business in this manner would be quite likely to prove impossible of enforcement.

Some improvement in these respects might result from removing from the law the exemption of Government security dealers from the "anti-manipulation" provisions of the Securities Exchange Act. Similar problems are being handled in other markets by the Securities Exchange Commission. There seems to be no reason why Government security dealers should not be subject to the same regulations as other dealers.

Reports on trading

The public is informed as to the amount, price, and sequence of current transactions only for the relatively insignificant amount of transactions on the floor. The published figures of volume of trading on the Exchange give a decidedly erroneous impression of the amount of transactions, and the published prices do not always indicate the prices at which transactions are occurring over the counter. Bid and asked quotations are furnished by dealers daily in circulars to their customers and more frequently by phone or wire upon request, and some newspapers publish the closing quotations of a selected dealer.

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At any given time quotations vary slightly from dealer to dealer. In addition, the customer is never sure that he receives the best price at the time of the transaction, since a dealer could make different quotations to different customers. This danger is considerably reduced, however, by competition among dealers, as is shown by the fact that the most successful dealer is the one who has the reputation for the fairest relations with his customers. It is to be noted also that there is relatively little complaint on this point from investors.

This situation could be improved by requesting the more important dealers each day to report to the New York Reserve Bank or the Stock Exchange the amount of their purchases and sales of each issue and the high and low price at which transactions in each issue were effected. The total figures for each issue would be published daily. This would give a much more accurate picture of the Government security market than is now obtained through the reported figures of dealings on the Stock Exchange and would also give customers a chance to check on the fairness of the prices at which their own transactions were executed.

At the present time the only information received currently from Government security dealers is a daily report on their position by types of securities, their borrowings, and the amount of their transactions in each type. It contains no information on prices. There has been suggested above a new daily report on the amount and prices of transactions in individual issues in the over-the-counter market, and it is further suggested that dealers be requested to report weekly by types of issue the amount of Government securities bought from and sold to each of the principal classes of holders. Similar information is now being confidentially reported by dealers in the bankers' acceptance market.

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Such reports would indicate the investment policy of each of the indicated classes of institutions. They would provide more exactly the information that is now obtained informally through personal contacts. They would be of considerable aid consequently in interpreting market movements. A proposed form for such reports has been prepared and carefully studied. It is a form on which each important dealer might be requested to report weekly and is shown in the accompanying table:

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TRANSACTIONS IN UNITED STATES GOVERNMENT SECURITIES OF

____
(Name of dealer)

during the week ending __________

(Par amount in thousands of dollars)

Purchases from or sales to	Purchases				Sales			
	Treasury bills	Treasury notes	Treasury bonds	Guaranteed issues	Treasury bills	Treasury notes	Treasury bonds	Guaranteed issues
Treasury - new issues, exchanges, and maturities................								
Federal Reserve banks..								
Commercial banks, trust companies, and private banks:								
New York City......								
Out of town........								
Savings banks..........								
Foreign banks..........								
Insurance companies....								
Other dealers..........								
Others.................								
Total.............								

Note: Figures should include transactions arranged during the week regardless of the date of delivery.

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Increased trading on the Stock Exchange

To summarize, the above suggestions are to reduce changes in dealers' portfolios by closer supervision, to remove the exemption of Government security dealers from the "anti-manipulation" provisions of the Securities Exchange Act, and to obtain additional reports from the largest dealers. These suggestions would not completely eliminate the defects of the market. They would, however, improve the market to a considerable extent.

It might be thought that the defects could be further reduced by requiring by law that all transactions in Government securities be handled on the New York Stock Exchange. If this could be done, there would be complete public reporting of the amount, price, and sequence of current transactions, and trading would be subjected to published rules. Defects that would not be eliminated would be the presence of fluctuating portfolios of speculators and the absence of buyers in periods of liquidation and of sellers in periods of accumulation. These defects can be remedied only by adequate Federal Reserve and Treasury transactions.

A short step in this direction might be desirable. It might be possible to increase the proportion of trading in Government securities on the Stock Exchange by increasing the trading unit from 1 bond to 10 bonds, by establishing a bond membership on the Exchange at a much lower price, by allowing transactions in 1/64's or preferably in 1/100's, and by larger use of the floor by the System Account. The specialist system might develop in Treasury bonds as in stocks. A specialist both trades for his own account and accepts for a small commission orders from other members. He may not trade for his own account when he holds an unexecuted order for a customer at the same or a better price, but he is required to trade for his own account when the lack of

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reasonable bids or offers threatens to create a disorderly market. With dealers acting as specialists on the floor and under strict rules, it should not be possible to manipulate prices, and the dealers would be under some compulsion to maintain an orderly market.

A complete elimination of the over-the-counter market, if this could be accomplished, would probably, however, reduce the liquidity of the market in normal times and result in more erratic fluctuations in prices. Three types of transaction, which between them make up the bulk of trading, would be difficult to handle on the floor. These types are swaps, trading in bills and possibly also in notes, and large transactions, which require negotiation. It is quite certain that investors as well as dealers would strongly prefer that these transactions be handled on an over-the-counter basis, and it seems desirable that they should be so handled.

Moreover, the elimination of non-bank dealers, while removing those dealers who are largely responsible for the abuses, would be unfair to those who are conducting their business in a satisfactory manner. If non-bank dealers alone were eliminated or placed on a commission basis, an important share of their business would probably go to dealer banks. This would reduce competition in the market and would retain all of the defects of the dealer mechanism. The elimination of large city correspondents as dealers might arouse the antagonism of small banks, who have found it generally satisfactory to trade with their large city correspondents.

If such a complete elimination of the over-the-counter market were attempted it would probably be necessary for the Federal Reserve to take over the dealer function altogether, since the market probably could not operate satisfactorily without over-the-counter trading. It is suggested in a later

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section that each Reserve bank should be allowed to act as dealer for its member banks. It is not suggested, however, that the Reserve banks should attempt to handle all of the over-the-counter business.

There are a number of reasons why this would be undesirable. Complete handling of the over-the-counter business by the Federal Reserve would multiply the accusations that the market is being manipulated by the Government. It would place the Federal Reserve System in a large and complicated business in which its experience is limited. There would be frequent and difficult choices between transactions to influence the credit situation and transactions to perform smoothly the function of dealer. Finally, the Reserve banks would need to bid directly for new Treasury bills and would need to make large purchases of rights before each new financing, which would further multiply the accusations that the market was being "rigged" by the Government.

It appears, therefore, that an attempt to bring all trading to the Exchange or to the Exchange and the Reserve banks would be difficult of accomplishment. If successful, it would raise new problems, which might be more difficult than the present problems. It might be desirable to make the suggested changes in Stock Exchange procedure, but the regulation of dealers for the present probably should not go beyond the suggestions made in a preceding section of this memorandum.

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SYSTEM OPEN MARKET ACCOUNT

Dealings in Governments

Each Reserve bank should be empowered to do some dealing in Government securities. The larger city banks act as dealers for their correspondents, and smaller banks have commented favorably upon this practice. At the present time when Reserve banks receive orders from their member banks they place these orders with brokers or with Government security dealers. As a result comparatively few transactions are handled through the Reserve banks.

It would be especially helpful in disorderly markets for the Reserve banks to take care of panicky liquidation closer to the source rather than to force all liquidation to come to one or two dealers in New York. Member banks have remarked that it is obvious when the only buyer is the Federal, because at such a time the only bids in the market are by one or two dealers in New York. If, on the other hand, each Reserve bank bought Government securities at such a time and perhaps gave some of the larger correspondent banks authority to purchase limited amounts of Government securities, there would be an appearance of wider buying interest in the market and some of the panicky liquidation might be forestalled.

One objection to this procedure, of course, would be the difficulty of managing the Account with twelve widely scattered operators in Government securities. Each Reserve bank might be given a trading account, however, and be authorized to buy and sell Government securities at current prices as long as this trading account were kept within limited amounts. The System's holdings of Government securities would fluctuate each week, since it would be difficult to strike an even balance in all transactions at the twelve Reserve banks, but if each Reserve bank were given definite limits within which to operate, these fluctuations would be small.

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Certain dangers might result from going too far in this direction and attempting to handle all Federal Reserve transactions with investors rather than with dealers. First, the elimination of all transactions with dealers would remove the System's influence over dealers. Second, it would remove the aid which the System gives to dealers and the market in working out large transactions. Third, the making of desirable shifts in the Account would be less flexible if they could not be carried out directly through dealers.

Publication of System holdings

The System is now required to publish weekly both the total of its Government security account and the maturities of this total. The total of the Account should be published weekly, since this reflects System policy with regard to member bank reserves. The composition of the Account, however, represents policy with regard to the technical situation in the Government security market. Shifts within the Account are generally made to maintain an orderly market and have no bearing upon the general credit policy of the System. Consequently, shifts within the Account are frequently misinterpreted by those who are following System policy. At times, also, exchanges with the Treasury are misinterpreted as changes in market policy.

The publication of these composition figures is at times a deterrent rather than an aid to the maintenance of orderly conditions in the market. Frequently before making shifts it is necessary to consider the psychological effect of the publication of the figures as well as to consider the technical condition of the market. It is impossible to determine in advance the psychological effect of a shift in the Account. At times of market weakness, for example, large purchases of Treasury bonds might either reassure investors by

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showing that the System Account was taking a firm attitude with regard to the market, or else it might precipitate further liquidation by showing that liquidation during the preceding week had been large.

Another result of the publication of holdings of Government securities by small maturity classifications is that dealers and banks are able to vary their bids for new bill issues in accordance with the needs of the System Account for replacing maturing bills. When the System Account has large maturities dealers and bankers know that it may be necessary to clean up the market in bills fairly completely in order to make replacements, and consequently the rate on Treasury bills may decline. When the System Account has small maturities it means that dealers may be forced to carry bills for a period, and consequently the rate may advance somewhat. This problem could be solved by keeping an even amount of Treasury bills maturing each week, but this is difficult to do in view of special demands for particular bill issues. It would also result in less flexibility in supporting the market for other issues through offsetting such purchases by allowing part of the current week's bill maturity to run off without replacement.

Legislation would be necessary in order to relieve the System completely of the requirement of publishing the maturity distribution of Government security holdings. The essential difficulties that arise from publication of the detailed maturity distribution could be removed without legislation by publishing only total holdings maturing within 2 years, 2 to 5 years, and over 5 years. These are the maturity periods that the Federal Open Market Committee has considered of sufficient importance to include in their resolutions. This change would involve revision of the published statement to exclude the breakdown of the composition of the Government security account by bonds, notes, and bills and to eliminate all maturity groups of less than 2 years.

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Direct purchases from Treasury

The Federal Reserve banks should not be prohibited by law from buying Government securities directly from the Treasury. The present restrictions prohibit the Reserve banks from covering a Treasury overdraft by purchasing special certificates of indebtedness. There has been no occasion for the use of this mechanism in the recent past, but it is helpful in a period when the Treasury is retiring debt. Treasury expenditures for the redemption of maturing securities are made generally on the 15th of the tax collection months, while income tax receipts are not available until the 16th and later. As a result the Treasury has a large excess of payments for a few days and in the past has covered this excess by selling to the Reserve banks a special certificate of indebtedness. With this method of handling temporary overdrafts prohibited the Treasury might find it necessary to ask for bids on a special Treasury bill issue, which would be a somewhat less flexible procedure than handling the overdraft directly with the Reserve banks.

The present law also forces the Reserve banks to buy their weekly replacements of Treasury bills above the issue price. Dealers and banks bid for the new Treasury bill issues and sell them to the System Account at a discount which is generally 0.015 percent less than the average rate at which the new bill issue was sold. With present extremely low rates, the difference has been reduced to 0.010 percent.

If the System were permitted to bid for new bills and were always able to guess the average rate exactly, the System would be saved about $60,000 a year. Since they are likely to miss the bid on some weeks, however, the actual saving would be considerably less.

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One advantage of bidding for new issues of bills would be that the Reserve System could establish what was in effect a buying rate on Treasury bills by taking whatever bills were alloted to them at that rate. Question may be raised as to the desirability of having the System Account enter bids with the Treasury for new bill issues, since there is always the possibility of being accused of opening other bids before making their own bid. Even before this law was passed, the Reserve banks did not bid for new issues of Treasury bills but purchased the issues each week from dealers and banks. The weight of this objection would be reduced by advance publication of the System's buying rate.

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Loan
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Mr. Currie

Mr. Longstreet

Reduction in volume of open-market commercial paper

During the past twenty years the volume of commercial paper outstanding in the open market has been cut by about 80 percent. Between 1919, the earliest year for which figures are available, and the middle of 1935 the volume outstanding declined from about $1,000,000,000 to less than $100,000,000. Owing to increased borrowing by finance companies arising from the growth in installment buying, the volume of such paper has since increased to about $225,000,000. These figures are presented in the following table along with the other information you requested on the amount of commercial loans of member banks of the Federal Reserve System, open market rates for commercial paper, and rates charged customers by banks in leading cities.

VOLUME OF COMMERCIAL BORROWING AND INTEREST RATES

(Dollars in millions)

June	Commercial borrowing, end of June		Interest rates (percent):		
	On paper in the open market	From member banks of the Federal Reserve System 1/	Open-market commercial paper	Average customer rates charged by banks in: New York City	Average customer rates charged by banks in: 35 other leading cities
1919	1,046	2/	5.50	5.45	5.78
1921	736	12,584	6.50	6.43	7.01
1923	885	12,051	5.00	5.21	5.64
1929	274	12,400	6.00	5.93	6.08
1933	75	5,603	1.75	4.10	5.24
1938	225	3/ 7,448	.75	2.36	3.70

1/ Total loans excluding loans on real estate and on securities partly estimated through 1923.
2/ Not available
3/ As of March 7.

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It appears that the decline in the importance of the commercial paper market has not been due to any change in practice on the part of borrowers to borrow directly from banks instead of through the open market. Instead it is attributable to alterations in business management that have placed large business concerns of the type that borrow in the open market on a more self-supporting basis. During the '20's such concerns improved their cash positions by issuing stocks in the bull security market, and in general large concerns have been operating in recent years with greater short-term liquid assets than during the '20's. At the same time the need for cash by such concerns has been decreased by new forms of merchandising, including producer to consumer sales as exemplified in chain stores, and by increasing the turnover of merchandise and reducing inventories, which have been aided by improved transportation.

The decline in the volume of open-market commercial paper has been accompanied by a sharp reduction in the rates on such paper. The present rate of 3/4 of 1 percent is well below the average of rates charged customers by banks, which is about 2 1/3 percent in New York City and about 3 3/4 percent in 35 other leading cities. Some of the better credit risks, however, are having to pay less than 1 1/2 percent on loans in New York City. This is not much above the commercial paper rate if allowance is made for the note broker's commission.

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REC'D IN FILES SECTION
OCT 25 1938

April 7, 1938

Mr. George L. Harrison, President,
Federal Reserve Bank,
New York, New York.

Dear Mr. Harrison:

I wish to acknowledge receipt of your letter of April 6 with the enclosed copy of the letter and questionnaire which went to the thirty investment banking firms. I am arranging to have this circulated so that the Board members and staff heads may have an opportunity to read it.

Thanking you for sending it to me, I am,

Sincerely yours,

(Signed) Chester C. Davis

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FEDERAL RESERVE BANK
OF NEW YORK

April 6, 1938.

Dear Mr. Davis:

Our plans, which I discussed with you recently, for obtaining regular reports from a representative group of investment banking firms, which we hope will improve our knowledge of the capital position and the inventory position of the new issue market, have progressed to the point where we are approaching about thirty firms asking their cooperation. Enclosed is a copy of the letter and the questionnaire which we have sent to these firms, and which I thought you might like to see and to bring to the attention of the other Members of the Board.

Faithfully yours,

George L. Harrison,
President.

Hon. Chester C. Davis,
Board of Governors of the
Federal Reserve System,
Washington, D.C.

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MISC. 140 A 15 M 2-37

FEDERAL RESERVE BANK OF NEW YORK

April 6, 1938.

Dear Mr.

It is one of the duties and responsibilities of the Federal Reserve Bank of New York, as the bank of issue in the principal money market of the country, to keep itself informed concerning the functioning of that market, both with respect to short term credit factors and long term capital transactions. The experiences of the past few years have emphasized our need for more comprehensive information concerning the latter of these two phases of the money market, since the effect of credit policy upon new financing and the repercussions of the functioning of the new issues market upon credit policy, have been an important aspect of the whole recovery problem. At other times, the operations of the new issues market have had a substantial influence upon the international movement of funds, which is also a matter of general concern in the field of credit policy and therefore of particular interest to this bank.

I have recently discussed the possibility of improving our knowledge of the new issues market with several of those who are factors in it, and they have expressed a willingness to cooperate with us by furnishing us with weekly reports, along the lines of the enclosed questionnaire. I am, therefore, approaching a representative group of the leading investment banking houses, having offices in this city, including two or three whose main offices are in other centers, asking them to join in this voluntary undertaking. In addition, to these weekly reports, it is contemplated that each firm will supply us with quarterly statements of condition beginning with the statement as of March 31, 1938 (or nearest date) and with an audited statement of condition, at least once a year, beginning with a statement as of December 31, 1937 (or nearest date). If such statements are now

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being furnished to other agencies or if, in the future they are required by other agencies, copies could of course be furnished to us, as it is not our desire to cause any unnecessary duplication of work on your part.

As you will see, our principal purpose is to obtain information concerning the capital and inventory position of the whole new issues market, and we want to request only such information as is essential to our purpose and as can be readily supplied, without the preparation of figures which reporting firms would not ordinarily compile for their own use.

The confidential character of the figures submitted by individual firms will, of course, be preserved. No one but those officers of the bank, who are directly concerned, and the few employees, who will be engaged in the tabulation and combination of the reports, would have access to them. Until we have had some experience with the reports, I am not even able to say that we shall give back to the reporting firms, or make public, the aggregate figures which we compile. Nevertheless, I cannot help but feel that you will find it useful to have a neutral central body in a position to know the status of the whole market.

I hope that you will advise me that your firm is willing to furnish us with weekly reports of its operations and with periodic statements of condition. I shall then notify you of the date of commencement of the reporting service, which we should like to set within the next two weeks, and shall supply you with a set of blank forms and instructions for use in reporting to us. As we proceed with this undertaking and gain experience in the analysis of the figures, it may be that we shall want to modify it in some respects, and I should always, of course, welcome any suggestions which you may wish to make concerning it.

Faithfully yours,

George L. Harrison,
President.

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CONFIDENTIAL WEEKLY REPORT FROM SECURITY UNDERWRITERS

TO THE FEDERAL RESERVE BANK OF NEW YORK

Firm Name ______________________ Report as of close of business Friday ____________, 1938.

(Except as otherwise indicated amounts should be reported in terms of face value or number of shares, as the case may be.)

1. Commitments under underwriting agreements to purchase securities not yet publicly offered for sale.

Name of Issue	Total Issue	Commitment	Purchase Price	Approximate Date of Public Offering

2. Net position in securities with respect to which firm participated in an underwriting agreement which has not been terminated.

Name of Issue	Original Underwriting Commitment	Amount Retained For Sale By Us	Net Additional Purchases	Net Position (L-long) (S-short)	Ledger Value

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3. Securities purchased under underwriting agreements which were terminated within the last six months.

Name of Issue	Net Position (L-long) (S-short)	Ledger Value	Estimated Market Value

4. Money Borrowed

A) From Banks in the United States $.............

B) From Others $.............

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5. (To be answered only by representatives of other underwriters of an issue involving a public offering.)

A) Please attach a list showing the names and commitments of the several underwriters in each underwriting entered into during the past week.

B) NET position of the account maintained for the several underwriters or participants with respect to any securities referred to in Item 2 and for which settlement has not been effected with such underwriters or participants.

Name of Issue	Total Issue	Amount Reserved for Sale for the Accounts of the Several Participants	Net Additional Purchases	Net Position (L-long) (S-short)	Ledger Value

6. Brief description of prospective issues with respect to which firm has no definite commitment but expects to act as manager or representative of other underwriters, including name and amount of issue, and the approximate date of public offering.

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INSTRUCTIONS

Item #1. Report only actual, not prospective commitments, under this item.

A joint account formed to bid for and to offer publicly municipal issues should be classed as an underwriting. Joint accounts for purposes of trading need not be reported in this item.

In the case of commitments to purchase the unsubscribed portion of securities offered or to be offered to existing security holders, the commitment should be reported under Item #1 until the amount the underwriter will be required to purchase has been definitely determined. Thereafter the position of the firm with respect to such commitment should be reported under Item #2 or Item #3, as the case may be. In the last column enter date of expiration of existing security holders' subscription rights.

Item #2. An underwriting agreement should be considered as having been "terminated" on the day as of which the final accounting is made.

Purchases and sales made by underwriter's representative for your account and for which settlement has not been made should not be reflected under "Net Additional Purchases" or in "Net Position." Such data will be reported in total by such representative in Item 5(B).

The "Amount Retained for Sale by Us" should represent the portion of the original underwriting commitment reserved by you for direct distribution or released by the underwriter's representative for direct distribution by you and should be adjusted by reason of additional securities released by or to the underwriter's representative. Securities confirmed by the underwriter's representative on so-called selling group terms should be included under "Net Additional Purchases" rather than as adjustments in the "Amount Retained for Sale by Us."

Item #3. Only securities the ledger values of which are $100,000 or more need be separately recorded; all other securities may be combined and entered as "other issues."

Item #4. Customers' free credit balances should not be included.

Item #5. See instructions for Item #2. It is expected that the report of the manager or representative of other underwriters will reflect all positions which are not indicated by the reports of other underwriters or participants under Item #2.

Item #6. Include only issues the offering of which appears likely within a few weeks, and not those simply in the discussion stage.

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April 22, 1937

Board of Governors

Mr. Dreibelbis, Assistant
General Counsel.

Amendments to section 14(b) of Federal Reserve Act and 4(n) of Home Owners Loan Act proposed by Federal Home Loan Bank Board.

At Mr. Clayton's request I have reviewed Mr. Daiger's memorandum of April 17th addressed to Chairman Eccles upon the subject "Open Market Operations proposed by the Federal Home Loan Bank Board". This review, however, has been confined solely to an analysis of the existing applicable statutes and the legal effect of suggested amendments to section 14(b) of the Federal Reserve Act and section 4(n) of the Home Owners Loan Act, which amendments, I understand have been proposed by the Federal Home Loan Bank Board. For the convenience of the Board the various Acts involved are separately analyzed under descriptive headings, as follows:

FEDERAL FARM MORTGAGE ACT

The Federal Farm Mortgage Corporation Act creating the Federal Farm Mortgage Corporation was approved January 31, 1934.

This Act authorized the Corporation to issue $2,000,000,000 of bonds fully guaranteed by the United States both as to interest and principal, which bonds, among other things, may be exchanged for consolidated Farm Loan bonds of equal face value issued under the Federal Farm Loan Act.

The Act amended section 13 of the Federal Reserve Act by making the bonds of the Corporation eligible for pledge as security to a member bank's fifteen day collateral note. At the same time, section 14(b) of the Federal Reserve Act was amended to make bonds of the Corporation having maturities from date of purchase of not exceeding six months eligible for purchase and sale in the open market.

HOME OWNERS LOAN ACT

The Home Owners Loan Act creating the Home Owners Loan Corporation was approved June 13, 1933.

The Act originally authorized the issuance of $2,000,000,000 of bonds guaranteed as to interest only by the Government. By process of amendment the Act finally authorized the issuance of $4,750,000,000 of bonds guaranteed both as to interest and principal by the United States. Approximately $1,500,000,000 of this sum remains unissued.

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Section 4(n) of the Act authorises the Corporation to (1) purchase Federal Home Loan Bank bonds, debentures, or notes, or consolidated Federal Home Loan Bank bonds or debentures; (2) to purchase full paid income shares of Federal Savings and Loan Associations after funds made available to the Secretary of the Treasury for the purchase of such shares have been exhausted, such purchases to be on the same terms and conditions as apply to the purchase of such shares by the Secretary of the Treasury. $300,000,000 of the authorised bond issue is set aside for the purpose of this subsection.

It is now proposed to amend the subsection by allocating the $300,000,000 to the purchase of shares of Federal Savings and Loan Associations and providing that the total amount of unused bond authorization of the Corporation ($1,500,000,000) shall be available for the other purposes of the subsection; to wit, the purchase of Federal Home Loan Bank bonds, debentures, or notes, or consolidated Federal Home Loan Bank bonds or debentures.

In an amendment of the Act (April 27, 1934) providing for the guarantee by the United States, both as to principal and interest, of bonds issued by the Corporation, sections 13 and 14 of the Federal Reserve Act were amended in the same manner as already amended with respect to bonds of the Federal Farm Mortgage Corporation. Section 13 of the Federal Reserve Act was amended by making the bonds of the Corporation eligible for pledge as security to a member bank's 15 day collateral note. Section 14(b) of the Federal Reserve Act was amended to make bonds of the Corporation having maturities from date of purchase of not exceeding 6 months eligible for purchase and sale in the open market.

FEDERAL HOME LOAN BANK ACT

The Federal Home Loan Bank Act, authorizing the establishment of Federal Home Loan Banks, was approved July 22, 1932.

Any building and loan association, savings and loan association, cooperative bank, homestead association, insurance company, or savings bank, is eligible to become a member or a nonmember borrower of a Federal Home Loan Bank and a Federal Home Loan Bank under certain conditions and against certain security may make advances to its members, as well as, to nonmember borrowers.

Each Federal Home Loan Bank is authorized to issue debentures, bonds, or other obligations upon such terms and conditions as the Board may approve. The Act also provides for the issuance of consolidated

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Federal Home Loan Bank debentures representing the joint and several obligations of all Federal Home Loan Banks. These debentures cannot be issued if any of the assets of any Federal Home Loan Bank are pledged to secure any debts and are limited in amount to five times the total paid-in capital of all of the Federal Home Loan Banks. If no debentures are outstanding, consolidated Federal Home Loan Bank bonds constituting the joint and several obligations of all of the Federal Home Loan Banks may be issued upon such terms and conditions as the Board may prescribe.

The Act provides that all obligations of Federal Home Loan Banks shall plainly state that such obligations are not obligations of the United States and are not guaranteed by the United States.

It is now proposed to amend section 14(b) of the Federal Reserve Act to make bonds, debentures or other obligations issued under the provisions of the Federal Home Loan Bank Act, as amended, eligible for purchase and sale in the open market.

ANALOGY BETWEEN FARM CREDIT ADMINISTRATION AND FEDERAL HOME LOAN BANK SYSTEM WITH RESPECT TO AVAILABILITY OF FEDERAL RESERVE FUNDS UNDER EXISTING LAW.

Bonds of the Federal Farm Mortgage Corporation pursuant to the provisions of section 14(b) of the Federal Reserve Act may be bought and sold by Federal Reserve banks.

Correspondingly, bonds of the Home Owners Loan Corporation pursuant to the provisions of section 14(b) of the Federal Reserve Act may be bought and sold by Federal Reserve banks.

Bonds of the Federal Farm Mortgage Corporation may be exchanged for consolidated Farm Loan bonds issued under the Federal Farm Loan Act.

Correspondingly, bonds of the Home Owners Loan Corporation may be used by the Home Owners Loan Corporation to acquire Federal Home Loan Bank bonds, debentures or notes of consolidated Federal Home Loan Bank bonds or debentures, at present within the limit of the $300,000,000 allocated for that and other purposes and, if the proposed amendment to section 4(n) of the Home Owners Loan Act is enacted, within the limit of the unused bond authorization of that Corporation ($1,500,000,000).

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Bonds of both the Federal Farm Mortgage Corporation and the Home Owners Loan Corporation are fully guaranteed as to principal and interest and pursuant to the proviso added to section 14(b) of the Federal Reserve Act by amendment at the time of the enactment of the Banking Act of 1935 these bonds may now be bought and sold without regard to maturities.

Section 943 of Title 12 U. S. C. A. provides as follows:

"Any Federal Reserve bank may buy and sell farm loan bonds issued under this chapter to the same extent and subject to the same limitations placed upon the purchase and sale by said banks of State, county, district and municipal bonds under section 14(b) of the Federal Reserve Act of December 23, 1913 (maturities from date of purchase of not exceeding six months)."

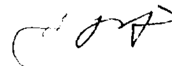
Paragraph 3 of section 13(a) of the Federal Reserve Act provides as follows:

"Any Federal reserve bank may also buy and sell debentures and other such obligations issued by a Federal Intermediate Credit Bank or by a National Agricultural Credit Corporation, but only to the same extent as and subject to the same limitations as those upon which it may buy and sell bonds issued under Title I of the Federal Farm Loan Act."

Drawing an analogy the Federal Home Loan Bank Board asserts that inasmuch as Farm Loan bonds and Intermediate Credit Bank obligations may be bought and sold, obligations of the Federal Home Loan Banks should likewise be made eligible for purchase and sale by Federal Reserve banks under section 14(b) of the Federal Reserve Act. The suggested amendment to accomplish this purpose would make "bonds, debentures or other obligations issued under the provisions of the Federal Home Loan Act, as amended," eligible for purchase without reference to maturity.

It may be pointed out, however, that since the proposed amendment would permit the purchase of Federal Home Loan Bank obligations without reference to the maturity thereof, whereas, the purchase of Farm Loan bonds and Intermediate Credit Bank obligations is limited to obligations with maturities not exceeding six months from the date of purchase, the eligibility of Federal Home Loan Bank obligations for purchase by Federal Reserve banks would be broader than that of Farm Loan bonds and Intermediate Credit Bank obligations.

Respectfully submitted,



J. P. Dreibelbis,
Assistant General Counsel.

JPD/ebb

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Mr. Morril – ✓

Mr. Bethea ✓
Mr. Carpenter ✓

The original of this memo was sent to Mr. Ransom –

JPD

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Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 20, 1937.

To Mr. Wyatt, General Counsel,

From Mr. Hackley, Law Clerk.

Subject: Meaning of term "open market"

GPO 16—852

An exhaustive search of the authorities has been made for the purpose of determining what meaning, if any, the courts have given to the term "open market". No case has been found which expressly defines that term; but the following cases clearly indicate by associated words of description, certain definite characteristics of an open market:

(1) An open market is a market in which the price of an article, generally dealt in, is fixed by lawful trade and competition.

Thus, in Lovejoy v. Michels, 88 Mich. 15, 49 N. W. 901 (1891), the plaintiff agreed to sell knives to the defendant without fixing a definite price. Upon breach of the contract on the part of the defendant, plaintiff brought suit and recovered damages determined by the price which had been fixed by the Knife Makers' Association, of which the plaintiff was a member. Upon appeal by the defendant, it was held that the Knife Makers' Association was a combination in restraint of trade; that the price fixed by such Association could not be regarded as "fair market value"; and that therefore other evidence should have been considered in determining the amount of damages. Accordingly, the judgment was reversed. In this connection the court said:

> "* * * The market price of an article manufactured by a number of different persons is a price fixed by buyer and seller in an open market, in the usual and ordinary course of lawful trade and competition. * * * Associations of this character (combinations in restraint of trade) give the buyer no voice, and close the market against competition. * * *" (49 N. W. at 903)

In Wallingford v. Western Union Tel. Co., 53 S. C. 410, 31 S. E. 274, 276 (1898), plaintiff sued the defendant for failure to deliver a telegram containing an offer for a carload of mules alleging that as the result of such failure, he was forced to keep them for considerable time and to sell them for a sum which was less than the offer. It was held that the plaintiff's loss was the direct result of the defendant's negligence and that the complaint therefore stated a cause of action. In this

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connection, the court declared that the measure of damages should be the difference between the market value of the mules on the same terms at the time the message should have been delivered and the price offered in case such market value was less than the price offered. With respect to "market value", the court said:

> "* * * By 'market value' is meant the price that could have been obtained in open market, on fair competition, on similar terms, * * *."

In Carey Lithograph Co. v. Magazine and Book Co., 70 Misc. 541, 127 N. Y. Supp. 300, 302 (1911), the plaintiff had agreed to submit sketches for advertising lithographs to the defendant and upon breach of the contract by the defendant, plaintiff brought suit alleging that defendant had given the contract to another person notwithstanding the fact that defendant had promised plaintiff to accept his lithographs at the "market price". Defendant contended that the sketches had been submitted on a "competitive bid" basis and that plaintiff's bid was higher than that of the person to whom the contract had been given. It was held that the parties contemplated a price fixed by open competition and accordingly, judgment was rendered for the defendant. In this connection, the court quoted from the Lovejoy case, supra, and then went on to say:

> "Where the subject of the price is an article commonly dealt in, this price will be fixed in a more or less definite sum by the consensus of all the buyers and sellers dealing in the article. The term 'market' assumes the existence of trade, and the price is fixed in trade by the highest bidder and the lowest offerer."

In Peoria Gas Light & Coke Co. v. Peoria Terminal Railway Co., 146 Ill. 372 N. E. 550 (1893), the plaintiff railroad brought eminent domain proceedings to condemn for its right of way a portion of defendant's property. Over the defendant's objection, the plaintiff was permitted to prove the price paid to other owners along the same right of way in determining the amount of compensation. Upon appeal by the defendant, the case was reversed for other reasons; but with respect to the manner of computing compensation it was held that the evidence in question had been properly admitted on the theory that such evidence tended to show the "fair market value" of the property. In this connection, the court said:

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"* * * It cannot be doubted that such sales, when made in the free and open market, where a fair opportunity for competition has existed, become material and often very important factors in determing the value of the particular property in question. * * *"

(2) Except for the influence of such competition, an "open market" is otherwise free; and buyers and sellers are subject to no compulsion.

In Huskie v. Griffin, 75 N. H. 345, 74 Atl. 595, 597 (1909), the plaintiff alleged that the defendant had maliciously caused him to be discharged from his employment. The trial court nonsuited the plaintiff and he appealed. It was held that the nonsuit was improper and that the trial court had erred in not submitting to the jury evidence of fraud, malicious injury and unreasonable interference with the plaintiff's right to an open market in the procurement of employment. In the latter connection, the court stated:

"* * * Prima facie a man can demand an open market; and, since this is so, one who interferes with this free market must justify his acts or respond in damages."

In McGarry v. Superior Portland Cement Co., 163 Pac. 928 (Wash. 1917), the plaintiff had bought cement from the defendant with an agreement that the plaintiff would receive a rebate in the event of a drop in the market price. Subsequently, the defendant sold cement to a third person at a lower price; and in a suit brought by the plaintiff, it was held that he was entitled to the rebate provided for in the contract. In discussing the question whether there had been a drop in the market price, the court said:

"* * * 'market price' implies price or value in an open market, and that buying and selling have some influence upon the price. If the market is not open but subject to control by all who offer a commodity of like kind, by fixing a price either by express agreement, or by a common, though unexpressed, understanding, how can it be said that there is a market price?"

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(3) Where the article sold is corporate stock, certain cases indicate that to constitute an "open market" the stock must be listed on an exchange.

In Pett v. Spiegel, 202 N. Y. S. 650 (1923), the plaintiff's assignors and the defendant had entered into a copartnership agreement to form and promote a corporation. Defendant violated the terms of the contract in the methods followed by him in organizing the corporation. Subsequently, he became bankrupt and the plaintiff sought an accounting to recover his proportionate value of the stock issued by the corporation. The referee in bankruptcy rendered a report fixing the value of such stock and his report was ratified by the court. In his report the referee explained that he had determined the value from a consideration of the business of the corporation and the value of its assets rather than from the price at which the stock sold. In this connection, the referee stated the value of the stock could not be ascertained from market quotations since the stock was very closely held and since

> "* * * It has never been listed on any exchange. There has been apparently no 'open market' for the purchase and sale of the same."

In Joseph v. Sulzberger, 136 App. Div. 499, 121 N.Y. Supp. 73 (1910), the defendant had agreed to buy certain corporate stock for the joint account of the plaintiff, the defendant, and others. Upon breach of the contract, plaintiff brought suit and recovered substantial damages which were determined from a consideration of the "book value" of the stock in question. Upon appeal by the defendant, it was held that the plaintiff had failed to prove the contract alleged in his complaint and accordingly, the judgment was reversed. However, the court felt that since a retrial would be necessary, it was proper for it to consider the measure of damages. In this connection, therefore, the court expressed the opinion that the method by which the value of the stock had been determined in the trial court was improper; that ordinarily damages for breach of contract to sell stock is the difference between the contract price and the market price; but that where there was no market price, the value of the stock should be determined by the price for which the stock could have been bought from a third person. In this connection, the court pointed out:

> "There was no open market for the stock of the company in this case, in the sense that it was dealt in or quoted upon any stock exchange; * * *"

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but that the plaintiff could have bought this stock from a member of the Schwarzchild family and that that price fixed and limited the damages suffered by reason of the defendant's refusal to deliver.

Respectfully,

Howard H. Hackley

Howard H. Hackley,
Law Clerk.

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TO: Mr. Smead

FROM: J. M. Daiger

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IN GENERAL FILES

April 17, 1937

Mr. Eccles — Open-Market Operations Proposed

J. M. Daiger — by Federal Home Loan Bank Board

Mr. Preston Delano, Governor of the Federal Home Loan Bank System, wishes to obtain an expression of your views regarding two provisions of a bill which the Federal Home Loan Bank Board has submitted to the Acting Director of the Budget "for consideration and for presentation to the President and for advice as to the position of the President in reference to the same."

As both the provisions to which Mr. Delano refers involve matters of open-market operation, and as both seem to me to carry implications that are questionable from the point of view of credit and fiscal policy, I am giving to you herewith the substance of the two provisions, a summary of the arguments made in support of them, and my own comments and suggestions in regard to them.

The provisions take the form of an amendment to paragraph (b) of section 14 of the Federal Reserve Act and an amendment to subsection (n) of section 4 of the Home Owners' Loan Act. The present and proposed forms of these measures are appended to this memorandum. (Appendix A)

Proposed Amendment to Federal Reserve Act

Paragraph (b) of section 14 of the Federal Reserve Act would be amended to include bonds, debentures, and other obligations of the Federal Home Loan banks among the securities which

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the Federal Reserve banks are authorized to buy and sell. The authorization would be permissive only and would apply only to open-market transactions, but there would be no limitation as to maturities.

Proposed Amendment to Home Owners' Loan Act

Subsection (n) of section 4 of the Home Owners' Loan Act would be amended to the following effect:

1. The $300,000,000 previously made available to the Home Owners' Loan Corporation for (a) the purchase of Federal Home Loan Bank bonds, debentures, or notes, (b) the purchase of shares, certificates of deposit, or investment certificates of member or insured savings-and-loan institutions, and (c) the making of deposits in such institutions, would henceforth be available exclusively for the purchase of shares, certificates of deposit, or investment certificates.

2. The unused bond authorization of the Home Owners' Loan Corporation (approximately $1,500,000,000) would be made available to the Corporation for the purchase of Federal Home Loan Bank obligations. The sale of HOLC bonds for this purpose would be subject to the approval of the Secretary of the Treasury, but the funds subsequently realized by the HOLC from the sale or payment of Federal Home Loan Bank obligations would be available for reinvestment in similar support of the Federal Home Loan Bank System.

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Relevant Provisions of the Reilly Bill

In connection with the foregoing proposals of the Federal Home Loan Bank Board, relevant provisions of the Reilly Bill (H.R. 3420) should also be noted. This bill was introduced by Congressman Reilly of Wisconsin at the request of the United States Building and Loan League. Mr. Morton Bodfish, executive vice-president of the League, informed me that he drafted the bill after consultation with officials of the HOLC and indicated that they regarded its provisions favorably. The provisions of the Reilly Bill relating to Federal Reserve matters are, briefly, as follows:

1. Section 13 of the Federal Reserve Act would be amended to authorize the Federal Reserve banks (a) to buy debentures or bonds issued by the Federal Home Loan banks; (b) to make loans to Federal Home Loan banks "upon the security of notes or notes secured by mortgage or other real-estate lien;" and (c) to authorize the Federal Reserve banks to "rediscount such notes and notes secured by mortgage or other lien on real estate with the endorsement of such Federal home loan banks." The Board of Governors would be authorized to prescribe rules and regulations "not inconsistent herewith."

2. Section 14 of the Federal Reserve Act would be amended to authorize the Federal Reserve banks to buy and sell bonds, debentures, or other obligations of the Federal

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Home Loan banks. No limitation is made as to maturities and, unlike the draft prepared by the Federal Home Loan Bank Board, transactions are not limited to the open market.

The full text of the foregoing provisions, which appear as sections 11 and 12 of the Reilly Bill, are appended to this memorandum (Appendix B). Apropos of them, Mr. Bodfish has written to me as follows: "I doubt if there will be any particular objection to any of the sections except 11 and 12, and I really believe it would be both fair and wise to give the same privileges to the twelve Federal Home Loan Banks as are now enjoyed by the Federal Intermediate Credit Banks."

General Argument for Home Loan Bank Board Proposals

Mr. Delano is of the opinion that a concerted effort will be made during the present session of Congress to obtain further legislation to strengthen the Federal Home Loan Bank System. This effort, he says, will have behind it "a pretty damned powerful lobby." On the one hand, there is the proposal of the United States Building and Loan League to give to the Federal Home Loan banks, and thus indirectly to their 3,800 member institutions, borrowing and rediscount privileges at the Federal Reserve banks that the law denies to Federal Reserve member banks. As you know, some of the high officials of the Federal Home Loan Bank System have themselves been disposed to urge that the Federal Home loan banks be given power of note issue comparable to that of the the Federal Reserve

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banks, or else that the Federal Home Loan banks be admitted to membership in the Federal Reserve System in order that their member institutions might thereby have indirect access to the Federal Reserve banks. These officials have contended, as have the building-and-loan people, that "some way" must be found to assure the Federal Home Loan banks of currency when they need it to meet the demands on their member institutions.

The provisions of the Reilly Bill that would open the reserve banks to the building and loan associations reflect, then, something more than the views of Mr. Bodfish and the objectives of the lobby that Mr. Delano speaks of. They reflect what was until comparatively recent months at least, even if it is so no longer, a substantial body of opinion within the organization of the Federal Home Loan Bank Board.

Mr. Delano apparently regards these various ideas as extreme and impracticable, but also apparently thinks that they will have a good deal of support in Congress. On the other hand, available as an alternative, are the provisions of the bill prepared for the Federal Home Loan Bank Board by its general counsel, Mr. Horace Russell. Mr. Delano holds that the two open-market provisions, as I have called them, in Mr. Russell's draft, are far more moderate than the Federal Reserve provisions in Mr. Bodfish's draft; that they avoid the controversial aspects of the latter; and that their sponsorship by the Administration, with the assent of the Secretary

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of the Treasury and the Board of Governors of the Federal Reserve System, would effectually preclude the adoption of measures which the Treasury and the Reserve System would find objectionable, but which, in the absence of an Administration bill, Congress would be under great pressure to enact in the interest of the Federal Home Loan Bank System.

Arguments in Behalf of "Psychological Amendments"

Speaking quite frankly, Mr. Delano says his Board feels that the Federal Home Loan Bank System "needs dressing up with a few psychological amendments." The authority for the Federal Reserve banks to buy Federal Home Loan bank obligations in the open market is sought as a sort of "window dressing" to help the sale of those obligations. The authorization being purely permissive, it might never be availed of by the Open Market Committee of the Federal Reserve System; nevertheless its inclusion in the Federal Reserve Act would be "a good talking point" in respect of Federal Home Loan Bank bonds and debentures.

So with the proposed authority for the HOLC to sell up to $1,500,000,000 more of bonds. The availability of such a revolving fund for use in supporting the market for Federal Home Loan Bank securities would of course be a very strong talking point. The authorization, however, would be permissive only, and the sale of HOLC bonds would in any case be subject to the approval of the Secretary of the Treasury.

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Mr. Delano says that his Board wishes to make a special effort to round out the Federal Home Loan Bank System by making it representative of the life insurance companies and mutual savings banks as well as of the building and loan associations. In this effort, the Board believes, it needs some such strong inducement to membership as the potential reserve of $1,500,000,000 would represent. The development of "a real home-mortgage system" is seen, therefore, as a very compelling reason why the unused bond authorization of the HOLC should be made available in the manner which the Board has proposed.

The further point is made that, if the present unused bond authorization of the HOLC were thus "frozen" for the purpose of supporting the Federal Home Loan Bank System, there would be an end to various efforts to have the $1,500,000,000 made available for other purposes, chief among them being a resumption of direct lending to distressed home owners.

Arguments Relating to Farm Credit Administration

Mr. Delano and Mr. Russell in discussing the proposals of the Federal Home Loan Bank Board, and Mr. Bodfish in discussing the proposals of the United States Building and Loan League, have each drawn certain analogies between privileges already enjoyed by the Farm Credit Administration, or by agencies under its supervision, and the privileges now sought in behalf of the Federal Home Loan Bank System. Thus Mr. Delano points out that the Federal Reserve

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banks have authority to purchase obligations of the Federal Farm Mortgage Corporation, the Federal Land banks, and the Federal Intermediate Credit banks. Noting that this authorization is limited to obligations having maturities of not more than six months from date of purchase, he suggests that at least a similar authorization with respect to Federal Home Loan Bank securities would be unobjectionable, even if the Board of Governors should not look favorably on the proposal to authorize the purchase of these securities by the reserve banks "without regard to maturities."

Of the proposed amendment to make the present unused borrowing power of the HOLC available for investment in Federal Home Loan Bank obligations, Mr. Russell states in the covering memorandum to the Acting Director of the Budget: "At present, the Federal Farm Mortgage Corporation can supply funds to the farm credit corporations, such as the Federal Land Banks, by purchase of their bonds, and this amendment is designed to enable the Federal Home Loan Bank Board to employ the remaining resources of the Home Owners' Loan Corporation in the support of the Federal Home Loan Bank System, if necessary."

In this same connection Mr. Delano observes that the Federal Farm Mortgage Corporation has a bond authorization of $2,000,000,000 available to support the market for Federal Land Bank bonds, and that under this authorization the Corporation has purchased some $700,000,000 of such bonds. He cites this as evidence that the proposal to

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make $1,500,000,000 available to the Home Owners' Loan Corporation for a similar purpose has ample precedent and should meet with no valid objection.

Objections to the General Argument

The first thing to be said of all these arguments is that the reasoning behind them is very much oversimplified and that they proceed for the most part upon mistaken assumptions.

To begin with, the general argument for the two open-market proposals of the Federal Home Loan Bank Board is an argument for political expediency on the part of the Administration in combatting what is purported to be a formidable building-and-loan lobby. The assumption is that a pressure group exists to which important concessions must be made; in other words, that the Administration is under the practical necessity of choosing between a radical change in the composition of the Federal Reserve System on the one hand and, on the other, the creation of a huge potential reserve fund, based upon Federal credit, for the Federal Home Loan Bank System.

Since you and I have had virtually a parallel experience over the past four years in dealing with the so-called building-and-loan lobby, I think you will agree that the lobby in question consists in the main of one very resourceful young man, who is not, however, as our experience has shown, altogether invincible. The crux of the matter in dealing with the lobby, therefore, is a matter of will and intention on the part of the Administration and not a

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political necessity of surrender or compromise.

The great difficulty, now as in the past, is to differentiate between pressure from without and pressure from within; to differentiate, that is, between what the building-and-loan lobby is after and what the governmental agencies directly concerned are after; to differentiate between private maneuvering for advantage or expansion and official maneuvering for advantage or expansion. As you have put it more than once: "The trouble is you never know where you stand with these fellows; you just have to watch them all the time." What can be said with certainty is that, regardless of the origin and authorship of a given proposal or set of proposals, the building-and-loan group and the HOLC group are alike habitually building-and-loan minded rather than financial minded. They can usually be found aiming at pretty much the same objectives, urging pretty much the same arguments, and in any event seeking special favors for building and loan associations. This was the case in 1933, 1934, 1935, and 1936. It is again plainly the case in 1937.

The present proposals of the United States Building and Loan League and of the Federal Home Loan Bank Board have a common origin in the natural resentment of the building-and-loan people toward the enlarged real-estate-loan and eligibility provisions of the Banking Act of 1935. When that measure was pending in Congress, the building-and-loan people were lobbying against it. Their contention was that real-estate loans had no place at all in demand-deposit institutions, and that the proposals which you had put

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forward would simply make a bad situation worse. They argued that to authorize national banks to use a larger proportion of their assets for real-estate loans, and to make long-term amortized loans on real estate, was to encroach on the building-and-loan field and to improve the competitive position of national banks in relation to building and loan associations. They argued further, with forcible logic, that the enlarged eligibility provisions gave to real-estate paper held by Federal Reserve member banks an exceptional status which no other real-estate paper possessed, and that this preference given by the Government to the member banks placed the building and loan associations at an extreme competitive disadvantage.

The building-and-loan opposition was not pressed in the open, however, because the personal and political factors were in your favor right where Mr. Bodfish ordinarily found them in his favor. He was well advised, as I informed you at the time, not to embarrass friends of his who were committed to your support (or at any rate not in a position to oppose you) and not to embarrass himself by a defeat from which they could not then save him. Partly because of these considerations, and partly because he was unable to get the mutual savings banks and the life insurance companies to join the building and loan associations in an attack before the Congressional committees, Mr. Bodfish withdrew his request for a hearing of himself and other building-and-loan witnesses against

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your proposals. But the Banking Act of 1935 has been gall and wormwood in the Federal Home Loan Bank System ever since.

It has been only a question of time, therefore, when the United States Building and Loan League and the Federal Home Loan Bank Board would come forward with a plan to "compensate" the building and loan associations for the liquidity presumably given by the Banking Act of 1935 to real-estate paper held by member banks. You and I have been hearing Mr. Fahey, Mr. Delano, Mr. Russell, and Mr. Bodfish talk about this in one form or another for the past eighteen months. At first it appeared that the building-and-loan group and the HOLC group would make a concerted effort to obtain borrowing and discount privileges at the Federal Reserve banks for the Federal Home Loan banks. The circumstances under which the Reilly Bill subsequently originated tended to confirm that earlier impression. More recently, however, the HOLC open-market or central-reserve plan has been proposed as an alternative.

The important point to be noted here is that the essence of the two sets of proposals is the same--namely, that an additional source of borrowing and discount must be provided for the Federal Home Loan banks, so that they in turn may be assured of funds to meet the demands on their institutions. The essential question to be determined, then, is not whether the building-and-loan lobby can be conciliated in a manner unobjectionable to the Treasury and the Federal Reserve System, but whether the home-mortgage institutional situation calls for the additional borrowing and discount

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facilities that the bill drafted by Mr. Bodfish would obtain through the Federal Reserve banks and that the bill drafted by Mr. Russell would obtain through the sale of Government-guaranteed bonds in the open market.

In short, I think that Mr. Delano is unduly alarmed over the building-and-loan lobby and quite unnecessarily concerned about the threat of the Reilly Bill to the Federal Reserve System. The Reilly bill was threatening only insofar as it may have embodied the aims of both the building-and-loan people and the HOLC people, whose combined political strength is obviously very great. Once the alternative plan of the Federal Home Loan Bank Board were devised, however, the Federal Reserve provisions of the Reilly Bill were effectually disposed of. For Mr. Bodfish is sensible enough to have no pride of authorship. He would be the first to concede that the availability in the HOLC of a $1,500,000,000 open-market or central-reserve fund is a far better proposition for the building and loan associations than anything he had proposed in the Reilly Bill.

Hence, if there is to be during the present session of Congress, as Mr. Delano suggests, a concerted effort to "strengthen the Home Loan Bank System," it will be because a governmental agency is pressing for a larger measure of new assistance to building and loan associations than their own trade body has asked for.

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Objections to the "Window-Dressing" Arguments

From the point of view of Federal Reserve policy, there could scarcely be any objection to a proposal to make Federal Home Loan Bank obligations of short maturity available for open-market operations of the Federal Reserve banks. Such a proposal would be wholly in accord with a variety of provisions in existing law. But this is not the proposal submitted by the Federal Home Loan Bank Board to the Acting Director of the Budget.

The proposal as submitted is "without regard to maturities." The principal objection to it, therefore, is that it singles out one class of non-governmental paper from all others and puts it into a special category now reserved to direct and guaranteed obligations of the Government. Manifestly, a departure of this kind could not, as a matter of legislative or financial policy, be confined to the bonds of the Federal Home Loan banks; for these bonds possess no peculiar elements that set them above all other corporate issues which, like these, carry no governmental guarantee.

The proposal is not objectionable from the broad point of view of central-banking operation. Theoretically, it might well be argued, the monetary authorities ought to be free to engage in whatever open-market operations would in their judgment give effect to the credit policies for which their operations were projected. It might even be argued that they ought to be free to ease the credit position of the Federal Home Loan banks if such an operation appeared

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to be in the public interest and compatible with the general credit conditions existing at the time. Such an argument, however, would be susceptible of indefinite extension to a great variety of special situations in the capital markets for which the Federal Reserve Act makes no provision.

The suggestion that the proposed amendment to the Federal Reserve Act would confer merely a permissive power, and hence need not be exercised by the Federal Reserve authorities if they were disposed to disregard it, is not one that could be countenanced with propriety simply to help the sale of Federal Home Loan Bank securities. That would be making a show window of the Federal Reserve Act, besides being altogether at variance with the ethical standards contemplated in the Securities Exchange Act. Furthermore, no exaggerated imagination is required to see that, if the Board of Governors now formally or tacitly assents to the enactment of the amendment as proposed, the Open Market Committee would in all probability at some time in the future be under pressure to act in accordance with it, and would be subjected to questioning and criticism if it failed to do so.

The suggestion that the authority to create a huge revolving fund for support of the Home Loan Bank System would likewise be permissive only, and hence would not necessarily be availed of, is what William James, who was the leading American psychologist of his day, would have called "monstrously simplified." It ignores

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the plain evidence of experience with the pressure groups that have in recent years obtained such a large measure of governmental assistance for the building and loan associations. There may be arguments which can be advanced to demonstrate that an additional $1,500,000,000 of Federal credit should be made available in support of the Federal Home Loan Bank System, but the idea that the present proposal is moderate, or tentative, or more psychological than real, is far too simple to be considered seriously.

In these circumstances, it is hardly necessary to argue the point that the main body of mutual savings banks and life insurance companies would not respond to mere psychological treatment. The great majority of these institutions have thus far resisted all efforts to bring them into the Home Loan Bank System, and the reasons for this are well known. The System was designed from the outset with building and loan associations primarily in view; it has from the outset been dominated by the building-and-loan group. This is no doubt attributable in large part to the original apathy of the mutual savings banks and life insurance companies--to their superior feeling of self-sufficiency--which left the building-and-loan group unopposed in shaping the pattern of the System and the terms of membership in it to their own advantage as against the other groups.

The fact nevertheless remains indisputable that these two large groups are for the most part now hostile to the System, first

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because they regard it as a vested interest of the building and loan associations, and second because they regard many of its activities as competitive rather than cooperative with their own interests. Moreover--and this is probably the principal reason for their abstention from membership--the mutual savings banks and life insurance companies are not primarily home-mortgage institutions, so that membership could only afford them in any event a relatively small advantage. It may therefore reasonably be asked whether the plan proposed by the Federal Home Loan Bank Board is not too high a price for the Federal Government to offer as an inducement to these groups to do what not even the experience of the recent depression could induce them to do.

The availability of the proposed revolving fund would unquestionably make it possible for the Home Owners' Loan Corporation to support the market for Federal Home Loan Bank bonds in a period of general credit stringency. It would thus be able to supply funds to the member institutions of the Federal Home Loan Bank System. In such a period, however, the fiscal and monetary authorities of the Government would necessarily have as a principal concern the market for Treasury securities, and the injection into the market at that time of additional guaranteed obligations of the Government to relieve pressure on the obligations of the Home Loan banks would be a complicating rather than an ameliorating factor. The practical problem, then, would be one of emergency lending and not one of

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open-market operation.

At other times no such huge fund as that proposed would be required for the purpose of supporting the Home Loan bond market. The problem would be only a temporary one, such as the maintenance of the market against offerings that might interfere with the sale of a new issue. The current Federal Home Loan Bank Review shows the outstanding advances of the Home Loan banks as $141,205,000 and the total borrowing capacity as $973,000,000. The conditions under which such a sum as $1,500,000,000 would have to be available in order to support the Home Loan bond market are therefore extremely problematical and remote. In fact, since more than half of the $300,000,000 already made available for bond purchases and share subscriptions still remains unused, there would seem to be no difficulty in giving the Home Loan bond market whatever support it may require for some time to come.

On the other hand, the present would seem to be a propitious time to remove the pressure against cancelling the unused portion of the $4,750,000,000 bond authorization of the HOLC. Where considerations of psychology are involved, the affirmative action of the President in asking for the cancellation of the $1,500,000,000, and the affirmative action of Congress in effecting the cancellation, would certainly have a more beneficial effect on the budgetary situation and on the market for Federal securities than a move at this time to "freeze" that amount of Federal credit for the future benefit of

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the Federal Home Loan Bank System.

Objections to Arguments from Analogy with FCA

There is a fundamental difference between the Federal Land Bank System and the Federal Home Loan Bank System that is almost invariably left out of account when persons speak of them as if the latter were to the home-mortgage field what the former is to the farm-mortgage field. The difference is inherent in the nature of their respective member agencies.

The Federal Land Bank System is a system of borrowers' cooperatives, designed to get cheap mortgage money for farmers. The Federal Home Loan Bank System is a system of savers' cooperatives, seeking a relatively high return on small savings. The Federal Land banks operate as mortgagees, taking the farm-borrower's mortgage, obtaining funds in the open market, and basing their lending rate on the market rate. The Federal Home Loan banks do not operate as mortgagees taking the home-borrower's mortgage, but as lenders to mortgagees whose main source of funds is small local savings. Through the Federal Home Loan banks these mortgagees, more than 99 per cent of which are building and loan associations, have access to the open market as a secondary and indirect source of funds.

To the extent that the member associations of the Home Loan banks do supplement their main source of funds by borrowing, they are pyramiding on small savings and creating a class of claims

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prior to that of the savers. There is nothing parallel or even remotely comparable to this in the Federal Land Bank System.

The operations of the building and loan associations are now entering a phase that is entirely new in the brief history of the Federal Home Loan Bank System. It is a phase of borrowing for the extension of new credit. This is an operation apart from and in addition to the purchase of building-and-loan shares by the Federal Government, though these shares, together with those of the small savers, form the base of the pyramid. The assets of building and loan associations as a whole are apparently still declining, the ratio of Government capital to private capital in the member associations is apparently still increasing, and the expansion of building-and-loan lending through borrowing at the Federal Home Loan banks is now apparently a settled policy, to be pursued because of the revival of real-estate and building activity at a rate faster than the active lending associations can attract local savings.

A serious credit problem is present here, involving conflicting theories that were dormant during the deflation and depression years when the Federal Home Loan Bank System came into being. The problem is this: Is the functional relationship of the Home Loan banks to their member associations (a) that of supplying long-term funds for new credit or (b) that of adjusting temporary fluctuations between savings and loans and meeting the demands of

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shareholders in periods of emergency? If the relationship is the former, then in the pyramiding on savings the borrowing institutions can of course increase their earnings beyond the possibilities of their share capital alone, but in the process of getting more earnings they will diminish and eventually exhaust the borrowing power that is presumably to serve their shareholders in periods of emergency.

No such possible conflict of functional relationships is inherent in the Federal Land Bank System. With respect to the analogies drawn by Mr. Delano, Mr. Russell, and Mr. Bodfish, therefore, the question most pertinently suggested to one who thinks in banking and financial terms is whether pyramiding on the assets of small savers should now be encouraged, and in practical effect ultimately underwritten, by making the Federal credit available for purchase of $1,500,000,000 of Federal Home Loan Bank bonds.

There is no real analogy, as Mr. Delano evidently has been told there is, between putting the HOLC in a position to support the market for Home Loan Bank bonds and the acquisition by the Federal Farm Mortgage Corporation of $700,000,000 of Land Bank bonds. Whoever advised Mr. Delano that these bonds were bought in supporting the market was wholly in error. The bonds in question represent disbursements made in the form of Federal Farm Mortgage Corporation bonds during the period of emergency lending, just as the mortgages held by the Home Owners' Loan Corporation represent disbursements

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made in the form of HOLC bonds during the same period.

The analogy with the Federal Farm Mortgage Corporation is stated in the memorandum to the Acting Director of the Budget as if it were self-explanatory. As a matter of fact, it in no way indicates what the Federal Home Loan Bank Board has in mind with respect to the proposed revolving fund, except that it would be available "in the support of the Federal Home Loan Bank System, if necessary." Apparently there is a great reluctance to say in plain words that the Board proposes (a) to make the HOLC permanent, (b) to make up to $1,500,000,000 available to it in addition to the unused portion of the $300,000,000 previously made available for bond and share purchases, and (c) to have the fund operate as a super-reserve or central-discount fund for the twelve Federal Home Loan banks. Yet the bill submitted in draft form seems clearly open to such an interpretation.

Some such course as this might be the practicable way to resolve the credit anomaly presented by the Federal Home Loan Bank System if the long-term expansion function were done away with, or if the twelve banks were to be authorized to buy mortgages without recourse instead of making advances against them. Either of these changes would remedy the conflict of functional relationships in the existing pattern of the System.

Sooner or later the Government will have to face the fact that the System for which the support of additional Federal credit

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is proposed is a hybrid system. It has no counterpart in the Federal Reserve or Federal Land Bank pattern, nor in the building-society pattern of Great Britain, nor in the mortgage-bank pattern of Continental Europe or South America. It is not a central-banking system with the power of note issue; it is not a system of credit cooperatives formed to effect economies for borrowers; it is not a system limited to the investment of savings funds; it is not a mortgage-banking system making or buying mortgage loans and selling bonds against them. It is apparently designed to be a building-and-loan reserve system for bad times and a building-and-loan expansion system for good times.

The trouble with this is that the expansion in good times is accomplished by a method that is incompatible with the fiduciary function of a savings system and that leaves the reserve function in doubt for periods of credit stringency. It is the same as if mutual savings banks, life insurance companies, commercial banks, and trust companies borrowed against their assets, and thus created a preferred class of creditors, solely for the purpose of enlarging their mortgage portfolios. If it were then proposed that the Federal Government make its credit available for the encouragement and support of such pyramiding operations on the part of any one or all of these other groups of institutions, the proposal would be rejected in short order as plainly contrary to good banking and credit policy.

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Would you not say that the present proposal ought to be rejected for the same reason in the case of building and loan associations?

N.B.--See next page for summary of loans and investments made by Federal Government to assist building and loan associations.

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LOANS AND INVESTMENTS BY FEDERAL GOVERNMENT

IN BUILDING AND LOAN ACTIVITIES

Bonds of Home Owners' Loan Corporation as of June 12, 1936, given in exchange for mortgages in distress held by building and loan associations.	$ 875,300,000
Paid subscription from Federal funds as of January 1937 for stock of the Federal Home Loan Banks - 99.7% of whose member institutions are building and loan associations.	119,972,500
Loaned by the Reconstruction Finance Corporation as of November 30, 1936, to building and loan associations (including receivers of building and loan associations).	116,559,180
Paid subscription by the United States Treasury and Home Owners' Loan Corporation as of January 13, 1937, for shares of the Federal Savings and Loan Associations.	177,084,200
Paid subscription by the Home Owners' Loan Corporation as of January 13, 1937, for shares of State building and loan associations.	22,094,900
Paid subscription by Home Owners' Loan Corporation as of November 30, 1936, for shares of the Federal Savings and Loan Insurance Corporation - only building and loan associations are eligible for this insurance protection.	100,000,000
Total	$1,411,010,780
Amount repaid as of November 30, 1936, by building and loan associations to Reconstruction Finance Corporation.	113,845,175
Net amount of funds loaned or invested by the Federal Government in building and loan associations and in instrumentalities of the United States serving principally building and loan associations.	$1,297,165,605

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APPENDIX A

Present Form of Paragraph (b), Section 14, Federal Reserve Act

Every Federal reserve bank shall have power:

(b) To buy and sell, at home or abroad, bonds and notes of the United States, bonds of the Federal Farm Mortgage Corporation having maturities from date of purchase of not exceeding six months, bonds issued under the provisions of subsection (c) of section 4 of the Home Owners' Loan Act of 1933, as amended, and having maturities from date of purchase of not exceeding six months, and bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any State, county, district, political subdivision, or municipality in the continental United States, including irrigation, drainage and reclamation districts, such purchases to be made in accordance with rules and regulations prescribed by the Board of Governors of the Federal Reserve System: Provided, That any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to principal and interest may be bought and sold without regard to maturities but only in the open market;

Proposed Form of Paragraph (b), Section 14, Federal Reserve Act

Section 22. Paragraph (b) of Section 14 of the Federal Reserve Act, as amended, is further amended to read as follows:

"(b) To buy and sell, at home or abroad, bonds and notes of the United States, bonds of the Federal Farm Mortgage Corporation having maturities from date of purchase of not exceeding six months, bonds, debentures or other obligations issued under the provisions of the Federal Home Loan Bank Act, as amended, bonds issued under the provisions of subsection (c) of section 4 of Home Owners' Loan Act of 1933, as amended, having maturities from date of purchase of not exceeding six months, and bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any State, county, district, political subdivision, or municipality in the continental United States, including irrigation, drainage and reclamation districts, such purchases to be made in accordance with rules and regulations prescribed by the Federal Reserve Board. Provided, that any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to principal and interest, and obligations issued pursuant to the provisions of the Federal Home Loan Bank Act, as amended, may be bought and sold without regard to maturities but only in the open market."

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Present Form of Subsection (n), Section 4, Home Owners' Loan Act

(n) The Corporation is authorized to purchase Federal Home Loan Bank bonds, debentures, or notes, or consolidated Federal Home Loan Bank bonds or debentures. The Corporation is also authorized to purchase full-paid-income shares to Federal Savings and Loan Associations after the funds made available to the Secretary of the Treasury for the purchase of such shares have been exhausted. Such purchases of shares shall be on the same terms and conditions as have been heretofore authorized by law for the purchase of such shares by the Secretary of the Treasury: Provided, That the total amount of such shares in any one association held by the Secretary of the Treasury and the Corporation shall not exceed the total amount of such shares heretofore authorized to be held by the Secretary of the Treasury in any one association. The Corporation is also authorized to purchase shares in any institution which is (1) a member of a Federal Home Loan Bank, or (2) whose accounts are insured under title IV of the National Housing Act, if the institution is eligible for insurance under such title; and to make deposits and purchase certificates of deposit and investment certificates in any such institution. Of the total authorized bond issue of the Corporation $300,000,000 shall be available for the purposes of this subsection, without discrimination in favor of Federally chartered associations, and bonds of the Corporation not exceeding such amount may be sold for the purposes of this subsection.

Proposed Amendment to Subsection (n), Section 4, Home Owners' Loan Act

Section 17. The last sentence of subsection (n) of Section 4 of Home Owners' Loan Act of 1933, as amended, is amended to read as follows:

"Of the total authorized bond issue of the Corporation, $300,000,000 shall be available for the purchase of shares, certificates of deposit or investment certificates of any member or insured institution as hereinbefore authorized, without discrimination in favor of Federally chartered associations, and bonds of the Corporation not exceeding such amount may be sold for such purposes; and the total amount of unused bond authorization of the Corporation shall be available for the other purposes of this subsection and bonds of the Corporation not exceeding such amounts may be sold, subject to the approval of the Secretary of the Treasury, for such purposes; and any funds realized by the Corporation upon, or from the sale of, investments made under the provisions of this subsection in Federal Home Loan Bank bonds, debentures, or notes, or consolidated Federal Home Loan Bank bonds or debentures may be reinvested by the Corporation at any time in said bonds, notes and debentures."

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APPENDIX B

Relevant Provisions of the Reilly Bill

SEC. 11. Section 13 of the Federal Reserve Act, as amended, is further amended by adding the following two new sections:

"SEC. 13b. Any Federal Reserve bank may, under rules and regulations not inconsistent herewith prescribed by the Board of Governors of the Federal Reserve System, buy debentures or bonds issued pursuant to the provisions of section 11 of the Federal Home Loan Bank Act, as amended.

"SEC. 13c. Any Federal Reserve bank may, subject to regulations not inconsistent herewith prescribed by the Board of Governors of the Federal Reserve System, make loans to Federal home loan banks upon the security of notes or notes secured by mortgage or other real-estate lien taken by such Federal home loan banks pursuant to the Federal Home Loan Bank Act, as amended, and any Federal Reserve bank is authorized to rediscount such notes and notes secured by mortgage or other lien on real estate with the endorsement of such Federal home loan banks."

SEC. 12. Paragraph (b) of section 14 of the Federal Reserve Act, as amended, is hereby further amended so as to read as follows:

"(b) Every Federal Reserve bank shall have power to buy and sell, at home or abroad, bonds and notes of the United States, bonds of the Federal Farm Mortgage Corporation having maturities from date of purchase of not exceeding six months, bonds, debentures, or other obligations issued under the provisions of section 11 of the Federal Home Loan Bank Act, as amended, bonds issued under the provisions of subsection (c) of section 1463 of this title and having maturities from date of purchase of not exceeding six months, and bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any State, county, district, political subdivision, or municipality in the continental United States, including irrigation, drainage, and reclamation districts, such purchases to be made in accordance with rules and regulations prescribed by the Federal Reserve Board: Provided, That any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to principal and interest may be bought and sold without regard to maturities but only in the open market."

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STATEMENT OF THE OPEN MARKET COMMITTEE
OF THE FEDERAL RESERVE SYSTEM

FOR THE PRESS

For release in morning newspapers of
Monday, April 5, 1937.

With a view (1) to exerting its influence toward orderly conditions in the money market and (2) to facilitating the orderly adjustment of member banks to the increased reserve requirements effective May 1, 1937, the Open Market Committee of the Federal Reserve System is prepared to make open market purchases of United States Government securities for the account of the Federal reserve banks in such amounts and at such times as may be desirable. This purpose is in conformity with the policy announced by the Board of Governors of the Federal Reserve System in its statement on January 30, 1937, which declared, with reference to the increase in reserve requirements, that by this action the System would be placed in a position where such reduction or expansion of member bank reserves as may be deemed in the public interest may be effected through open market operations.

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April 2, 1937.
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COURSE OF ACTION SUGGESTED BY WEAKNESS IN BOND PRICES

In view of (a) the substantial fall in bond prices that has occurred since the first of the year and (b) the possibility that certain banks will have to make further adjustments to meet the pending increase in reserve requirements, the question arises whether the System should engage in any open market purchases and, if so, of what character and in what degree.

Action must necessarily be based on diagnosis, objectives, and a weighing of the probable consequences, in all of which differences of opinion exist. My own view is as follows:

Diagnosis

While the increase in reserve requirements may have had something to do with the fall in bond prices there are various considerations that suggest that other factors have been more important. For one thing, the movement started back in December. For another, it would seem that the extent of the movement, combined with the fact that it is known that banks will be left with some $600 million excess reserves and that other funds available for investment are abnormally large, indicate that other considerations are paramount. These considerations appear to be a renewed fear of inflation arising from rapid price and wage advances, rearmament, the fall of interest rates in England, and the warnings of various writers. Recently this has been aggravated by a change in the federal budget picture, and a rejection of the proposal to levy additional taxes.

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If this is the correct diagnosis of the present situation there would be danger that open market purchase of government obligations would be interpreted as inflationary in its implications and contribute to increased rather than reduced sales of bonds. This view was expressed in financial editorial comments in both the New York Times and the Wall Street Journal in recent days, following the rumor that henceforth the Federal Reserve would have to support the bond market. In short, it appears hardly proper to adopt "inflationary" measures to cope with a situation which arises from inflationary fears. An affirmation by the President that there will be no boom would be more effective than a reaffirmation of an easy money policy on our part, if the above diagnosis is correct.

Objectives

There appear to be two objectives that would be served by open-market purchases. One would be to support government bond prices by direct purchases. The other would be to prevent forced sales to meet increased reserve requirements, by giving banks more reserves. While related, these two objectives are capable of separate treatment.

The first objective of supporting bond prices implies

(a) that we feel responsibility for the level of government bond prices,

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(b) that we feel that the present levels or any further recessions will be detrimental to the course of business,

(c) that our action would be effective and

(d) that we would have no difficulty in disposing of our purchases and mopping up the additional excess reserves at a later date. I will consider these points in order.

(a) Now that almost all the financing requirements of the government are out of the way, it does not appear that we should feel much responsibility for the level of government bond prices, except to the extent that a decline may be attributable to action on our part. In this case it should be one of the considerations that must be weighed against other considerations. Financial critics of the Administration have repeated again and again that the ship of monetary control would founder on the rock of fiscal policy -- that the Treasury would never permit its interest cost to be raised. Deliberate action to support bond prices might be interpreted as confirmation of this view.

(b) It appears unlikely that the recent movement in bond prices is detrimental to the course of business. A substantial portion of new capital has been raised by new stock issues and

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the bulk of bond financing has been for refunding purposes. The effect of refunding at this stage of the cycle is to increase profits which are already mounting rapidly. The recession cannot be long continued and new capital issues will appear in abundance when prices are stabilized. A temporary slackening of new issues might even be held to be salutary at the present time, tho this is more [illegible]. Even should bond prices remain at a lower level than before the movement began, a difference of one-half percent or even one percent in bond yields in this phase of the cycle would be a negligible influence in checking expansion. Present conditions, in other words, differ widely from those in 1931, when buying was declining rapidly, or 1934, when the recovery was still uncertain. If, of course, a wide open break occurred, accompanied by dumping of all bonds regardless of price, the situation would be different.

With reference to the position of member banks, we are naturally concerned to prevent bank failures. So far, however, recession has mainly cancelled paper profits and has not resulted in large actual losses. The movement would have to be much more drastic to threaten the solvency of banks.

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(c) As remarked before, there is no guarantee that purchases will be effective in achieving their objective, as this depends on the uncertain psychological repercussions. It is worth noting that the Treasury has expended some $200 million without arresting the decline. A fixed amount of purchases might be worse than ineffective. A bold policy of unlimited support might entail purchases of very large magnitude, undoing much of the increase in reserve requirements.

(d) Finally, there is no guarantee that the additional excess reserves created through Government bond purchases can be absorbed later without affecting bond prices when the securities are sold. This depends on the amount, the future course of the market, confidence, etc. This may not be a serious danger, but it deserves mention. Additional bond purchases, by increasing excess reserves relative to our Treasury bill holdings, would leave us in a less secure position to mop up excess reserves and arrest deposit expansion in the future.

The second objective is to prevent forced sales arising from the adjustments incident to meeting the new requirements. This appears to be a more justifiable objective and does not

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lend itself to the same inflationary implications as would a policy of supporting government bonds. It would be consistent with our general policy of moving toward the absorption of excess reserves as a precautionary measure, while not departing for the time being from an easy money policy. We could adopt the position that while we do not feel that the fall in bond prices attributable to inflation fears justifies a counteractive policy on our part, we do feel that banks should not have to dispose of governments at this time in order to meet the increase in requirements.

There is a real problem in making this distinction clear. The explanation would not be accepted, in my view, if we bought government bonds on balance. It could be pointed out that if we wanted to supply additional reserves we could do so without directly buying long-term government bonds. There is a similar danger in buying Treasury bills. The financial community has got into the habit of lumping together all government obligations held by all the reserve banks. Any increase in the grand total of $2.4 billion of government obligations, even tho attributable solely to increased Treasury bill purchases, might be regarded as indicative of a change in open-market policy and, hence, inflationary.

These objections and difficulties would not apply to increased purchases of acceptances. Variations in acceptance holdings have

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been the traditional means of making temporary and seasonal adjustments and are not generally regarded as indicative of any change in "open-market policy". There would be assurance that the reserves created by additional purchases would go to the large city banks that need additional reserves. Bond purchases, on the other hand, might create reserves for country banks that have plenty of reserves already and are merely selling because they mistrust the future trend of bond prices.

Recommendation

I would favor an immediate reduction in the bill buying rate from one-half percent to three-eighths percent. I do not think this action would be regarded as inflationary and it would have the effect of giving additional reserves to New York banks and forestall the necessity on their part of disposing of bonds at present prices. I believe, moreover, that the present relatively generous yields combined with the knowledge that excess reserves will amount to some $700 or $800 million (depending on our acceptance purchases) and that further forced selling or borrowing will be obviated, would contribute to a cessation of pressure on the market and possibly to a rally. If, however, this does not happen, nothing will have been lost and we will still be in a position to consider whether any further action on our part is required. It is to be expected that the Treasury will continue to work for an orderly market. In the present uncertain conditions prudence suggests that resort to possible dangerous expedients be delayed until after we have given a fair trial to relatively safe expedients.

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Listing the various expedients in order of preference I would suggest:

(1) A vigorous anti-inflationary statement by the President.

(2) Purchase of acceptances by reserve banks.

(3) Purchase of bonds by the Treasury in ways that do not involve the creation of additional excess reserves.

(4) Purchase of bonds by the Treasury thru use of the free gold.

(5) Suspension of gold sterilizing operations by the Treasury for time being.

(6) Use of inactive gold.

(7) Purchase of bonds by the reserve banks.

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JAN 21 1937
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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

X-9797

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

January 19, 1937

Dear Sir:

Reference is made to the Board's letter of December 23, 1936 (X-9768) supplying certain code words for use in telegrams between the Federal Reserve Bank of New York and other Federal Reserve banks in connection with transactions in United States Government securities in the System Open Market Account.

Under the procedure adopted effective January 1, 1937, the number of telegrams and the number of entries in the Interdistrict Settlement Fund involved in purchase and sale transactions could be reduced considerably by making settlement between the New York bank and each other Federal Reserve bank in a single amount representing the net amount due to the Federal Reserve Bank of New York, or due from the Federal Reserve Bank of New York, as a result of such transactions on a given day. Accordingly, Mr. W. Randolph Burgess, Manager of the System Open Market Account, has suggested that two new code words be furnished for use in this manner in lieu of the code words furnished in the Board's letter referred to above.

Pursuant to this suggestion the following code words have been designated for use in connection with transactions in United States Government securities in the System Open Market Account and should be inserted

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X-9797

on page 134 of the Federal Reserve Telegraph Code, following the word JUMTOLD:

JUMTYNE - We credit you today in the Interdistrict Settlement Fund, (A) $__________ representing the net amount due you as a result of transactions today in United States Government securities in System Open Market Account as follows: Credits due you, (B) $__________ par value, (C) $________ premium, (D) $__________ accrued interest, (E) $_________ discount, (F) $_________ profit on sale, less credits due us, (G) $_________ premium, (H) $____________ accrued interest, (I) $________ discount, (J) $__________ loss on sale. The classification of your pro rata share in total holdings at the close of business today is (K) $_________ par value Treasury bills, (L) $_________ par value Treasury notes, (M) $_______________ par value Treasury bonds.

JUMYAK - Credit us today in the Interdistrict Settlement Fund, (A) $_______ representing the net amount due us as a result of transactions today in United States Government securities in System Open Market Account as follows: Credits due us, (B) $__________ par value, (C) $_________ premium, (D) $__________ accrued interest, (E) $_________ discount, (F) $__________ loss on sale, less credits due you, (G) $_____________ premium, (H) $_________ accrued interest, (I) $__________ discount, (J) $__________ profit on sale. The classification of your pro rata share in total holdings at the close of business today is (K) $_________ par value Treasury bills, (L) $_______ par value Treasury notes, (M) $__________ par value Treasury bonds.

Very truly yours,

L. P. Bethea,
Assistant Secretary.

TO PRESIDENTS OF ALL FEDERAL RESERVE BANKS

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