Excellent

Question 3

What is the practical significance of shifting policy emphasis from the view of "maintaining orderly conditions" to the view of "correcting disorderly situations" in the security market?

The shift in emphasis of System policy reflected by the substitution of "correcting disorderly situations" for "maintaining orderly conditions" in the Government security market was in fact only part of a broader reassessment of the role the central bank can and should play in that market. Other policy actions growing out of this reassessment were the limitation of System Account transactions to Treasury bills (except to correct disorderly conditions) and the limitation of transactions solely to the purpose of supplying bank reserves (again, except to correct disorderly conditions). As a corollary, the System also ceased providing any type of direct market support for Treasury offerings of its securities. And there was explicit recognition that the new doctrine meant that the System would have no concern with interest rates in the ordinary conduct of its credit policy.

The shift in emphasis to "correcting disorderly situations" in itself would not have precluded regular operations in securities other than Treasury bills, designed to affect the availability and cost of credit. But it would preclude operations in other securities to influence their prices except when such operations were considered necessary or desirable for the promotion of the objectives of credit policy. The decision to trade only in bills, however, together with the decision to operate solely for the purpose of affecting bank reserves, has effectively eliminated operations in securities other than Treasury bills except to correct disorderly market conditions. In short, the combined effect of this decision has been to eliminate all transactions the purpose of which is to influence market conditions unless disorder develops.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

It is very difficult to define either "orderly" or "disorderly" conditions in terms that would be generally acceptable. One of the reasons for the shift of emphasis was the difficulty of reaching agreement on what was implied by the commitment to maintain orderly market conditions. During the war and the early postwar years, the maintenance of orderly market conditions had come to be understood by many as synonymous with the "pegging" of prices of Government securities. It need not, of course, have that meaning. In fact, prior to the entrance of the United States into World War II, it was taken to signify only action to moderate adjustments in the market for Government securities--for example, in the spring of 1937 and in the months following the outbreak of war in Europe in September 1939. Operations in the latter period were not limited to purchases at times of market weakness, but included later reversal of the transactions through sales when the market was sufficiently strong to absorb them readily.

During and after the war (up to the time of the Treasury-Federal Reserve "accord"), however, Federal Reserve open market operations were at most times influenced by the objective of preventing yields on short and long-term securities from rising above predetermined--although not always rigidly fixed--levels. It was this type of operation that made it impossible for the Federal Reserve System to carry out its credit policies with full effectiveness. When investors offered securities for sale at the "support prices," the System was forced to make purchases, even if such purchases were in conflict with the objectives of its credit policies. This gave "the market" the initiative in determining the amount of Federal Reserve credit extended, and prevented effective control over the general availability of credit by the Federal Reserve authorities.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

After the "accord," the System regained the initiative in adjusting its open market operations to the needs of the economy, but fears of becoming involved in pegging operations again still colored System thinking. There was a general determination to avoid any action that might be interpreted by the market as evidence that pegging had not been dropped completely. That is the principal reason for the shift of emphasis from "maintaining orderly market conditions" to "correcting disorderly situations." There still remains room for differences of opinion as to when "disorderly situations" exist, but the area for differences of opinion is much less than was the case with respect to "maintaining orderly conditions." The question of whether or not to act should be less difficult to decide and any action taken to correct disorderly conditions should be subject to much less misinterpretation and "second guessing" in the market. If an effort is to be made to check incipient disorder, however, the area of uncertainty and difference of opinion is considerably widened.

<u>What were the considerations leading the Open Market Committee to confine its operations to the short end of the market (not including correction of disorderly markets)?</u>

The Federal Open Market Committee at its meeting in March 1953 adopted a procedural change in trading practices for the System Open Market Account which limited such transactions exclusively to short-term Government securities, except for the correction of disorderly market conditions. While the Committee action specified "short-term" securities, in practice the System Account has transacted business almost exclusively in Treasury bills since the change in trading practices was adopted. All transactions in 1954 have been in bills. This limitation of open market operations reflected a belief on the part of a majority of the Federal Open Market Committee that its adoption would encourage a broader, more independent, and more resilient market for Government securities.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A study of the relationship between the Federal Reserve System and the market for Government securities had been undertaken by a special subcommittee of the Federal Open Market Committee during 1952. The subcommittee report concluded that the institutional arrangements and market organization already in existence provided a satisfactory foundation for the development of a broad and free market in which prices and interest rates would reflect accurately the underlying supply and demand conditions and therefore would command the confidence of investors. It was concluded that the participation of the System Open Market Account in the market exerted a seriously limiting influence on the ability of the market and the dealer organization to function as efficiently as they might.

Trading practices in the market for Government securities require that the private dealer firms assume the risks of price fluctuation inherent in a free market by buying and selling, as principals, for their own accounts. The breadth of the market and its ability to respond resiliently to changing supply and demand conditions, therefore, depend to considerable degree upon the willingness and ability of dealers to quote firm prices and to make markets (buy and sell) in volume at quoted prices. In turn, if the dealers are to assume the risks involved in making broad markets and carrying positions, they must have confidence in their ability to gauge the relative importance of the various influences affecting the market and to forecast the price developments that will result from these influences.

It was the opinion of the subcommittee, and this opinion was accepted by a majority of the Federal Open Market Committee, that the unlimited participation of the Federal Reserve System Account in the market for various maturities imposed an unreasonable handicap on the ability of the markets' professionals

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

to appraise price and yield prospects. The System Account holds the largest single block of marketable Government securities. When it trades, it is in a position to exert an important influence upon the structure of prices and yields. At the same time, trading for the System Account is not motivated by profit considerations, as is the trading for other accounts, but is entered into for broad policy purposes that may not always be predictable or even understood by the dealers. Some dealers, therefore, argued--and the subcommittee and a majority of the Federal Open Market Committee agreed--that if the System Account is allowed to operate in all sectors of the market, and particularly when it operates under instructions to "maintain orderly conditions," uncertainty is fostered and the willingness of dealers to make broad markets is directly affected.

Buying or selling by the System Account in the Government securities market, even if confined to short-term bills, necessarily influences the level and structure of security prices and yields. In addition to the direct effect upon the total supply of securities and upon the relative availability of different maturities, the Federal Reserve credit released by purchases or absorbed by sales affects the supply of money and thus the levels of interest rates. But it was the opinion of the majority on the Federal Open Market Committee that operations confined to Treasury bills, the shortest-maturity securities, would have the least effect upon the level and structure of price and yields. In the first place, it was reasoned that changes in open market interest rates and short-term security yields reflect money conditions rather than the demand for and supply of capital funds, and they can move within a moderately wide range in reflection of money market conditions without materially affecting prices of the longer maturities. In the second place,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the volume of trading in Treasury bills by commercial banks, industrial corporations, and others is much greater day to day than the volume of trading in Government issues of longer maturity. Therefore, a System Account transaction of a given size undertaken to accomplish a credit policy purpose can be executed more readily, and with less direct impact on rates, in the Treasury bill market than in any other segment of the market.

The decision to restrict System operations to Treasury bills was not viewed by its proponents as a limitation upon the ability of the Federal Reserve System to perform its primary function as a central bank, i.e., the regulation of the cost and availability of commercial bank credit. It was felt that the desired effect of System Account transactions on bank reserves could be accomplished as readily through transactions in Treasury bills as in any other maturity. At the same time, they expected that in a broad and freely functioning market the money market conditions produced by System operations, and the resulting levels of short-term interest rates would influence the terms of credit throughout the maturity structure in the direction indicated by Federal Reserve policy. This would result from the arbitrage process it was assumed would be set in motion by alert dealers and traders whenever persistent discrepancies or distortions appeared in the pattern of interest rates.

Therefore, on the basis of such arguments, the majority of the Federal Open Market Committee concluded that, in the interest of promoting a freer Government securities market, possessing greater breadth, depth, and resiliency, transactions could and should be limited to Treasury bills. It concluded, further, that the System's responsibilities could best be discharged by limiting open market operations to those conducted solely for the purpose of supplying or absorbing bank reserves.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The final form of this question seems to have been carefully designed to bring out the affirmative arguments for the policy referred to, and to provide no opportunity for negative arguments, although it is not likely that was the intention of the Joint Committee. The following paragraphs contain a brief discussion, although it was not requested, of the negative side.

The reasoning of the majority of the Federal Open Market Committee in limiting System Account transactions to Treasury bills and in limiting the purpose of such transactions to their effect upon bank reserves was not accepted by all the members of the Committee. In the view of the minority, it was unwise for the System to establish a rigid commitment to trade only in bills, although it was agreed that transactions in bills would usually accomplish the System's purpose. Furthermore, the minority members thought it unlikely that the change in operating procedures would materially improve the breadth, depth or resiliency of the market, and they believed that the limitations upon the type and purpose of System Account operations implied much too narrow a concept of the central bank's function.

In large part, the difference of opinion grew out of differing concepts of the way in which the Government securities market operates. The majority believed the market could develop into a broad, impersonal mechanism in which gradual and orderly changes in demand and supply conditions would be reflected in equally orderly changes in prices and yields, if only the System Account were out of the picture so that dealers might rationalize their expectations. The minority, on the other hand, viewed the market as one in which the major disturbing forces were the so-called "natural forces," not the System Account. So long as dealers perform the dealer function the acceptance of risk is unavoidable. The principal uncertainty created by the Federal Reserve System stems from the possibility of shifts in its basic policy not from

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the areas of the market in which it might operate. In fact, it is reasonable to believe that from time to time the possibility of System assistance to the market, when needed, might well encourage dealers to make broader markets than they otherwise would.

Another part of the disagreement within the Federal Open Market Committee stemmed from differing interpretations of the role a central bank should play. The minority members believed that the responsibilities of the Federal Reserve System may not always be met by System Account transactions limited to Treasury bills nor by purposes limited to the effect on bank reserves. Direct operations in other sections of the marketmay at times be the most efficient or only method by which a desired effect on conditions in the credit and capital markets can be achieved. The record of the Government securities market indicates that "arbitrage" may not be relied upon as a dependable means of realizing an objective in the longer maturities through transactions in bills.

Most important, the minority argued that the limitation to trading in Treasury bills was an unnecessary restriction upon the System's freedom of action. By adopting a particular operating procedure as a rule of conduct, the System has needlessly created a situation wherein any operations outside the rule, no matter how worthy the purpose, will truly create uncertainty and confusion in the market. In the opinion of the minority members, the Federal Reserve System has of its own volition limited its capacity for flexible central banking action to promote economic stability.

What has been the experience with operations under this decision?

The experience thus far with the policy of limiting System Account operations to Treasury bills has, on the whole, been fairly satisfactory.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

It should be noted, however, that in the period since March 1953 there have been only a few occasions on which it is at all likely that any different type of operation would have been undertaken, had the policy not been adopted. The ability of the Federal Reserve System to maintain the desired degree of control over the aggregate volume of member bank reserve balances was not affected by the decision to operate exclusively in bills. If it be accepted that System Account operations should be undertaken exclusively for the purpose of adding to or taking away from member bank reserves in the aggregate, then Federal Reserve open market operations have effectively achieved their purpose.

But, in a sense, this begs the question, since acceptance of such a limitation on the legitimate purposes of System open market operations precludes consideration of the question of whether the System can fully discharge its responsibilities merely by regulating the volume of bank reserves. If the System's responsibilities are more broadly conceived to comprise taking whatever action may be required, within the limits of its authority, to promote the conditions in the credit and capital markets most conducive to economic stability and progress, there may be room for questioning whether the narrowly restricted type of open market operation has accomplished all that could usefully have been done in all circumstances. The answer to this question will depend not only upon assumptions with regard to the role and responsibility of the central bank, but also upon varying interpretations of actual developments. Furthermore, it should be remembered that the restrictive policies being followed by the Federal Reserve System at the time the limitation on operations was adopted, in March 1953, soon began to shift toward a policy of active ease and that ordinarily situations calling for System transactions in securities

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

other than bills are less likely to arise in periods of easy money than in periods when restrictive credit policies are in effect.

During the period of market disturbance in the last half of May and opening days of June 1953, there were good grounds for believing that operations for the System Open Market Account in securities other than bills might have been more effective in checking the rapid plummeting of security prices at that time, without relasing any more Federal Reserve credit than was actually released, and perhaps less. Several influences bore upon the unsatisfactory conditions in the market: the long-term 3 1/4 per cent bonds sold for cash on May 1 had traded steadily at discounts from par since before their issue date; the Treasury had had an unfavorable response to its big refunding of certificates and bonds in the last half of May, and the new certificates had fallen to a discount before issue; it had become increasingly apparent that the Treasury had underestimated its cash needs (particularly after the heavy attrition in the refunding) and the sale of a new issue of September tax anticipation bills added to the pressures in the market; and statements by both Treasury and System officials during the spring months had led the market to conclude that even higher interest rates were in prospect. It cannot be said positively at this distance that purchases of bonds (and perhaps purchases of the rights to the certificate refunding) would have prevented or greatly reduced the price erosion that occurred, but market sources at the time indicated that minimum purchases of this sort would have been viewed by the market as a sign that the System was definitely concerned and intended to check any tendency for the market to become progressively tighter. It is evident, however, that purchases of bills for System Open Market Account and the use of repurchase agreements (bill purchases and repurchase agreements aggregating more than

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

300 million dollars were entered into between May 18 and May 29) were not sufficient to turn the tide prior to the aggressive purchase of more than 80 million dollars of bills at the bottom of the market on Tuesday, June 2. Even on that day, much of the resistence to the decline grew out of the simultaneous purchase of 3.5 million of long-term bonds for Treasury accounts. There were widespread rumors that these purchases were in larger amount and were actually for the System Open Market Account. It has been reported that these fallacious rumors were at least in part responsible for the market's turnaround and subsequent recovery.

This is the key sentence I think JHW.

Another, though less obvious, occasion when transactions in securities other than bills might have made an important contribution toward the broad aims of System policy arose in the spring months of 1954. As the result of a series of large refunding operations, the volume of short-term Treasury securities had been sharply reduced over the space of a few months, while an equivalent volume of issues was added to the intermediate maturity range. The result was a sharp decline of short-term yields during the spring months to levels indicating easier money conditions than were actually intended, while interest rates on intermediate and longer-term issues tended to rise. If the Federal Reserve System had chosen at this time to help the market adjust to the sudden, sharp change in the structure of outstanding maturities by selling short-term issues on swaps against intermediates, the transition to a longer average maturity in the Treasury debt might have been effected with less distortion of rates than actually developed, and the market then and later might have been considerably broader. But this cannot be proved, it must remain a matter of judgment.

1954

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

It was noted earlier that the principal consideration leading the Federal Open Market Committee to confine its operations to Treasury bills was the desire to stimulate greater breadth, depth, and resiliency in a free market. Available evidence would indicate that this objective has not been furthered—at least not recognizably—by the exclusion of the System Account from any transactions outside the bill market. At periods when the market has had particularly difficult adjustments to make, comments have been received from dealers and others that some assistance from the System might help to promote broader trading. It has been said that aggregate dealer "positions" (the inventories which reflect the extent to which the professionals who make markets are actually providing breadth to the market) have shown more and more tendency to shrink in the face of new developments as the policy of "bills only" has continued.* While no proof can be offered that occasional assistance from the System (perhaps taking the form largely of swaps) would actually have promoted a broader and more satisfactory market, the continued existence of thin markets and occasional air pockets leads to the conclusion that this principal objective of the change in policy has not yet been attained.

* Quite understandably, the dealers tend to reduce their holdings and to back away from offerings (by dropping their bid quotations) when tendencies toward weakness appear in the market, and to increase their holdings and raise their bids when the market shows strength. Obviously this is the way for dealers to maximize their profits, but it tends to accentuate the swings in prices and to discourage broad and active trading by investors. It is at least arguable that participation by the Open Market Account, to the extent of helping to adjust unevenness of supply-demand relationships in the various maturities, would tend to alleviate temporary distortions in the market and help to promote a market of greater "depth, breadth, and resiliency."

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis