FOMC

A.S. 6/11/53

1.. Since the last meeting of the Federal Open Market Committee we have been operating under two prohibitions adopted by the Committee, the general prohibition limiting operations to short-term securities at all times, and the special prohibition limiting operations, during periods of Treasury financing, to exclude the purchase of maturing issues, when-issued securities, and outstanding issues of comparable maturity to those being offered in exchange.

2. In my opinion, the present situation and the likely situation during the next three months require that we remove these prohibitions and restore to greater freedom of action. Private demands for capital and credit continue strong, and the Treasury is going to be a large and necessitous borrower. Our policy, in the circumstances, is one of maintaining restraint in credit expansion, while trying to prevent that restraint from being intensified by Treasury demands on the banking system. If this continues to be our policy, and if we continue to confine our operations to purchases of bills, I do not think we can walk the tightrope successfully. Our policy of restraint will be intensified at a time when it should be levelling off with the boom.

3. On what grounds would we continue to deprive ourselves of freedom of action? With respect to the prohibitions we adopted at our last meeting,

(a) we were told that the market should be relieved of the threat of our intervention in the longer term areas so that it might develop breadth, depth, and resiliency.

(b) we have not intervened in these areas for some months and, in one way or another, the market has acquired the idea that we are not going to intervene. Yet seldom has the market shown less breadth and depth while quotations have shown, if anything, too much resiliency.

(c) I think it has been demonstrated that if apprehension concerning our intervention in the market was once the cause of uncertainty, it was a transient phenomenon. Other factors have since been at work. Recently there has been our restrictive credit policy, continued heavy private demands for funds, and mounting Treasury cash needs. These have generated the expectation of a decline in Government security prices (and private security prices) and a rise in interest rates of unknown extent and duration.

(d) Under such conditions a market of the size and present vulnerability of the Government security market doesn't develop real breadth, depth, and resiliency, and the Treasury's necessitous financing can be made unnecessarily difficult and onerous.

(e) Insofar as credit policy is responsible for this, the problem is how to direct open market operations with sufficient flexibility and versatility to minimize the adverse effects of the general policy without sacrificing the general objective.

4. I don't think we can do it if we continue, as we have been doing, to confine ourselves at all times to operations in Treasury bills. We have been told that operations in bills would have prompt and persuasive effects throughout the market. That was the theory of perfect fluidity -- perfect arbitrage. I think historical records and current observation indicate that a prompt and invariable response between short and long markets can not

always be expected. Under present conditions operations solely in bills may relieve the reserve position of the banks without giving timely relief from the complex pressures in the credit and capital markets created by large Treasury borrowing operations.

5. If the threat of our intervention isn't the source of lack of breadth, depth, and resiliency in the Government security market, and if that market and the whole capital market isn't as fluid as the theory of perfect arbitrage would suggest, why do we deprive ourselves of freedom of action? It seems to me that we must either still be reacting violently against market pegging or embracing a somewhat doctrinaire attitude on free markets.

6. There is a middle road. No one here wants to return to pegging nor to try to substitute our judgment as to prices and yields for those of the market. But if our credit policy calls for putting funds into the market, as it does, and if at the same time we can assist the Treasury with its very difficult task of debt management, we should do it. It would be in accord with the resolution we adopted on relations with the Treasury and it would contribute to economic stability. We should be free, particularly at times of Treasury financing, to make purchases in whatever area of the market is under most pressure, so that there will not be an unnecessary erosion of rates, affecting adversely investor and banking psychology and intensifying the restrictive effects of our credit policy at the wrong time.

7. We have made it clear to the market that we are not interested in pegging prices, and the Treasury has made it clear that it wants to price its obligations in the market, not on us. Within this framework, I think we should reserve for ourselves maximum freedom to operate in any way which, without

sacrificing credit policy, will support the Treasury's program and the stability of the market.

8. To withhold the System portfolio from participation in the market, except for bill transactions, in the light of the present economic situation and the Treasury's needs, seems to me to be sacrificing credit policy to untried theory. To go further, and to withhold the System portfolio from participation in the tremendous redistribution and swapping process which takes place in the market during the short period of a Treasury financing is likely to prove to be irresponsible.

9. I suggest the elimination, from the instructions of the full Committee to the executive committee, of the present prohibition against open market operations in other than short-term securities, and against operations in certain kinds of securities during Treasury financings.

10. Even though our operations continue to be largely in bills, effective credit policy can best be achieved, in my opinion, by ~~retaining~~ the ~~present~~ greatest flexibility of action to meet the unpredictable circumstances which are always arising. To freeze the System into a pattern of behavior which involves not doing certain things could be just as harmful to the success of credit policy as a frozen commitment to do certain things. We can't afford a succession of black Mondays and Treasury near-failures over the next few months and the omens are none too good.