

decision with respect to the amount, as well as the issues, of their open market portfolios. They hold, at the moment, nearly \$24 billion of securities, the greatest investment portfolio by far in the history of the world. It is wholly in the discretion of the Federal Open Market Committee to direct the investment of large additional amounts.

(137) In an even more general sense, the Federal Open Market Committee stands in a fiduciary relationship to the whole American economy. It could be called special trustee for the integrity of the dollar, for the preservation of its purchasing power, so far as that integrity can be preserved by its operations. It is especially charged, also, to use its powers to provide an elastic currency for the accommodation of agriculture, commerce, and business; i.e., to promote financial equilibrium and economic stability at high levels of activity.

(138) This unique structure of the Federal Open Market Committee was hammered out after long experience and intense political debate. Like other components of the Federal Reserve System, it exemplifies the unceasing search of the American democracy for forms of organization that combine centralized direction with decentralized control, that provide ample opportunity for hearing to the private interest but that function in the public interest that are government and yet are screened from certain governmental and political pressures since even these may be against the long-run public interest.

(139) When the substance, rather than the form, of the Federal Open Market Committee is analyzed against this background, certain possible anomalies arise. It has no individual budget, nor does the act provide for one. There is no single person on its operating staff who is responsible to the Committee alone. Each of its officials is paid either by the Federal Reserve Board or by a Federal Reserve bank. Each would automatically cease to have any relationship with the Federal Open Market Committee the moment that connection was severed. No member of the Committee, nor of its staff, is charged to give exclusive attention to its concerns. Everyone connected with it wears also another hat. Even the manager of the open market account, who comes nearest to devoting his full time to its functions, has heavy independent responsibilities in connection with the fiscal agency and other operations of the Federal Reserve Bank of New York.

(140) The Federal open market account is not managed by the Federal Open Market Committee. This function has been delegated to the Federal Reserve Bank of New York, subject to policy directives that provide discretionary leeway within which the management operates. The manager of the account is selected by the directors of the Federal Reserve Bank of New York and approved by the full Federal Open Market Committee each year. In his day-to-day operations, he is subject to the authority of the Federal Reserve Bank of New York, and not to that of the Federal Open Market Committee.

(141) The subcommittee urges that the Committee take the initiative in re-examining and reviewing this structure of organization. There has been much experience since the arrangements were first established. In the light of that experience, is the structure well designed to carry out the Committee's important functions? For example, should the Federal Open Market Committee operate under a budget of its own? This might require legislation, but if a separate budget would improve its operations, the Committee is morally obligated to suggest such legislation to the Congress.

(142) Should all or part of the staff of the Foreign Open Market Committee be separate and distinct from the staffs of the Federal Reserve Board and the Federal Reserve banks? However paid, should they wear one hat, and one hat only, devoting all their time exclusively to the operations of the Federal Open Market Committee? There are both advantages and dangers in this suggestion which must be weighed. The Federal Reserve System is a family, and the Federal Open Market Committee urgently needs the knowledge, the judgment, and the skill of all the members of that family. It would be extremely difficult to build up a new and independent staff as qualified as the personnel which it now enlists to work on its problems. It would be equally unfortunate to lose the contributions of that staff to System problems that fall outside the limited area of responsibility of the Federal Open Market Committee. Yet there are equal dangers in a situation where the time of no one person on the whole staff of the Committee is wholly devoted to its responsibilities, where everyone wears two hats, and where each must fulfill duties separate and distinct from those imposed by the Federal Open Market Committee.

(143) Should the present situation, which delegates the management of the open-market account to the Federal Reserve Bank of New York, be retained, or should the manager of the open-market account be made directly responsible to the Federal Open Market Committee? The present arrangement has the advantage that the mechanical operations of the account, the keeping of its books and records and the handling of its funds, are under the immediate supervision of the Federal Reserve Bank of New York with its superb facilities. More important, it has the advantage that the president of the Federal Reserve Bank of New York, situated as he is in the center of the Nation's money market, with his personal insight into problems of monetary policy and his immediate access to financial information not so readily available to anyone else, can supervise on the spot the execution of the general policy directives of the Federal Open Market Committee and the executive committee and thus determine that that policy is made effective in operations.

(144) It has the disadvantage that the president of the Federal Reserve Bank of New York sits at meetings of the Federal Open Market Committee and of the executive committee necessarily in a somewhat different role from that of his colleagues. He comes not only as a contributor to the discussion on policy formation, but, also necessarily, as a protagonist for the actual day-to-day operations of the account. These operations are his responsibility. He cannot criticize them without criticizing his own staff. The committee, therefore, in some part loses contact with the critical insight of its best informed member. It has the disadvantage also that other members of the Federal Open Market Committee, reluctant to seem critical of a colleague, may hesitate to scrutinize adequately the technical operations of the account. This is a serious deficiency because the other bank president members of the Committee are usually scattered and out of intimate touch with one another as well as with the market. They must depend on give and take discussion at Committee meetings and at the meetings of the executive committee to sharpen their appreciation of the Committee's operating problems.

(145) The present arrangement makes one major contribution of paramount concern to effective operations. There must be confidence throughout the market and throughout the financial community generally that open-market operations are immune from political pressures. This confidence is undeniably strengthened by the fact that the Federal Reserve Bank of New York actually conducts open market operations for the Committee. Under the present management arrangement, the actual contacts of the market are contacts with personnel of the Federal Reserve Bank of New York, subject to the discipline of its directors.

(146) There is, of course, the equal necessity of maintaining the confidence of the public generally that the Committee's operations are immune from banker domination. This consideration is reflected in the general structure of the Federal Reserve System with the Board of Governors and the regionally decentralized Federal Reserve banks. It is also reflected in the actual statutory composition of the Federal Open Market Committee. From this point of view, the present arrangement by which the management of the open-market account is delegated to the Federal Reserve Bank of New York requires that the individual members of the Federal Open Market Committee maintain close contact with all important aspects of its operations.

(147) Throughout its consideration of the recommendations it is making in this report, the subcommittee has had this problem in mind. These recommendations do not stop with the evaluation of technical practices of the Committee, originated during the period of the pegs, that now handicap the development of a free market. The subcommittee has been aware also of the urgent necessity of simplifying as much as possible the operating procedures of the committee and the points of impact which its operations have on the market mechanism. The problem has been to work out procedures (1) that will provide more effectively for the execution of the Committee's monetary policies in the open market, (2) that will do this in a way that will minimize confusion in the market with respect to the committee's purposes, and (3) that will enable individual members of the Federal Open Market Committee to maintain more intimate contact with its technical operations. The subcommittee feels that operations under its recommendations will not only make for greater depth, breadth, and resiliency in the market, with less misunderstanding, but will also enable each member of the Federal Open Market Committee to carry out more effectively his individual statutory responsibility as a committee member.

(148) The subcommittee desires to raise one aspect of the problem for special consideration. It urges that the full Federal Open Market Committee take a definite position with respect to the suggestion advanced above that the manager of the open-market account be employed by the Federal Open Market Committee as a whole, rather than by the Federal Reserve Bank of New York.

(149) The subcommittee is not proposing this shift. It is recommending, however, that the change be most seriously considered. The operations of the account would continue to be located in the Federal Reserve Bank of New York, as at present, and the Federal Open Market Committee would continue to avail itself of the personnel, wisdom, and experience of the whole Federal Reserve System, as at present. The only change would be that the manager of the open-market account would be employed by the Federal Open Market Committee as a whole, that he would be solely responsible to the Federal Open Market Committee, and that he would have no responsibilities other than those imposed on him by the Federal Open Market Committee.

(150) Should the Committee decide to make such a move, certain details of organization would have to be solved. They are not of concern at this point. The immediate concern is whether such a move would be in the public interest, whether it would improve the functioning of the Federal Open Market Committee. Certain features of the proposed arrangement stand out as crucial. Since the manager of the open-market account would be directly responsible to the whole Federal Open Market Committee, the individual members of the Committee might feel less reluctant to make direct contact with him and thereby familiarize themselves with details of the Committee's operations. The manager of the account also would no longer occupy the dual role of manager of the account and also of vice president of the Federal Reserve Bank of New York. He would be relieved of responsibility to its directors with respect to any of his activities. Finally, he would no longer participate in transactions originating in the fiscal agency or foreign correspondent relationships of the Federal Reserve Bank of New York.

(151) Some duplication of facilities would result from this change but there would be offsetting advantages. For example, the money market might be less confused with respect to the significance of orders transmitted through the trading desk. The execution of an order for the Treasury, or for a foreign correspondent, could not then give rise to rumors that the Federal Open Market Committee had entered the market.

(152) The chief change, of course, and the one which requires the most serious consideration would be the change in the relationship of the president of the Federal Reserve Bank of New York to the account. As Vice Chairman of the Federal Open Market Committee, he would have, as he now has, full access to all the operations of the account and continuing responsibility for maintaining a vigilant scrutiny over them. He would continue to be in the same building with the manager of the open-market account, and would be as continuously available for consultation as at present. The line of responsibility between the whole Committee and the manager of its account, however, would be direct and undivided. It would not impose upon the president of the Federal Reserve Bank of New York the added individual responsibility which he now bears for operational and discretionary decisions within the directives laid down by the whole Committee or its executive committee.

#### *Relations with the Treasury*

(153) There is one final recommendation the subcommittee would like to make. It falls in the difficult and delicate area that deals with problems of debt management and Treasury relationships. Specifically, the subcommittee recommends that the Federal Open Market Committee inform the Treasury that in the future it will keep the Secretary continuously informed as to its credit and monetary policies but that it will refrain as an official body from regularly initiating specific proposals with respect to details of individual Treasury offerings. That is, it will no longer on its own initiative regularly write formal letters or seek official interviews to lay before the Secretary of the Treasury its suggestions as to issues, coupons, etc., that in its judgment would be appropriate for particular debt management operations. The Federal Open Market Committee would, on the other hand, be prepared to respond to a request of the Secretary for the committee's judgment as to whether the terms he had in mind for a new issue were appropriate in the light of market conditions, i.e., whether the

committee would expect them to develop a sufficient rights value, and also whether they would create complications for monetary management or would conflict with or run into difficulties because of credit operations in contemplation by the Federal Open Market Committee.

(154) The subcommittee urges this change in procedure in order to establish formal official communications with the Treasury on a more correct basis than prevails at present. The Secretary of the Treasury is primarily responsible for decisions in the area of debt management. In coming to those decisions, he should feel free to consult and talk over his problems with anyone he wishes, commercial bankers, investment bankers, security dealers, etc., and also with anyone he chooses within the Federal Reserve System, either in or out of the Federal Open Market Committee. So far as system personnel is concerned, however, it should be wholly understood that he consulted them as individuals. The decision he arrives at should be a decision for which he, as the responsible official, takes full responsibility. Neither the Federal Open Market Committee nor the executive committee should take responsibility, as it now does, for initiating a recommendation as to coupon and terms in the area of debt management.

(155) In the judgment of the subcommittee, the present practice under which the Federal Open Market Committee convenes itself and, after consideration and vote, writes a letter outlining its official recommendation with respect to debt management policies is improper and unwise, in view of the clear location of responsibility for debt-management decisions in the Treasury. It is just as unwise and improper as the converse would be, namely, that the Secretary of the Treasury should regularly and officially, as a member of the President's Cabinet, write the Board of Governors and the Federal Open Market Committee his considered views with respect to future credit policies and open-market operations.

(156) Such formalized action by either, however well intended, trespasses upon the statutory responsibility of the other. It tends to complicate rather than to facilitate that adjustment of views and of official decisions which is essential to the achievement of their common objectives in the public interest.

#### SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS<sup>1</sup>

##### *A. Relations with the market*

The subcommittee finds that a disconcerting degree of uncertainty exists among professional dealers and investors in Government securities with respect both to the occasions which the Federal Open Market Committee might consider appropriate for intervention and to the sector of the market in which such intervention might occur, an uncertainty that is detrimental to the development of depth, breadth, and resiliency of the market. (35-43) In the judgment of the subcommittee, this uncertainty can be eliminated by an assurance from the Federal Open Market Committee that henceforth it will intervene in the market, not to impose on the market any particular pattern of prices and yields but solely to effectuate the objectives of monetary and credit policy, and that it will confine such intervention to transactions in very short-term securities, preferably bills. (44-48) The subcommittee feels most strongly that it would be wise to give such an assurance.

The subcommittee finds two outstanding commitments that may require intervention by the Federal Open Market Committee in other than the very short-term sectors of the market, and that may add to or subtract from reserve funds available to the market for purposes other than the pursuit of monetary policies directed toward financial equilibrium and economic stability. (49) These commitments are, first, the directive to the management of the open-market account to "maintain orderly conditions" in the market for United States Government securities, and, second, those arising from the practice of purchasing rights on maturing issues during periods of Treasury financing, and also on some of these occasions of purchasing when-issued securities and outstanding securities of comparable maturity to those being offered for cash or refunding.

With respect to the first of these commitments, the subcommittee recommends that the Federal Open Market Committee amend its present directive to the executive committee by eliminating the phrase "to maintain orderly conditions

<sup>1</sup> For the convenience of readers, the number of the paragraphs in the report specifically dealing with each recommendation have been inserted opposite to the same recommendation as it appears in this summary.

in the Government securities market" and by substituting therefor an authorization to intervene when necessary "to correct a disorderly situation in the Government securities market." It has indicated in its report the conditions it would consider sufficiently disorderly to require correction. (50-56) The subcommittee recommends also that such intervention be initiated by the executive committee only on an affirmative vote after notification by the manager of account of the existence of a situation requiring correction.

With respect to the second, the subcommittee recommends that the Federal Open Market Committee ask the Treasury to work out new procedures for financing, and that as soon as practicable the Committee refrain, during a period of Treasury financing, from purchasing (1) any maturing issues for which an exchange is being offered, (2) when-issued securities, and (3) any outstanding issues of comparable maturity to those being offered for exchange. (57-74)

The subcommittee feels that such qualifications as are implicit in these two recommendations would not seriously impair the constructive effect of a general assurance from the Committee that its intervention henceforth will be limited to the effectuation of monetary policies and will be executed in the very short sector of the market. It recommends most strongly that such assurance be given as soon as its existing commitments have been appropriately modified. (75-76)

#### *B. Relations with dealers*

The subcommittee finds no present or prospective justification for continuing the present system of rigid qualification for dealers with whom the account will transact business, and recommends that the system be dropped. (116-124)

In the event the Federal Open Market Committee, contrary to the subcommittee's basic recommendations, decides to maintain the system of recognized dealers the subcommittee recommends:

(a) that the present list of recognized dealers be revised, both by eliminations from and additions to the list. (25)

(b) that repurchase agreements be extended impartially to all dealers who participate regularly in the weekly bill auction, irrespective of whether or not they are on the recognized list. (108)

(c) that if rights are acquired in support of Treasury refundings they be purchased as freely from nonrecognized as from recognized dealers. (115)

(d) that transactions to correct disorderly conditions in the Government securities market be made with unrecognized as well as recognized dealers. (85)

#### *C. Operating techniques*

The subcommittee finds that many of the present operating techniques of the account are upsetting to the smooth functioning of the market. In general, these techniques were prescribed by the Federal Open Market Committee at a time when it was attempting to peg market prices and yields of United States Government securities. With respect to market techniques, the subcommittee recommends specifically:

(a) that "reluctant buying" be completely abandoned, and that supporting operations in the market, if undertaken at all, be executed through a technique of aggressive rather than reluctant purchasing. (81-86)

(b) that agency transactions be abandoned and that the account conduct its transactions with dealers as principals on a net basis. (87-93, 110-113)

(c) that if rights are acquired during refundings they be purchased from dealers without regard to whether or not they come from the dealers' positions. (114)

(d) that refusal to buy bills acquired by dealers on a cash basis be discontinued. (102)

(e) that nonbank dealers be informed adequately in advance when repurchase facilities will be made available. (103)

(f) that repurchase facilities at an appropriate rate and with appropriate limitation as to volume be made regularly available to nonbank dealers over weekends. (94-104)

The subcommittee finds that relations between the open market account and the dealers are not as impersonal as is desirable now that the Committee is no longer trying to peg prices and yields on Government securities by maintaining a tight rein on the activities of dealers. It recommends:

(a) that the Open Market Committee make known to the dealers the "ground rules" which henceforth will govern the occasions for its transactions with dealers. (59, 75-76)

(b) that the individual morning dealer conference be abandoned. (131-132)

(c) that the information obtained by the trading desk from dealers be so restricted as to eliminate the possibility of identification, directly or by inference, of individual customers. (131-132)

(d) that reports on individual dealer positions and activity be collected by an officer of the System other than the manager of the account, that the individual reports be kept confidential, and that only aggregates compiled from the individual dealer reports be disclosed to the manager of the account. (131-132)

(e) that the present practice of asking dealers to report transactions currently during the trading day in sufficient detail to permit the computation of current individual dealer transactions sheets be discontinued. (131, 133)

The subcommittee finds that there is a serious gap in the structure of the money market as it affects the functioning of the market for Government securities. Continuously in recent months, funds available to dealers to carry portfolios have been inadequate in volume and available only at rates higher than the yield of their portfolios. This deficiency could not exist so continuously in a central money market equipped (1) to attract temporarily idle funds from over the country to New York, and (2) to make these funds available on call to dealers in the money market. The subcommittee recommends that the feasibility of reestablishing a central call-money post for dealers be explored. (106)

#### *D. Federal Reserve reports*

The subcommittee finds that the Federal Reserve System can improve the data which it makes available to inform the market on its operations. It recommends that the following information be shown henceforth on the weekly condition statement of the Federal Reserve banks:

- (a) securities held on repurchase agreement;
- (b) special certificates of indebtedness held by the system;
- (c) weekly averages of member bank borrowing. (130)

#### *E. Organization of the Open Market Committee*

The subcommittee finds many anomalies in the structure and organization of the Federal Open Market Committee, particularly (a) the absence of a separate budget covering its operations, (b) the absence of a separate staff responsible only to the Committee, and (c) the delegation of the management function to an individual Federal Reserve bank. It recommends that the Committee re-examine and review its present organization, and in particular that it consider the advantages and disadvantages that would ensue, were the manager of the open market account made directly responsible to the Federal Open Market Committee as a whole, and not, as at present, responsible through the Federal Reserve Bank of New York. (139-152)

#### *F. Relations with the Treasury*

The subcommittee finds that the Federal Open Market Committee is frequently placed in an inconsistent position by its present practice of initiating advice to the Secretary of the Treasury with respect to decisions in the area of debt management. It recommends that the Committee inform the Secretary of the Treasury that henceforth it will refrain, as an official body, from initiating regularly proposals with respect to details of specific Treasury offerings, and will confine itself officially to providing information currently on its monetary policies and to counseling on the credit and monetary implications of debt-management suggestions advanced for its consideration by the Treasury. (153-156)

### OUTLINE OF STUDY

- (1) Outline of Study prepared by ad hoc subcommittee on the Government securities market.
- (2) Letter dated May 28, 1952, from Chairman Martin to individuals and organizations receiving the Outline of Study for informational purposes.
- (3) List of recipients of Outline of Study for informational purposes.
- (4) Letter dated May 28, 1952, from Chairman Martin to individuals who received, as addressees, the explanatory letter and Outline of Study.
- (5) List of recipients of Outline of Study as addressees.

## I. FUNCTION OF DEALERS IN TREASURY OBLIGATIONS

A. What are the essential functions performed by dealers in Treasury obligations? Discuss their functions in relation to the operations of banks and financial institutions, of the Treasury, and of the Federal Reserve banks, particularly the open-market account. How were these functions affected by the maintenance of pegs by the Federal Open Market Committee?

B. What are the essential attributes which a dealer must possess to perform these functions efficiently (capital, borrowing facilities, moral and technical qualifications, etc.)? Were these affected by the maintenance of pegs? How are these attributes affected by specialization: (a) geographical (with respect to location of customers; (b) structural (with respect to types of securities; (c) types of customers (e.g., banks as against insurance companies, etc.)?

## II. EFFECT ON DEALERS OF OPERATIONS OF FEDERAL OPEN-MARKET ACCOUNT

A. How have the operations of the open-market account affected the ability of dealers to perform their essential functions? Discuss with relation to amount of capital required, credit availability, adequacy of commissions, effect on spreads, willingness and ability of dealers to take positions, etc. Distinguish between open-market-account operations during maintenance of pegs and the effects since the discontinuance of pegging operations.

B. From the point of view of successful dealer functioning, what are the advantages and disadvantages of qualification? Distinguish between conditions prior to and following the discontinuance of pegs.

C. Either as a qualified or nonqualified dealer, have you any suggestions or criticisms of the effect of the operations of the open-market account on your own operations? Do you feel that the standards for qualification are appropriate and are applied objectively?

D. Is disclosure to the Federal Reserve by qualified dealers of the general sources of customer orders a justifiable aid to the orderly functioning of the market?

E. Do you feel that the operations of the account are, or have been, discriminatory and, if so, that the discrimination was not justified by overriding considerations? Distinguish between operations of the account when it was working under the overriding directive to maintain a relatively fixed pattern of yields and operations since the discontinuance of the pegs.

F. To what extent have you been directly or indirectly influenced in the quotation and positioning of selected issues of Government securities by the open-market management?

## III

What should be the general relation of the open-market account to the dealers and the market in view of the discontinuance of pegging operations? Are any broad changes in the organization of the open-market account indicated? How frequently and under what conditions should the account intervene in the market, either through outright purchases and sales of securities or through resort to repurchase or resale contracts? Is it desirable to effect a closer liaison between the open-market management and dealers? If so, what suggestions do you have for achieving a closer liaison? Discuss separately under each of the following headings:

A. Operations to temper seasonal, emergency, and week-to-week or day-to-day fluctuations in the money market resulting from changes in currency demand, float, Treasury calls and payments, etc.

1. Should the account operate from day to day to offset such fluctuations in the availability of funds or can the necessary adjustments be left to the market mechanism with necessary access to and absorption of Reserve bank funds provided by member bank borrowing? Under which circumstance would the market develop greater breadth, resilience, and strength?

2. If you feel that direct operations of the account are needed in addition to member bank borrowing, should these be provided mainly through outright purchases and sales of securities or should more use be made of repurchase and resale agreements?

3. If outright purchases and sales are used, should they be made in that sector of the market best able at the moment to absorb such operations in the judgment of the management of the account, or should they be concentrated, as a matter of routine, in the very short maturities?



4. Are the present repurchase facilities adequate to enable dealers to take positions and make markets? Do you have any suggestions for the improvement of the present type of repurchase contract?

5. Would it be worth while to explore the use of 1-day resale agreements to absorb reserves when they are temporarily redundant? For example, the open market account might make bills or certificates available to the market on a 1-day resale agreement for sale to banks with redundant excess reserves.

6. To what extent does the increasing use of Federal funds transactions between banks in different Federal Reserve districts affect the short-term market for Government securities?

B. Operations affecting dealers as underwriters of the weekly bill offering. In view of the importance of bills as a medium for Treasury financing, it is desirable that dealers be in a position to enter bids sufficient to assure adequate coverage of each auction.

1. Are the dealers now in a position to perform this function effectively or is greater assurance needed that, in the event of an unexpected stringency, Federal funds will be available on repurchase agreement?

2. Assuming repurchase facilities are provided, what limitation should be placed on their use?

3. When the Open Market Committee purchases bills to relieve congestion in the money market, should such purchases be made at a penalty rate, as in London, and should these operations be confined to short-dated bills?

C. Operations during periods of Treasury refundings.

1. Should the open market account maintain a rights value on maturing issues during refunding?

2. Have you any criticism of the technical operations of the account during refundings; or any suggestions for improvement in the technique?

D. Operations to maintain orderly markets in Treasury securities.

1. What, in your judgment, constitutes an "orderly" market?

2. What criteria should the open market account apply to determine whether intervention is necessary for the maintenance of order in the market?

3. Except for extreme emergencies, do you foresee the frequent occasion for System intervention to maintain "orderly" conditions?

E. Operations to carry out basic changes in credit policies of the Reserve authorities for the mitigation of economic instability, i.e., major changes in the open-market portfolios of considerable duration designed to reduce the availability of credit during periods of boom or to make credit much more freely available during periods of recession.

1. Have you any recommendation as to the types of securities to be sold or purchased in operations of this type?

2. Should the operation normally be in the long-term or the short-term sector of the market? Why?

3. What would be the effect of large-scale operations in the long-term sector on the market mechanism and on the ability and willingness of dealers to hold adequate portfolios?

#### IV. ADEQUACY OF DEALER ORGANIZATION

A. What has been the effect of greater market flexibility since the accord on willingness of dealers to take positions, participate in the bill auction and make markets, both in long-term and short-term Treasury issues?

B. Are more dealers needed and is more dealer capital desirable? If so, how could it best be attracted?

C. Has the lack of personnel trained to operate under flexible market conditions hampered operations and smooth market functioning since the discontinuance of the pegs?

D. Have you any suggestions or comments concerning the basic organization of the market for Treasury obligations? Does the present over-the-counter market adequately fill the need or would a continuous auction market enlarge participation and give greater depth and breadth to the market? If so, should an existing securities exchange be used? How would this be effected?

#### V. APPROPRIATENESS OF PRESENT ORGANIZATION OF OPEN-MARKET ACCOUNT

A. Would the employment of a special broker to execute Federal Reserve System transactions (in substitution for the operations of the present trading desk) be adequate for the performance of System operations? Would it be



preferable? Have you any other suggestions as to an appropriate organization for System operations in Treasury obligations? Please discuss this problem with specific reference to System operations under each of the five major headings in question III above.

B. Assuming the continuance of operations as presently organized, i. e., over-the-counter markets with a trading desk in the Federal Reserve Bank of New York, have you any suggestions as to the basis of distinction for the qualification of dealers? Please discuss this problem as it would be affected under each of the five major headings in question III above.

1. Are formally qualified dealers needed?

2. If so, what should be the essential requirements for qualification?

3. Should qualified dealers be required to report positions to the open market manager? If so, in what form do you suggest that reports be made?

4. Can distinctions be drawn between the role of bank and nonbank qualified dealers? In what respects should they be differentiated?

C. Would it be desirable to make additional data regarding System operations available through the regularly published weekly figures of the Federal Reserve banks? For example, should repurchase figures be segregated from total System holdings of United States Government securities? Should daily average member bank borrowings be included in the published figures? Do you have any other suggestions?

#### VI. MARKET COVERAGE

Have you any suggestions for broadening and deepening the customer market for Treasury obligations?

A. Institutional.

Is there adequate coverage of institutional investors, such as small insurance companies, commercial and savings banks, etc.?

B. Noninstitutional.

What suggestions have you to encourage greater participation by corporations, particularly smaller corporations and businessmen, and by individual investors?

C. Is there any manner in which Federal Reserve banks and branches outside New York City could be more helpful in aiding smaller investors in the purchase and sale of Government securities? Is it an economical operation for the dealer organization to attempt this type of coverage?

#### VII. TECHNIQUES OF OPEN-MARKET OPERATION

A. Assuming for policy reasons the Open Market Committee desires to effect changes in total holdings or in the composition of the portfolio, what methods aside from letting maturing securities run off should be employed to effectuate these changes with a minimum of disturbance to prices? Would it be desirable to employ the mechanism of secondary offerings by inviting bids or offerings up to a certain time limit on specific blocks of Government securities?

B. Should the open-market management buy and sell on dealers' quotations and should dealers be required to make firm markets up to some minimum amount? If so, what minimum would you suggest?

BOARD OF GOVERNORS  
OF THE FEDERAL RESERVE SYSTEM,  
Washington, May 28, 1952.

Enclosed is an outline of a technical study, together with explanatory letter, which is being sent to dealers and other specialists in the United States Government securities market. We are sending you copies herewith for your information.

Sincerely yours,

WM. MCC. MARTIN, Jr.,  
Chairman, Federal Open Market Committee.

INDIVIDUALS AND ORGANIZATIONS WHICH RECEIVED A NOTE ENCLOSING COPIES  
OF THE LETTER AND OUTLINE OF STUDY FOR THEIR INFORMATION

S. Sloan Colt, president, Bankers Trust Co., 16 Wall Street, New York 15, N.Y.  
J. Luther Cleveland, chairman of the board, Guaranty Trust Co. of New York,  
140 Broadway, New York 15, N.Y.

Harold H. Helm, president, Chemical Bank & Trust Co., 165 Broadway, New  
York, N.Y.

- Homer J. Livingston, president, First National Bank of Chicago, Dearborn, Monroe, and Clark Streets, Chicago 90, Ill.
- Walter J. Cummings, chairman of the board, Continental Illinois National Bank & Trust Co., 231 South La Salle Street, Chicago 90, Ill.
- Winthrop P. Aldrich, chairman of the board, the Chase National Bank, 18 Pine Street, New York, N.Y.
- George Whitney, J. P. Morgan & Co., Inc., 23 Wall Street, New York, N.Y.
- August Ihlefeld, president, Savings Banks Trust Co., 14 Wall Street, New York, N.Y.
- Dr. G. Keith Funston, president, New York Stock Exchange, 11 Wall Street, New York, N.Y.
- Edward T. McCormick, president, New York Curb Exchange, 86 Trinity Place, New York 6, N.Y.
- James E. Day, president, Midwest Stock Exchange, 120 South La Salle Street, Chicago 3, Ill.
- O. Francis Cocke, president, American Bankers Association, care of First National Exchange Bank, Roanoke, Va.
- Harold Stonier, executive manager, American Bankers Association, 12 East 36th Street, New York 16, N.Y.
- Richard W. Trefz, chairman, Country Bank Operations Commission, American Bankers Association, care of Arkansas Valley Bank, Pueblo, Colo.
- George R. Amy, deputy manager, country bank operations commission, American Bankers Association, 12 East 36th Street, New York 16, N.Y.
- James S. Peters, president, the Independent Bankers Association, care of Bank of Manchester, Manchester, Ga.
- Ben Dubois, secretary, the Independent Bankers Association, Sauk Centre, Minn.
- Joseph M. Dodge, president, Association of Reserve City Bankers, care of the Detroit Bank, Detroit, Mich.
- Joseph J. Schroeder, secretary, Association of Reserve City Bankers, 105 West Adams Street, Chicago, Ill.
- Joseph T. Johnson, president, Investment Bankers Association of America, care of the Milwaukee Co., Milwaukee, Wis.
- Robert Stevenson 3d, secretary and treasurer, Investment Bankers Association of America, 33 South Clark Street, Chicago, Ill.
- Robert M. Catharine, president, National Association of Mutual Savings Banks, care of Dollar Savings Bank, New York, N.Y.
- John W. Sandstedt, executive secretary, National Association of Mutual Savings Banks, 60 East 42d Street, New York 17, N.Y.
- Clarence A. Bickel, chairman, National Association of Securities Dealers, Inc., care of Robert W. Baird & Co., Milwaukee, Wis.
- Wallace H. Fulton, executive director, National Association of Securities Dealers, Inc., 1625 K Street NW., Washington 6, D.C.
- Raleigh W. Greene, president, National Savings & Loan League care of First Federal Savings & Loan Association, St. Petersburg 1, Fla.
- Oscar Kreutz, executive manager, National Savings & Loan League, Ring Building, room 907, 1200 18th Street NW., Washington, D.C.
- Ben H. Hazen, president, United States Savings & Loan League, care of Benjamin Franklin Federal Savings & Loan Association, 517 Southwest Stark, Portland 4, Oreg.
- Morton W. Bodfish, chairman, executive committee, United States Savings & Loan League, 221 North La Salle Street, Chicago 1, Ill.
- Bruce E. Shephard, manager, Life Insurance Association of America, 488 Madison Avenue, New York 22, N.Y.
- Cecil Woods, president, American Life Convention, care of Volunteer State Life Insurance Co., Chattanooga, Tenn.
- Robert L. Hogg, executive vice president and general counsel, American Life Convention, 230 North Michigan Avenue, Chicago 1, Ill.
- M. Albert Linton, president, Life Insurance Association of America, care of Provident Mutual Life Insurance Co., Philadelphia 39, Pa.

#### CHAIRMEN OF THE FEDERAL RESERVE BANKS, MEMBERS OF THE FEDERAL ADVISORY COUNCIL

- Murray Hanson, General Counsel, Investment Bankers Association of America, 1625 K Street NW., Washington, D.C.
- Walter Maynard, president, Association of Stock Exchange Firms, 24 Broad Street, New York, N.Y.

R. M. Charters, executive secretary, Association of Stock Exchange Firms, 24 Broad Street, New York, N.Y.  
 George Sherman, assistant vice president, First Boston Corp., 231 South La Salle Street, Chicago, Ill.  
 Douglas R. Fuller, vice president, the Northern Trust Co., Chicago, Ill.  
 Eugene Barry, Shields & Co., 44 Wall Street, New York, N.Y.  
 Robert B. Rivel, assistant economist, the Chase National Bank, New York 15, N.Y.  
 Col. E. J. W. Proffitt, Manufacturers & Traders Trust Co., 1 Wall Street, New York, N.Y.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,  
 Washington, May 28, 1952.

The Federal Open Market Committee is undertaking a study of the technical and operational phases of the market for United States Government securities. As has been previously announced, the committee has appointed Mr. Robert H. Craft as technical consultant.

The study is occasioned by the fact that in effectuating general credit policy the main reliance is now placed upon discounts and open market operations. The study is in the nature of a fact-finding inquiry as to the breadth and most efficient functioning of the market and is not concerned with questions of national credit, monetary, or debt management policy.

The Federal Open Market Committee would like to have the benefit of the views of those most closely associated with this general subject. Enclosed is an outline of the scope of the study, which is designed primarily for your guidance. It is directed specifically to dealers in Government securities. We appreciate that there may be many phases of the study in which all of the recipients are not directly interested. At the same time it is realized that some of the recipients may wish to cover additional points, and it is not intended that the study necessarily be limited by the outline, which seeks merely to take account of various questions which have been raised from time to time but do not reflect any preconceived views of the committee.

For the purpose of obtaining background material, consideration is being given to scheduling a series of informal discussions in Washington with those most actively interested in this subject. In view of the confidential nature of some of the material or opinions sought in the study, the discussions would, of course, be treated in that light. Since time would not permit discussions with all who are interested in varying degrees in this study we would welcome written responses from anyone on phases of particular interest to them.

After you have had an opportunity to examine the outline, we would appreciate it if you will advise us of the extent of your interest in this study.

Sincerely yours,

WM. MCC. MARTIN, Jr.,  
 Chairman, Federal Open Market Committee.

INDIVIDUALS WHO RECEIVED, AS ADDRESSEES, THE EXPLANATORY LETTER AND  
 OUTLINE OF STUDY

C. J. Devine, Jr., C. J. Devine & Co., 48 Wall Street, New York 5, N.Y.  
 C. F. Childs, president, C. F. Childs & Co., Inc., Board of Trade Building, Chicago, Ill.  
 Mr. Girard L. Spencer, Salomon Bros. & Hutzler, 60 Wall Street, New York 5, N.Y.  
 Rudolf Smutny, Salomon Bros. & Hutzler, 60 Wall Street, New York 5, N.Y.  
 Emil J. Pattberg, Jr., executive vice president, the First Boston Corp., 100 Broadway, New York 5, N.Y.  
 Herbert N. Repp, president, Discount Corp. of New York, 53 Pine Street, New York 5, N.Y.  
 Robert C. Morris, vice president, Bankers Trust Co., 16 Wall Street, New York 15, N.Y.  
 Arthur H. Klendl, vice president, Guaranty Trust Co. of New York, 140 Broadway, New York 15, N.Y.  
 Alfred H. Hauser, vice president, Chemical Bank & Trust Co., 165 Broadway, New York, N.Y.  
 John H. Grier, vice president, First National Bank of Chicago, Dearborn, Monroe and Clark Streets, Chicago 90, Ill.

Francis M. Knight, vice president, Continental Illinois National Bank & Trust Co., 231 South La Salle Street, Chicago 90, Ill.  
 M. G. Briggs, Briggs, Schaedle & Co., Inc., 44 Wall Street, New York 5, N.Y.  
 Ralph W. Proctor, Harvey Fisk & Sons, 52 Wall Street, New York 5, N.Y.  
 Walter Oppenheim, New York Hanseatic Corp., 120 Broadway, New York 5, N.Y.  
 W. E. Pollock, W. E. Pollock & Co., Inc., 20 Pine Street, New York 5, N.Y.  
 Maurice A. Gilmartin, Jr., Chas. E. Quincey & Co., 25 Broad Street, New York 4, N.Y.  
 J. B. Roll, J. B. Roll & Co., Inc., 1 Wall Street, New York 5, N.Y.  
 Dominic W. Rich, D. W. Rich & Co., 81 Nassau Street, New York 5, N.Y.  
 Walter Frank, manager, United States Government Securities Department, Schroder Rockefeller & Co., Inc., 61 Broadway, New York 6, N.Y.  
 J. D. Gillespie, J. D. Gillespie & Son, Gulf States Building, Dallas 1, Tex.  
 Nelson Asiel, Asiel & Co., 11 Wall Street, New York 5, N.Y.  
 Harry Stuart, Halsey Stuart & Co., Inc., 123 South La Salle Street, Chicago, Ill.  
 James S. Baker, James S. Baker & Co., 40 Wall Street, New York 5, N.Y.  
 Francis D. Bartow, Bartow Leeds & Co., 57 Williams Street, New York 5, N.Y.  
 Aubrey G. Lanston, Aubrey G. Lanston & Co., Inc., 15 Broad Street, New York 5, N.Y.  
 Malon Andrus, J. G. White & Co., Inc., 37 Wall Street, New York 5, N.Y.  
 Paul J. Mahoney, Paul J. Mahoney, Inc., 115 Broadway, New York 6, N.Y.  
 Joseph King, Union Securities Corp., 65 Broadway, New York 6, N.Y.  
 Jacob Stone, Asiel & Co., 11 Wall Street, New York 5, N.Y.  
 James Mabon, Mabon & Co., 115 Broadway, New York 5, N.Y.  
 Robert Moulton, R. H. Moulton & Co., 510 South Spring Street, Los Angeles, Calif.  
 Russell A. Kent, vice president, Bank of America N. T. & S. A., 300 Montgomery Street, San Francisco 20, Calif.  
 L. Sumner Pruyne, vice president, the First National Bank of Boston, 67 Milk Street, Boston 6, Mass.  
 Sheldon R. Green, vice president, the Chase National Bank, 18 Pine Street, New York, N.Y.  
 Adrian M. Massie, executive vice president, the New York Trust Co., 100 Broadway, New York 15, N.Y.  
 W. Randolph Burgess, chairman of the executive committee, the National City Bank of New York, 55 Wall Street, New York 15, N.Y.  
 Daniel W. Bell, president, American Security & Trust Co., 15th and Pennsylvania Avenue NW., Washington 18, D.C.  
 A. L. M. Wiggins, chairman of the board, the Bank of Hartsville, Hartsville, S. C.  
 George B. Kneass, vice president, the Philadelphia National Bank, 1416 Chestnut Street, Philadelphia, Pa.  
 John M. Young, Morgan Stanley & Co., 2 Wall Street, New York, N.Y.  
 Lee M. Limbert, Blyth & Co., Inc., 14 Wall Street, New York, N.Y.  
 Robert B. Blyth, vice president, National City Bank of Cleveland, 623-629 Euclid Avenue, Cleveland 1, Ohio.  
 Milton C. Cross, Harriman Ripley & Co., Inc., 63 Wall Street, New York, N.Y.

#### APPENDIX B

##### ANALYSIS OF DISCUSSIONS ON SCOPE AND ADEQUACY OF THE GOVERNMENT SECURITIES MARKET

This analysis endeavors to evaluate the testimony and to reach some tentative conclusions as to the consensus of views presented by the various individuals interviewed on some of the more important aspects of the study. For this purpose, the analysis has been divided into four major categories: (1) The adequacy of the dealer organization to provide an efficiently functioning machinery and a broad market place for Government securities, (2) the relationship of the open market account to the market and to the dealer organization, (3) techniques governing open market account operations, and (4) organization of the open market account.

##### *Adequacy of the dealer organization*

The majority of the respondents advanced the view that the framework of the existing market mechanism is adequate to service the needs of investors efficiently and to provide a broad market in Government securities under normal

conditions. The amount of capital committed to the business was considered sufficient and it was indicated that any material increase in the number of dealers would tend to be cumbersome. This opinion also was substantiated by the non-dealer bankers, who indicated that consideration from time to time of the formation of dealer departments by the institutions they represented invariably had resulted in rejection of the proposal on the grounds, first, that the market was being serviced adequately and, second, that the volume of business and profit potentials were not sufficient to justify augmenting the existing machinery. It was further indicated that capital available to some of the larger dealer organizations is not being utilized fully at present. The impression was gained that, if the volume of trading were to expand and if the business were to become sufficiently attractive profitwise, more dealers and more capital automatically would be attracted.

The difficulty of obtaining competent personnel was deemed to be a condition common to the financial community, because of the current preferences of college graduates for careers in nonfinancial fields. This, however, was not adjudged by the dealers to be a serious problem.

Distinction was made between primary dealers, who generally make markets on a wholesale basis and maintain retail contacts with the larger investors, and secondary dealers, who perform more of a brokerage function and rely to a great extent on the primary dealers for execution of their orders. For the most part, respondents indicated that both types of dealers serve useful purposes in the marketplace. Local dealers are considered particularly helpful in providing coverage to some parts of the country which cannot be serviced economically by the primary dealers.

Many of the smaller institutional investors are serviced by the larger correspondent banks, which in turn funnel this business through the primary dealer organization. Although there was some indication that expansion of this activity might be desirable, there was no evidence that smaller investors do not enjoy adequate facilities for transacting business in marketable Government securities.

The Federal Reserve banks and branches probably could supplement the existing system in servicing the smaller banks, but question was raised about the propriety of engaging in this activity and some expressed the opinion that absorption of the cost of handling such transactions would constitute a subsidy which could not be justified.

Considerable discussion by representatives of the New York Stock Exchange and by one stock exchange member firm was directed to the possibility of attracting odd-lot business to that auction market. Figures submitted by exchange officials indicated that even during the most active years of bond dealings the volume on the exchange represented a very minor percentage of the total. Since the beginning of the period of pegged markets, however, Government bond business on the exchange has been virtually extinguished. This was directly attributed to the practice of the Open Market Committee of confining its business to over-the-counter qualified firms and apparent unwillingness of the account to transact business on the exchange. The existing exchange facilities appear to be well suited to the handling of odd-lot transactions, but stock exchange firms have been unable to compete effectively for this business, because of the fact that the over-the-counter firms generally are willing to absorb the costs of small-lot transactions as a side line to their regular business. In view of the unprofitability of the odd-lot business to the over-the-counter dealer firms, however, it is reasonable to assume that these firms would be anxious to cooperate in the development of a plan that would shift odd-lot business to the exchange. This is a problem susceptible to further study, but its satisfactory solution would appear to depend in part upon the resourcefulness and ingenuity of exchange officials and interested member firms and in part upon the adoption by the open-market account of a different attitude should it become necessary in the future to engage in open-market operations in other than short securities. Some possibility of attracting additional business to the exchange lies in the establishment of a specialist system, which was a suggestion advanced by one dealer. That dealer also felt that there is a place for an auction market alongside the over-the-counter market.

No apprehension exists about assuring adequate coverage for the weekly bill auctions. It was pointed out, however, that long holiday weekends during a tight-money period restrict nonbank dealers' willingness to bid for bills which may have difficulty in distributing immediately and are thus forced to carry at

a costly interest penalty. In such cases, dealers indicated that it would be helpful for them to know in advance if repurchase facilities would be made available. This subject will be discussed more fully under a separate heading.

Diverse opinions were expressed about the desirability of establishing a functioning trade organization to formulate and effectuate a plan for uniform dealer practices. There now exists a dormant organization which could be revitalized if the need should arise, but in order to avoid any implication of Open Market Committee regulation, it was felt that the impetus for such a move should come from within the dealer organization rather than from the open-market management. In opposition to formulation of a dealer organization, possible legal entanglements were cited.

Although the letter accompanying that outline of study specifically excluded any discussion of debt-management policies, this subject is so inextricably interwoven with central banking functions that responses inevitably referred to it. For example, a number of dealers indicated that any inadequacies in the present market stem not only from some of the actions of the open-market account but result also from debt-management policies pursued over the past several years. Emphasis was placed on the concentration of debt in short-term securities and the use of nonmarketable obligations as factors that tend to narrow the market. Others felt that the publicized rifts between the Treasury and the Federal Reserve before the "accord" contributed to the impairment of confidence in the freedom of the market place and that this has not been fully repaired by the events since the "accord." There was general opinion, however, that the lessened degree of interference since the "accord" has tended to strengthen and broaden the market for Government securities and that, as investors generally come to recognize that the Open Market Committee does not intend to intervene, the market will become increasingly broader.

*Relationship of the open-market account to the market and to the dealer organization*

With minor exceptions, the view was expressed that the objective of the Open Market Committee should be to reduce intervention in the market to an absolute minimum and that a free market without interference best serves a free economy.

Both qualified and nonqualified dealers expressed a definite antipathy to any extension of policing or regulation of dealer activities by the open-market management. In fact, there was almost unanimous opinion that the degree of control that had been exercised over the dealers in the past had exceeded the need.

In specific reference to the standards for qualification, the view was expressed that too precise rules encourage circumvention and the adoption of devious tactics on the part of the dealers to the detriment of the entire market. More particularly, it was indicated that the imposition of restrictions on the operations of dealers tacitly implies the assumption of an unwarranted degree of responsibility on the part of the open-market account to protect qualified dealers against loss and, in fact, to relieve them as a special group from all of the extraordinary risks inherent in the business.

One of the disadvantages attaching to qualification cited by most of the dealers is the serious handicap under which they are forced to operate during periods of refunding operations when rights values are being supported and at other times when quotations are being maintained at artificial levels by the open-market management. Qualified dealers strongly objected to the fact that in these circumstances they were not only excluded from the privilege of disposing of the supported securities held in their own positions to the only buyer—the open-market account—but were prevented from selling these securities at any price to others, because of their tacit agreement not to trade below official quotations. In many cases their inability to deal during the period of support operations forced the dealers subsequently to accept sizable losses.

Serious complaints were lodged by nonqualified dealers in connection with the effects of open-market operations during the period of supported markets. During that period they contended that inability to conduct business with the only purchaser—the open-market account—represented severe discrimination and forced the nonqualified dealers virtually to suspend operations or conduct their business consistently at a loss. In addition, these dealers pointed to the fact that they suffered loss of customer contacts which had been developed only over a period of many years of effort and service. The discrimination during that period was described by some as an operation in restraint of trade. Nonqualified dealers also considered it discriminatory for the open-market account to relieve only qualified dealers of their positions during periods of stress and to force

nonqualified dealers to accept the losses that resulted from the sharply lower level quotations subsequently posted by the Open Market Committee. As mentioned previously, one stock exchange member indicated that the practice of confining open-market-account business solely to the over-the-counter qualified firms also had the effect of completely eliminating the exchange as a marketplace for Government securities.

With further reference to the distinction between qualified and nonqualified dealers, respondents in all categories stated that some of the presently qualified firms do not appear to possess as many of the attributes for qualification as some of the nonqualified dealers. This emphasized the difficulty of formulating a set of standards that properly can be applied to permit sufficient flexibility in open-market operations and at the same time avoid recurring criticisms of the nature that have been lodged in the past.

Many supported the view that the distinction between qualified and nonqualified firms might have been necessary as a wartime expedient but that the need for this arrangement had long since expired. Some indicated that the present formalized distinction should be abandoned entirely.

Although close supervision and regulation of dealer practices were considered to be antithetical to the establishment of an efficiently functioning dealer organization and to the creation of a broader market, there was general recognition of the need for a continuing liaison between the open-market management and the dealer organization. Most of the dealers indicated, however, that the regularly scheduled morning meetings prior to the opening of the market are not the best means of accomplishing this objective and, in fact, many thought that these should be discontinued. As a substitute, some suggested that the press type of meeting that had been employed on occasions in the past, and at which dealers met in a group with some of the top officials of the New York bank, would provide a medium for a more satisfactory exchange of views. In the intervals between such meetings it was suggested that individual dealers should be encouraged and should feel free to call on the account manager for the purpose of discussing any matters of mutual interest.

There also was general support of the view that the open-market management should have access to whatever data is considered necessary and proper to aid in the efficient conduct of open-market operations. For example, disclosure to the open-market management of the general sources of buying and selling was deemed to be useful and proper information to assist the account manager in appraising market factors, particularly during periods of upset conditions. The dealers felt that disclosure of specific names was not justified in any circumstance, however, and indicated that such description always should fall short of establishing the identity of the buyer or seller.

Similarly, the need for apprising the open-market management of the size of dealer positions was recognized. It was suggested, however, that such information should be used purely for statistical purposes in evaluating money-market conditions. This objective could be achieved if figures on such positions were assembled by a source other than the management of the account and reported to the management of the account only in the aggregate. If handled in that way, the account management would not be open to the criticism that they were accepting responsibility for influencing individual dealer positions directly or indirectly. The general view was that the size of positions carried by any one dealer should be left to his independent judgment, limited only by access to private credit facilities.

There were a number of other more or less isolated complaints lodged by both classes of dealers. These will be detailed in the summary and for the most part were based also on the period of pegging operations; thus they are not as applicable under present conditions. In this connection, it should be emphasized that most of the criticisms were ascribable to the difficulties of operating under the compulsion to maintain a fixed pattern of prices and rates. Relatively few of the respondents were critical of the personnel of the open-market management, and most of these indicated that the inflexible system was largely responsible—that any personnel operating under such a system inevitably would be subjected to criticism.

It was clear also that most of the problems having to do with qualification arose from the past techniques employed by the open-market account, which are treated more fully in the following section. In further support of the view that distinction between qualified and nonqualified dealers should be eliminated, it was stated that the open-market management should be free to transact busi-



ness with those dealers who in the judgment of the management were best equipped to handle transactions for the account in the most efficient and least costly manner. It was indicated that, if operations of the account were confined to more or less routine transactions in the short-term area, the need for requiring dealers to comply with a rigid set of rules obviously would be considerably diminished. For that matter, the same line of reasoning could be applied if intervention in other sectors of the market were at times considered necessary. In the event of a national emergency, rules governing dealers' conduct readily could be reinstituted if necessary. In the present situation, however, some felt that a more proper relationship between the open-market account and the dealer organization would be one that would conform as nearly as possible to that which exists between dealers and other customers.

#### *Techniques governing open-market operations*

Nonbank dealers presented a strong plea for the use of repurchase agreements to aid them in functioning efficiently in short-term securities. In substantiation of the need for repurchase facilities, these dealers pointed to the concentration of activity in the short-term market, the importance of that market in effectuating credit policy, and the frequent exorbitant cost to which dealers are subjected in carrying positions. With the abandonment of the call money post on the stock exchange dealers are forced to rely largely on the New York money market banks for credit facilities. Resort to out-of-town banks and to repurchase arrangements with corporations severely restricts flexibility, which is so necessary in dealing efficiently in short-term securities.

Some opinion that repurchases tend to reestablish a peg in the market was refuted on the ground that the same objection was applicable to the discount rate. Dealers contended further that, if this objection had any validity, it could be overcome by the adoption of a flexible repurchase mechanism. Some advanced the line of credit theory as a means of assuring dealers in advance of bill auctions that they would not be too severely penalized in the borrowing costs during a tight money period. Others took the position that repurchase facilities should only be granted at the option of the open-market management but that advance notice of intention to make repurchases available should be given. One point of view in connection with a flexible repurchase arrangement was that the open-market account should be prepared to terminate or reinstitute repurchases from day to day based on the open-market management's judgment of the needs of the market.

The privilege of substituting securities as a means of enabling dealers to perform their normal market functions more efficiently was considered a desirable refinement. Under the present arrangement, dealers frequently are unable to meet specific market demand because of their inability to deliver the bills that have been sold to the Federal under repurchase agreement. Some also recommended that repurchase facilities should be extended to those presently nonqualified dealers who participate regularly in the bill auctions and who are adjudged by the open-market management to be real factors in the short-term market. Most of the bank dealers and nondealer bank representatives opposed the use of repurchase agreements on the grounds that they represent a form of pegging and that private credit extension is a banking system rather than a central banking function.

Some of the dealers recognized the desirability of a device designed to avoid temporary excessively easy money conditions which occur during tax rate periods but felt that 1-day resale agreements were not feasible because such an investment would not permit of any profit margin to the distributor. The subject, however, deserves additional consideration, and some means of private participation in Treasury overdrafts should be explored.

Dealers, generally, stated that commissions on open market account transactions during the war and postwar years have been largely responsible for narrowing dealers' quotations. It was contended that the setting of low commissions on agency transactions for the open-market account encouraged unwillingness of investors to accept dealers' efforts to quote securities at more reasonable spreads. Recognized dealers, generally, felt that open-market account commissions were too small, especially in the case of short-term issues. It was suggested that commissions should be enlarged in order to permit dealers to transact open-market account business profitably and also to encourage customers to trade on spreads that would provide reasonable profit margins to the dealers. There also was dissatisfaction expressed that open-market account commission rates had been adopted arbitrarily and without consultation with the dealers as

to whether or not these rates represented reasonable compensation. The view was advanced that this inequity could be corrected by abandoning the practice of paying commissions on open-market transactions and by adopting the more general practice of trading with dealers on a net basis. That procedure also would eliminate the difficulties that the open-market account has experienced from time to time in operating on an agency basis.

As a matter of operating technique, it was suggested that the open-market management might find it desirable at times to employ the services of only one dealer in connection with a specific transaction. Nondealers indicated that they had obtained better executions by lodging sizable orders with one dealer who was fully informed of the immediate aim of the investor. It was suggested that this procedure might also be adaptable to open-market operations.

The question involving the adaptability of the secondary offering type of technique to open-market account operations was misinterpreted by most of the respondents. Those few who eventually came to understand that the question was directed primarily to operations in the short-term sector of the list conceded that the technique might have some merit. On the whole, however, there was little enthusiasm for this type of procedure.

In the matter of the approach to broader techniques, the discussions clearly established strong sentiment for adoption of a set of ground rules that would conform to the principle of achieving as free a market as practicable—a market which under normal conditions would reflect solely the forces of supply and demand.

In support of the free-market thesis, dealers pointed to the disadvantages and unfortunate consequences that had resulted from some of the techniques that had been employed in the past. Reference was made particularly to (1) the policy of distinguishing between selling sources, (2) unwillingness to purchase securities that had been acquired by dealers on a cash rather than a regular basis, (3) unannounced changes in technique, (4) methods employed during Treasury financing operations, and (5) "reluctant buying."

It was indicated that refusal to take securities from dealers' positions at times when the open market account was maintaining an artificial level of quotations either encouraged evasive actions on the part of dealers, which they considered to be inconsistent with their functions, or resulted in the acceptance of sizable losses at the termination of a specific supporting operation. It also was contended that the psychologic effect of distinguishing between selling sources among investor classes was to build up potential selling rather than to discourage selling.

Dealers stated that unwillingness of the open market account to purchase securities acquired by dealers on a cash basis restricts dealers' ability to function efficiently during a period in which they are increasingly becoming obliged to conduct cash transactions with customers. This objection did not extend to the suggestion that the Open Market Committee deal on a cash basis but rather that the Open Market Committee be prepared at such times as it is operating in a specific class of securities to purchase from dealers without distinction as to whether the securities originally had been acquired on a cash or regular basis. A few dealers suggested that the Federal also should be prepared to operate on a cash basis at all times but most recognized the mechanical obstacles involved.

The frequently changing technique was described as a condition in which certain buying levels had been established by the Open Market Committee early in the day, temporarily abandoned and reestablished, usually shortly prior to the close of the market. This created a great deal of confusion in the minds of dealers and investors. Dealers suggested that they could better serve the objectives of the account managers if they were apprised sufficiently in advance of a change in technique to permit them to comply with the objectives.

With respect to refunding operations, the majority felt that only under conditions in which the Treasury recognized the needs of the market in the pricing of new and refunding issues could the dealers be expected to take positions in such issues and do the essential work of secondary distribution. It was pointed out that, if the Treasury were consistent in pricing its offerings in a manner to generate natural premiums, the need for open market account intervention and underwriting would be obviated. In the event that the natural premium originally placed by the market on a refunding issue was not maintained, because of some unexpected development between the period of the announcement of the terms and the closing of the books, some felt that the Federal would be justified in maintaining the rights value by direct purchase of the maturing issues at prices

that originally had been set by the market. Others indicated that, if possible, it would be preferable to support such offerings indirectly by placing additional reserves temporarily at the disposal of the banking system through purchase of short-dated bills; in the case of short-term refundings it was stated that the Federal indirectly could influence the price of the issue being offered by purchasing bills "down in rate" to the point that the issue being offered would become sufficiently attractive comparatively to assure success of the financing. An operation of this nature would have the advantage of permitting the Open Market Committee to reestablish the former member bank reserve position with less permanent disturbance to the market. Many held the view that any attempt to establish artificially high rights value encouraged greater than normal selling and thereby added to investor attrition. From the dealers' standpoint there was dissatisfaction about the unwillingness of the Open Market Committee to buy from their positions during periods when the direct purchasing technique had been used.

The principal criticism revolved about the "reluctant buying" technique that had been employed during periods of Treasury refundings and disorderly markets. The principal determinant of an orderly market was considered to be ability to consummate transactions at a price rather than the degree of fluctuations in prices themselves. This opinion was supported on the thesis that it is often better to allow an abrupt price decline and to support aggressively at the lower level than to engage in a step-like process of support. It was stated that the latter technique ordinarily contributes to a greater eventual price decline. Lack of orderliness was characterized more as the urgency of selling pressure and the volume of offerings than the degree of change in prices. Some felt that the System should confine its thinking to the correction of disorderly conditions rather than to the maintenance of orderly markets, because the term "orderly" connotes a market in which there is frequent intervention. One dealer characterized the most disorderly market in recent years as that which existed when the open market management was insisting on the maintenance of an artificial price level and simultaneously refusing to do business at that level.

The "reluctant buying" approach during those periods was considered to be a self-defeating policy and one which should never be employed if the objective is to maintain a specific level of prices. Respondents emphasized that inability to trade on quotations within a reasonably short time invariably heightens the uncertainty in the mind of the investor and usually encourages him to attempt to sell a larger volume of securities than he normally would wish to sell if the transaction were completed without hesitancy. It was almost unanimously recommended that, on occasions when intervention is necessary to correct disorderly conditions in the market or to support Treasury refunding operations, the open market account should adopt an aggressive policy by placing bids on as wide-spread a basis as possible. This, in the judgment of the respondents, would remove question from the minds of investors as to their ability to sell and thereby tend to discourage them from selling. It further was suggested that, during periods of market upset, the open market account should assume more prompt leadership by communicating its intentions to the dealers before the opening of the market.

In general, respondents felt that the System would be called upon rarely, if ever, to intervene in securities with longer than 1-year maturity and that the only justification for System intervention would be to correct disorderly conditions in the market resulting from an emergency, such as an unexpected development in international relations.

With two exceptions, respondents unanimously supported the view that the Open Market Committee should not operate in any manner to offset day-to-day fluctuations in the market and that without official interference the scope of the entire market would be considerably broadened.

As justification for a free market, some respondents pointed to the surprisingly good behavior of the market in the period following the "accord." This was considered particularly significant when viewed in the light of the sudden and unexpected abandonment of the pegged policies to which the financial community had for so long become accustomed.

In appraising the factors governing the present market, some comparison was drawn between the type of markets that existed prewar and that which exists today. Under present conditions, the large concentration of longer term marketable securities in the hands of sophisticated investors effectively precludes the possibility of market raids, rigging of prices, or abnormal gyrations. The general

investor consciousness of arbitrage possibilities tends to prevent other than temporary disequilibrium in prices between specific issues in one sector of the market. If left to the market mechanism, adjustment to a proper relationship should promptly occur. In general, the large concentration of holdings and increased investor astuteness are factors that naturally will tend to prevent inordinate price swings under normal conditions.

Most dealers clearly indicated their unwillingness to take even modest positions in a supported market in which there is any uncertainty as to the degree of support, pointing out that in such circumstances dealers function solely as agents for the open market account and not as dealers. On the other hand, if there were assurance that Federal operations would be confined to the short-term area except for aiding in Treasury financing and correcting disorderly markets, dealers, generally, stated they would be considerably more willing to carry positions and operate more actively in the long-term sector of the market. They invariably pointed to the difficulty of exercising independent judgments when forced to operate against the unknown of the Open Market Committee when a frequent intervention technique was employed. The majority view was that the private market mechanism would be greatly strengthened and that the interests of the investor, the dealer, and the Open Market Committee would be best served if open market operations were confined to (1) correcting disorderly markets, (2) aiding the Treasury in assuring successful refunding operations, and (3) effectuating credit policy and alleviating temporary money stringency through the medium of as short securities as possible.

#### *Organization of the open market account*

The majority feeling was that the present organization of the account is best suited to the needs of the Open Market Committee from the standpoint of providing an information gathering post on market developments and of carrying out transactions for system account. This view appeared to be predicated, however, on the assumption that the account intended to continue to function much in the same manner as it has in the past, involving more or less frequent intervention in all sectors of the market for one reason or another. Those who responded to the question on the basis that future operations might be considerably more restricted indicated that there probably was no need for as large personnel as now exists, and some took the view that several people would be adequate to handle System account transactions and other general market information in the event that operations were confined solely to the short-term area.

One respondent subsequently submitted a long memorandum, in which he recommended that the open market account operation be transferred to Washington for the purpose of eliminating the lack of coordination between the Committee and the management of the account. Two other respondents suggested that, in order to establish more complete responsibility for open market operations where it is now vested by law—in the Open Market Committee—the account manager should be an employee of the Committee and made directly responsible to the Committee, rather than an employee of the New York bank.

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### APPENDIX C

#### GROUND RULES

The Federal Open Market Committee can make a major contribution to the depth, breadth, and resiliency of the Government securities market by formulating a general set of ground rules to govern its transactions in the market. Dealers cannot be expected to take positions and make adequate markets at their own risk in the absence of reasonable assurance as to the circumstances under which the Committee might intervene in the market, the purpose of the intervention, and the sector of the market in which such intervention would occur.

One of the dominant facts which emerged from discussions with dealers and nondealers alike was the belief that real freedom does not yet exist in the Government securities market. Skepticism that the Federal Open Market Committee has abandoned the theory that the Government securities market must continue to be controlled within limits has not been dispelled. The fact that a deeper, broader, and more resilient market could best be achieved by reducing open market account intervention to a minimum was a point repeatedly emphasized throughout the hearings.

In a fully controlled market such as prevailed in earlier postwar years dealers are obliged to operate under serious handicaps. Under a policy of intervention dealers become brokers, are unable to perform their normal functions of making markets, rendering independent advice to customers, and engaging in normal arbitrage transactions. A natural corollary to a controlled market is the impairment of the health of the dealer organization because of removal of incentive and restriction on profits. These same handicaps operate, though in lesser degree, in a fluctuating market subject to intervention by the open market account. The mere fact that there is uncertainty surrounding the Federal Open Market Committee's attitude causes unwillingness on the part of dealers to carry positions or to make markets. As dealers increasingly look to and depend upon System guidance, markets tend to become more limited and narrower.

By nature, a guided market must rely on a closely knit System dealer or broker organization, e.g., a group of so-called qualified dealers. This raises accusations of discrimination by those dealers who are not eligible to conduct business with the Federal open market account. Investors likewise become inhibited because knowledge of System objectives is inaccessible to them and they are unable to appraise the significance of various account operations.

There can be little question that dealers are capable of operating far more effectively if left to exercise independent judgments and to perform their normal functions, based on these judgments, without interference from the open market account. This was brought out time and again in the discussions. Dealers are much better prepared to accept the business risks inherent in a market that is governed solely by the interplay of demand and supply forces than in a market subject to the hazard of unpredictable Committee action. This hazard is greatest when intervention occurs in the intermediate and long sectors of the market. Certainly a strong, alert, and efficiently functioning dealer organization can best be promoted by abandonment of open market account intervention outside the very short category.

The surprisingly good behavior of the market in the period following the accord is significant. It substantiates faith in the ability of the dealer organization to operate efficiently in flexible markets. This is particularly significant when viewed in the light of the sudden and unexpected abandonment of the pegged policies to which the financial community had for so long become accustomed. Market experience since the accord does not, however, represent a fair test of the inherent breadth of a free market place. Even during this period dealer and investor activities have been continually inhibited by the fear that freedom had not been fully restored to the market. If assurance could be obtained that intervention would be held to a minimum and confined to the short-term area, better market behavior could be expected in a technical sense, but, more important, System action could better be appraised and the Treasury would be provided with a clearer view of basic money market trends.

There should not be too much concern over the success of attempts to raid the market in the absence of account operations. The large concentration of marketable securities in the hands of sophisticated investors militates against the possibility of market raids, rigging of prices, or abnormal gyrations. The general investor consciousness of arbitrage possibilities tends to prevent other than temporary disequilibrium in prices between specific issues. If left to the market mechanism, adjustment to a proper relationship ordinarily will occur with reasonable promptness.

There is danger that continuous intervention for the purpose of setting prices or yields may vest too great a responsibility in the hands of a few whose market judgments cannot usually be expected to be a satisfactory substitute for the composite judgments of the wide variety of market participants. As was pointed out, the Government marketable debt is held in considerable degree by any investing group of unusual sophistication. This group also possesses the desirable characteristics of a wide and diversified economic and institutional interest.

Obviously, somewhat more erratic movement of prices can be expected in a free market than in one that is subject to intervention, but the guidance of economic decisions by free markets is a characteristic that has effectively served the American economy and for which there is no satisfactory substitute. Moreover, the Government bond market cannot be isolated from other markets nor can its influence on the policies of all lending institutions be minimized. That has been amply demonstrated in the past. The fact is that rates for Government securities are closely related to and affect interest rates on all classes of loans and investments. Indirectly the Government yield curve heavily influences policy decisions

and choice of investments by all lending institutions and ultimately capital commitments by all borrowers.

Arbitrary System intervention in the intermediate- and long-term areas can hardly fail to create a degree of artificiality in those markets. Establishment of any artificiality in the level of prices or yields on Government securities inhibits investment decisions and inevitably obstructs the ability of the System to influence financial institutions' lending policies. The results of a credit policy directed solely to controlling the volume and availability of credit can be much more accurately appraised. Only by permitting normal price and yield relationships to develop from an appropriate credit base can the value of an interest rate signal be realized.

The view that a modest amount of intervention is not harmful cannot be rationalized. The underlying situation is not corrected by such action. In fact, by preventing normal demand and supply forces from establishing proper relationships at a new price level such intervention tends to magnify the market imbalance.

A controlled market also encourages participation by speculative interests in the hope of profit but with a guaranty against loss and also encourages banks to finance such positions. Speculative holders are the first to react to any minor adverse development in the market. This in turn magnifies any subsequent problem of support, leading inevitably to greater intervention. Exposure to the risk of day-to-day fluctuations inherent in a free market tends to eliminate this speculative element from the market.

Perhaps an even more undesirable feature of System account intervention is the unsatisfactory position in which it places the Treasury. A System guided market seriously hampers debt management decisions. Only by permitting a market to develop from the free interplay of demand and supply forces can the Treasury accurately determine investor preferences. Beyond this, a policy of intervention inescapably results in the acceptance of continued System responsibility to underwrite Treasury offerings that do not conform to investor preferences.

It seems essential that every effort should be made to eliminate any basis for misunderstanding of Reserve banking functions and responsibilities. The Treasury should be fully apprised of what can be expected from the Federal Reserve System. Although progress in this direction has been made since the accord, there nevertheless exists a number of areas in which the working relationship leaves something to be desired. The present would seem to offer a propitious opportunity to clarify the position, based on the experience since the accord.

Decisions on which Federal Reserve credit policies are based must be subject to a variety of influences, such as the level and trend of commodity prices, the level of employment, the trend of credit demands, and uses to which bank and other credit are being put. Policy decisions to guide the timing and degree of credit actions cannot be governed by a rigid formula. From this it does not follow that, once policy decisions have been reached, effectuation of policy cannot best be achieved under a set of simple rules that are fully understood by all participants in the market.

Factors to be considered in formulating such ground rules fall into four general categories: (1) The most appropriate and efficient methods for effectuating general credit policies, (2) methods to relieve purely temporary and self-correcting disruptions in the money market, (3) operations of the account in connection with Treasury financings, and (4) methods of dealing with disorderly markets.

#### *1. The most appropriate and efficient methods for effectuating general credit policies*

The case for believing that open market operations in support of general credit policies can most effectively be carried out through the medium of very short securities—the nearest money equivalent—is persuasive. Account operations normally confined to Treasury bills would permit much greater flexibility in open market account operations, with a minimum of disturbance to prices and yields on longer maturities, permitting them (a) to reflect the natural forces of demand and supply, and (b) to furnish a signal of the effectiveness of credit policy aimed primarily at the volume and availability of bank reserves.

Treasury bills possess the unique attribute of near-term self-liquidating paper, in that they represent the one class of open market securities for which the Treasury does not offer a refunding issue in exchange. Rather, these are paid off at maturity and the Treasury's needs in the short-term category are re-

plenished by new cash offerings of whatever amount is necessary to cover the Treasury's short-term money requirements of the time. Thus there is no compulsion on the System to replace any maturing issues of bills that are held unless general credit policy at the time dictates replacement. Unlike other issues, Federal Reserve participation is unnecessary to assure the success of any new issue of Treasury bills. The market for this type of paper is so broad that coverage of the auction is assured by other investors at whatever rate the market considers the paper attractive for investment in the light of prevailing credit conditions.

The situation is quite different with respect to all other issues of marketable Treasury securities. So long as the Treasury is operating at an even balance or at a deficit, it usually is necessary to refund any other security by offering a new issue in exchange. In that circumstance and without regard to System policy existing at the time, the Federal Open Market Committee, practically speaking, is under compulsion to accept the refunding offer for any System holdings of the maturing issue, in order to avoid Treasury cash attrition. In effect, the System account thereby becomes a permanent holder as such securities are continuously refunded. In practice, therefore, acquisition by the System of any issues except Treasury bills results in a permanently frozen System portfolio and severely restricts flexibility in open-market operations to effectuate general credit policies. In the rare cases where a short-term security is refunded with an intermediate or longer term bond, the open-market account becomes an involuntary investor in a class of security that is not appropriate for inclusion in its portfolio and one in which freedom of action subsequently is even more severely restricted. The impact on the market of sales of intermediate and longer securities by the System tends to distort disproportionately an otherwise natural market level.

All things considered, it appears that normal credit control functions directed primarily at the availability and volume of bank reserves can best be effectuated through operations confined to Treasury bills. Adoption of such a guiding principle for normal open market operations would go far toward eliminating all of the criticisms and handicaps that attach to intervention. For example, the basis for criticism that dealers' normal market functions are hampered by a policy of intervention in other issues would be eliminated. Operations confined to bills would remove the need for continuing a closely knit dealer organization and would permit abandonment of the policy of distinguishing between firms that are and are not qualified to do business with the account. In such circumstance, the System would be free to conduct its business with those firms best equipped to function in the short-term market; more particularly, the Federal Open Market Committee would be relieved of any responsibility for protecting the qualified dealer.

One of the most beneficial results would be that the Federal Open Market Committee would be relieved of the necessity of involving itself in a discussion of technical methods of effectuating policy and would be able to devote its attention primarily to policy decisions with respect to the need for credit actions, based upon an appraisal of economic factors. Use of bills for effectuating general credit policies would permit of much greater flexibility in moving in and out of the market than would longer securities. The timing of the purchases and sales of longer securities is much more difficult because of the inability of anyone to appraise accurately the market effect of System operations. All too frequently the effects are out of proportion to the volume, solely because of the importance attached by the professional elements in the market to System operations. For these reasons, operations in intermediate and longer term bonds might prove to be self-defeating from the standpoint of achieving the desired effect upon the volume and availability of bank reserves.

## ***2. Methods to relieve purely temporary stringencies in the money market***

Although sufficient experience has not yet been gained to warrant the adoption of a specific formula under which repurchase agreements would be made available to dealers, some such mechanism appears to be best adapted for use in moderating purely temporary and self-reversing tight money periods, such as occur around tax dates and during temporary periods of currency expansion and decreases in float. Repurchase agreements would be especially useful over long holiday weekends when dealers are severely penalized in the interest cost differential of carrying short securities. Repurchase agreements should be extended to all dealers who regularly participate successfully in the weekly bill offerings.



*3. Operations of the account in connection with Treasury financings*

Obviously, the Treasury should be completely apprised of Federal Reserve policies and objectives at all times. This is essential to the formulation of intelligent long- or short-range debt management plans.

Beyond this, the Treasury should be fully informed of the extent to which it can expect aid from the System in carrying out its cash offering and refunding operations. Here, two choices are available. The first assumes that the System should be committed to a policy at all times of underwriting Treasury financing operations by direct participation to the extent necessary. In the case of refundings, this would involve the maintenance of a sufficiently high rights value on maturing securities to assure a minimum of overall attrition regardless of the natural preferences of holders of these issues. Of necessity, the maintenance of a rights value sufficiently high to encourage holders to sell to the System tends to discourage other investors from purchasing rights at levels they believe to be attractive from those holders who may not wish to acquire the specific securities offered in exchange. Of course, the support of issues of comparable maturity to those being offered in exchange automatically creates an artificial level of rates and results in the acquisition of other securities into which the account is frozen.

There are many other obvious disadvantages to such an approach.

(1) It seriously hampers freedom of action in effectuating general credit policy.

(2) It temporarily reestablishes a pegged market.

(3) As pointed out previously, it tends to freeze the open market portfolio permanently into whatever securities have been purchased, because at maturity of the securities the committee is again expected to avoid forcing attrition and thus becomes obliged to roll over. Resale before maturity would involve a judgment as to timing and could not avoid disruption to the normal demand and supply relationships, in some cases in disproportion to the actual volume of sales.

(4) It creates a false impression to the Treasury of the worth of Treasury securities and eliminates a guide to the Treasury of the classes of securities most sought after by investors, thus precluding an accurate appraisal of the maturity areas in which Treasury refundings or cash offerings could best be achieved.

(5) It tends to encourage the Treasury to rely too heavily upon System support and thus tempts the Treasury to borrow at lower rates than the market justifies.

(6) It eliminates dealers, as such, and turns them into brokers for the account.

(7) Experience has indicated that System sales of securities that are approaching maturity frequently are purchased by corporate and other nonbank investors who have a specific need for funds which coincides with the maturity of these issues. Thus such sales by the System frequently result either in cash attrition to the Treasury or subsequent reacquisition for System account. In the latter case, the System is obliged to roll them over into the new security that is offered in exchange at maturity.

In summary, such a policy embraces a multitude of problems, but it points up particularly the difficulty of achieving the desirable degree of flexibility so necessary to the effectuation of credit and monetary policy. This factor has been apparent in recent refunding operations. The System has created reserves in the banking system contrary to general credit policies. It has either purchased rights during refundings at an artificial level or other securities of comparable maturity to those being offered in exchange. These cannot be resold for the purpose of reestablishing the desired level of bank reserves (or borrowings) without unduly affecting the then existing structure of prices and yields.

Responsibility for debt management decisions clearly belongs in the Treasury. As stated previously, the Treasury should be completely informed at all times of the current credit and monetary policy objectives of the Reserve System. The Federal Open Market Committee should accept no responsibility for initiating advice to the Treasury as to the terms of new issues that the Treasury contemplates offering either for cash or for refunding. The Federal Open Market Committee might be expected upon request of the Secretary to render advice to the Treasury, based on its best judgment of the attractiveness of any issues that the Treasury proposes to offer in the light of the Federal Open Market Committee's appraisal of market and credit conditions prevailing at the time.

Beyond this, the System should assume no responsibility for directly underwriting any issues offered by the Treasury. It would follow from this that the System would refrain from purchasing any maturing issues for which an exchange was being offered, when-issued new securities, or any outstanding securities of comparable maturity to those being offered for cash or refunding.

Treasury offerings should be priced in line with market conditions and expected credit policies of the System and be sufficiently attractive to assure ready market acceptance.

Appropriate pricing by the Treasury can best be determined by announcing in advance the general terms of the issue to be offered, in order to give the market an opportunity to adjust to the impact of an additional volume of securities in any one maturity area. After sufficient time for such adjustment the specific terms should be announced, the books opened for subscriptions, and subsequently closed at the earliest possible time thereafter. This technique, which is particularly important in the case of new cash offerings, would also be desirable in the refunding of a short security into a longer-term issue.

Assuming that Treasury financings are sufficiently infrequent, it would not appear unreasonable for the Federal Open Market Committee to agree to suspend during these periods any open-market operations in which it normally might be engaged. Under such a commitment it might be agreed that the Federal Open Market Committee would refrain from any sales in the market beginning with the period of the Treasury's preliminary announcement of the general terms. Such commitment would permit natural market adjustment to the impact of the new offering. Further, it would appear that the only other justifiable deviation, least inconsistent with the rule of nonintervention, would be for the Federal Open Market Committee to assure the Treasury that it would take such steps as might be necessary to prevent a rise in open-market Treasury bill rates from exceeding the highest rates that had prevailed during the period between the preliminary announcement and the announcement of the specific terms. This commitment would promote arbitrage favorable to the offering. Such a commitment, however, would be in effect only during the period that the books were open. It would appear that this set of conditions would best assure proper pricing and successful offerings.

As a corollary to the commitment to maintain bill rates, however, it also should be understood both by the Treasury and the market that once the subscription books had been closed the Federal Open Market Committee would be entirely free to engage in open-market operations to effectuate whatever credit policies it considered appropriate at the time without regard to the effect of such open-market operations on the prices of the newly offered or any outstanding securities. This would involve freedom to dispose of any bills that might have been acquired during the period that the books were open or a lesser or additional amount of bills that it might be necessary to sell to accomplish the objectives of credit policy.

#### *4. Methods of dealing with disorderly markets*

Intervention by the System outside the bill market should be strictly limited to the correction of disorderly conditions in the market. To accomplish this, the directive to the manager of the open-market account should be changed to supplant the present directive of maintaining orderly conditions in the market. Since conditions of such disorder as to require account intervention are likely to be remote, judgment as to whether intervention is necessary probably should rest with the executive committee. The System account manager should be charged with the responsibility of informing the executive committee of developments in the market that in his judgment would justify intervention. While it is not possible to set specific criteria of what constitutes disorderly conditions, it might be advisable for the Federal Open Market Committee to describe generally the type of circumstances which could be adjudged to constitute disorderly conditions in order to avoid the risk of too hasty intervention.

#### CONCLUSION

Adoption of the foregoing set of ground rules, as a basis for System open market operations, would go far toward solving the problems to which this study has been directed and to achieving a deeper, broader, and more resilient market for Government securities.

## APPENDIX D

## CALL MONEY FACILITIES

In the American money market of today there is no counterpart for the highly organized call money market which has been a principal feature of other great money centers, past and present. There is no place at the present time where a lender can offer temporarily idle funds for loan, confident that the loan will be well secured and that the funds will be available on demand completely at his convenience and option. Conversely, there is now no place in the American money market to which a dealer in money market securities can go for loans to carry his position, confident that with suitable collateral money will always be available to him on a completely impersonal basis, repayable at his convenience at any time, and at a cost which on an average will be reasonable as compared to other money market yields. In other words, there is no truly open market for call loans or demand money in the United States at the present time.

The famous New York call loan market which was centered during the twenties at the money post on the New York Stock Exchange has disappeared. It long served as a medium for the employment of liquid funds and the adjustment of bank reserve positions. It ceased to operate in any important sense during the thirties when excess funds were so plentiful and so widely held that resort to an open market mechanism offered little advantage to either lender or borrower. It came to an official end in 1946 when its very convenient technical facilities for making loans and handling collateral were dismantled.

Now that the long era first of huge redundant excess reserves and then of very low pegged interest rates has come to an end, the lack of an open market for call loans is being felt. Member banks outside the money centers. In the absence of such an outlet for short funds, offer money in the Federal funds market or invest in Treasury bills. Funds can only be put to work in the Federal funds market on a one-business-day basis. The mechanics of bill purchase or sale, the minimum inescapable costs of handling the transactions, are such as to make this outlet unprofitable for money that will be available for only a small number of days. Large corporations and other potential nonbank lenders with temporarily idle balances face the same cost handicaps when they attempt to invest in very short-term bills.

Nonbank dealers in Government securities, on the other hand, in the absence of an open market for call loans, have found it difficult on a number of recent occasions, and even for some sustained periods, to borrow money except at rates which penalize their functioning as dealers. In addition to usual market risks, nonbank dealers have had to assume the burden of a negative carry on their portfolios at such times, and there has been a tendency for them to limit their participation in the market and to maintain very small positions.

Such a dealer reaction naturally weakens the entire market in periods of strain. A market with depth, breadth, and resilience needs instead a dealer group functioning on completely different inventory policy. For such a market, credit must be available to dealers on terms that will permit and even encourage them to absorb a substantial volume of securities when market pressures are most severe as well as to hold large positions in short-term issues on a continuing basis. In terms of today's debt, a fully satisfactory market would probably require that dealer positions regularly run several times larger than in recent months.

Some important elements of an organized call money market are already present in the current American money market. New York City banks have always felt a responsibility to the Government securities market and they offer loans to dealers on what is in many respects a call money basis. These banks use the Government security dealer loan as one instrument for adjusting their reserve positions. When a New York bank has surplus funds, it posts a lending rate designed to attract dealer loans; conversely, when its reserve position is deficient, it in effect calls dealer loans by posting a noncompetitive rate for new loans and renewals. With the development of sustained general tightness in the reserve positions of member banks, however, the New York banks have come under special pressures and the volume of money they have had available for this purpose has in general not been adequate. Accordingly, their rates on loans to Government security dealers have frequently been substantially above market yields on short-term Government securities. As a consequence, dealers have for some time been cultivating additional money sources through a series of individually negotiated customer transactions with larger banks outside New York and with some of their major corporate customers.

These facts suggest that some of the ingredients of a national call money market are forming under the pressure of need. There would seem to be considerable scope, however, for further and more organized development. Certainly, the present institutional gaps in the credit market are made clear by the fact that in recent months, when the money market has been tight, lenders throughout the country have been willing to hold bills and other short-term Government securities at considerably lower yields than the rates at which loans have been available to dealers, who offer these same Government securities as collateral and who assume the full risk of declines in security prices. Such a rate relationship may reflect the fact that many loan contracts with dealers have been on a customer basis in which the lender has not felt free to call in his funds without concern for possible inconvenience to the borrower. The relationship would be an anomalous one, however, if the dealer loans were essentially impersonal and could be called completely at the convenience of the lender. Then the loans would in fact be more liquid than the securities.

In a fully organized market, it would ordinarily be expected that the credit involving the lesser risk and greater liquidity to the lender would command the more favorable terms. In such a market Treasury bills should under most circumstances yield more in the market than a dealer loan made on an impersonal call basis and secured by bills. Investment in bills carries some market risk should the funds be needed before maturity. The dealer credit is virtually without risk of any kind since even the risk of adverse changes in the market for bills is underwritten by the dealer's capital. Loan rates to dealers should be much lower than the market rate on bills when the money market is tightening, when bill yields are rising to previous peak levels, and when uncertainty as to possible future yield increases is widespread. In such a situation, if there were facilities for doing so, many investors who are ordinarily fully prepared to accept the market risk of holding short-term Government securities would doubtless be glad to accept a lower return on their money in order to shift to another the risk of further price declines.

Except in a period of continuing ease, rates on dealer loans made on an impersonal call basis and fully secured by United States Government securities would tend to average below market rates on short-term Governments, provided there were an efficient mechanism for drawing call money together and making it available to dealers. Use of repurchase facilities would limit the upper range of fluctuations of such rates.

Under normal conditions there would seem to be large amounts of funds throughout the country which could be marshaled by a properly organized call money market. Banks, including many of the thousands of smaller banks, and large corporations hold millions in secondary reserves or idle balances which, if employed, must be available on very short notice. Much of this money cannot ordinarily be invested to advantage in short-term Governments, since the uncertainty of the period for which it might be invested, together with the trouble and risk involved in investment, tends to outweigh the interest that might be earned. It could be made available, however, for loans which are fully secured and subject to immediate call.

The potential supply of funds to a call-money market goes beyond this, however. A number of nonfinancial corporations and outlying banks are presently attempting to maintain reasonably fully invested positions in short-term Government securities, although they may not have the skilled personnel needed to limit risk while taking full advantage of the investment opportunities. Such investors might be better off to lend on call to Government security dealers rather than to hold securities themselves. On an average, a larger proportion of their secondary reserves could be safely invested in the day-to-day call loan. Thus, although they would ordinarily get a lower gross rate on a dealer loan than on the securities, the total net return to such lenders from the fuller use of their secondary reserve funds might well be larger in case dealer loans were available than the return they now obtain from more limited investment in Government securities. In addition, the time devoted by those who are following the Government securities market could be diverted to other activities.

It seems clear that the existence of an organized call-money market would be a major factor in encouraging dealers to assume a more active role in the Government securities market, thereby enlarging the scope of that market. It also seems likely that recent changes in the role of credit in the economy and the resulting greater need to economize on financial resources enlarges the potential demand for such an institution on the part of both lenders and borrowers. Banks

outside the money centers would find it very useful for close administration of their reserve positions. Business corporations would find it an outlet for surplus idle balances. New York City banks could service the loans for a fee.

The feasibility of a call-money post using such arrangements was demonstrated by the experience with the post of the New York Stock Exchange in the twenties. In the money-post operation of that decade, the New York banks made the loans for their correspondents on an agency basis. Low-cost techniques for handling collateral, including the substitution of collateral, were worked out. Considering the greater ease of handling Government securities and the larger loan unit that might be used, it may be that even more efficient procedures could be developed now for loans to Government security dealers. It was also the experience with the old call-money post that this market provided banks with a very useful mechanism for the rapid adjustment of reserve positions and that it served as a ready outlet for idle business funds.

It is fully recognized that one major question regarding the feasibility of a present-day call-money post for loans to Government security dealers would be whether lenders could safely depend on it as an adequate, consistent outlet for credit. Could such a call-loan market be large enough and stable enough to be a reliable mechanism for handling the secondary reserve positions of outlying banks? Obviously, a call-loan market of this size would require time for development. Dealers now are carrying positions which are small in relation to the size of the market. Nevertheless, in view of the fact that dealers are making outside arrangements for credit at considerable cost, it may be worth while to explore the possibility that an organized market might again be developed.

#### COMMENTS OF THE FEDERAL RESERVE BANK OF NEW YORK ON REPORT OF THE AD HOC SUBCOMMITTEE ON THE GOVERNMENT SECURITIES MARKET

##### PREFACE

The Ad Hoc Subcommittee on the Government Securities Market addressed itself to a study of the market under the changed conditions that have resulted from abandonment by the Federal Reserve System of its support of a relatively fixed pattern of prices and yields, and to an examination of the relevance and adequacy of the Federal Open Market Committee's own procedures and operations in the context of a market free to respond to changes in supply and demand. The report of the subcommittee emphasizes that the Federal Open Market Committee should be in a position to operate promptly and in appropriate volume at all times without fear of disruptive technical repercussions on the market. This, it is suggested, requires a market characterized by "depth, breadth, and resiliency." Consequently, the subcommittee says, "It is with these characteristics of the market that this report is mainly concerned."

The subcommittee concludes that the best way in which the Federal Open Market Committee can promote the development of these market characteristics is to reduce its intervention in the market to the minimum required for the execution of monetary and credit policies. Furthermore, it recommends that such intervention be limited to short-term securities, preferably Treasury bills; that the operating techniques and relations with the Treasury of the Federal Open Market Committee be changed to conform with the principles of minimum intervention; that "ground rules" be made known to the dealers, which will henceforth govern the transactions of the Federal Open Market Committee with dealers; and that specific measures be adopted to facilitate the financing of dealers (and in this connection, revival of a call loan market be studied). Finally, "The subcommittee finds many anomalies in the structure and organization of the Federal Open Market Committee \* \* \*" and recommends "that the Committee reexamine and review its present organization, and in particular that it consider the advantages and disadvantages that would ensue, were the manager of the open-market account made directly responsible to the Federal Open Market Committee as a whole, and not, as at present, responsible through the Federal Reserve Bank of New York."

The Federal Open Market Committee, with the general concurrence of other officials of the System, has already moved a considerable distance in the direction of certain of the recommendations. Other recommendations, however, raise a number of questions. Among them are the following:

1. May not there be overemphasis on promoting the "depth, breadth, and resiliency" of the market for Government securities as an appropriate aim of the Federal Reserve System? And will those characteristics, in fact, be promoted

at all times by minimizing System intervention in the market and by confining System operations to short-term securities?

2. Are such market characteristics always essential to the effective execution of the monetary and credit policies of the System? Or may there, at times, be conflict between efforts on the part of the System to promote these characteristics and achievement of the aims of monetary and credit policies?

3. Is limitation of Federal open-market operations to very short-term securities necessarily consistent with minimum intervention in the Government securities market in all circumstances? May not such limitation, in fact, require larger-scale intervention at times, with resulting unnecessary expansion in the volume of Federal Reserve credit outstanding? Also, may it not risk unnecessary repercussions and distortions in one sector of the market?

4. In view of such questions, how far is it necessary or appropriate for the Federal Open Market Committee to go in making commitments limiting its scope of action for the future?

5. (A related question) Are "ground rules" of the kind suggested necessary to enable dealers to operate effectively, and would they constitute any guaranty of dealer operations of such a character as to promote the "depth, breadth, and resiliency" of the market? Can we have be sure that they would contribute to, and not interfere with, the effectiveness of System operations?

6. Would extension of repurchase facilities more freely to the dealers be consistent with the principle of minimum intervention in the market? Or would it constitute a new and indirect form of market support?

7. If the system of recognized dealers were abandoned, should the manager of the open-market account be left to decide in his own discretion with whom he will deal? Or what criteria should he observe in declining with whom he will deal?

8. If the system of recognized dealers were retained, but the list of such dealers revised, what are the qualifications that should be observed in determining which dealers to "recognize"?

9. If, in conducting certain special types of transactions, such as those designed to correct disorderly market conditions, the manager of the account is to do business with dealers outside the recognized group (if that group is continued), on what basis should he distribute the business?

10. What advantages to the Federal Open Market Committee or to the System as a whole are expected to result from curtailing the sources of information available to the manager of the account? What disadvantages might result?

11. Is it correct to say that the aspects of the present organization of the Federal Open Market Committee mentioned at the bottom of page 85 are "anomalous"? Or are there good reasons based on past experience for the present type of organizational arrangements?

12. Are the presumed disadvantages of the present status of the manager of the account valid? Would it be a feasible and effective arrangement to have the manager of the account conduct day-to-day (and, in fact, hour-to-hour) operations under the direction of the Federal Open Market Committee as a whole or its executive committee?

These and related matters are discussed in the following pages in three main sections. Part I deals with broad questions of policy; part II with the details of procedures and relations with dealers; and part III with organizational arrangements for conducting open-market operations. A final section sums up the conclusions indicated by the preceding sections.

## I. THE SYSTEM'S INTEREST IN AND GENERAL RELATIONS WITH THE GOVERNMENT SECURITY MARKET

Continued active interest of the Federal Open Market Committee and of the Federal Reserve System generally in the market for Government securities is inevitable, despite the withdrawal from active support of the market early in 1951. That, action could not mean complete divorcement of the System from any involvement with the market, since, as the subcommittee points out, the Federal open market account is still the largest single holder of Government securities. Not only do the System's open market operations have greater potential effects on the market than those of any other investor (because of their effect on bank reserves), but even inactivity of the System account—in the form of declination to participate in arbitrage operations, for example—may have an important influence on the market. The "accord" had as its major objective

freeing the System, not to withdraw from the market entirely, but rather to operate in a manner consistent with the dictates of monetary and credit policy, and thus to restore open market operations to their potential position as the one most important instrument of System policy.

Unquestionably, as the report of the subcommittee points out, effective execution of open market policies requires a Government securities market of some "depth, breadth, and resiliency," yet there may be danger in going quite so far as the subcommittee has done in accepting the promotion of such market characteristics as a major objective of the Federal Reserve System. In order to promote them, the subcommittee proposes various commitments with respect to open market policies and operations which require the most careful consideration by the System to make sure that any such commitments, if adopted, would not prove a handicap in carrying out effectively the System's major responsibilities for monetary and credit policy.

The market characteristics just mentioned, and repeatedly emphasized in the subcommittee report, unquestionably are desirable from the viewpoint of debt management, but is it equally clear that the interests of debt management and of monetary policy necessarily coincide in this respect under all circumstances? May it not, in fact, be more desirable from the viewpoint of monetary policy to inhibit some types of market activities at times—particularly those which tend to facilitate expansion of bank credit in periods when the System is endeavoring to restrain credit expansion?

Still fresh in our minds is the extensive discussion of the question of shifting the public debt more largely into nonmarketable form and of compartmentalizing the debt to a much greater extent as a means of reducing potential offerings on the market of Government securities. It is true that such proposals were most relevant before the System had freed itself from the responsibility for maintaining relatively stable prices and rates in the Government securities market, and have become less relevant since the "accord." In any event, the subcommittee report reflects a strong tendency in the direction of broadening the market by permitting and encouraging the free play of the forces of supply and demand, rather than of recommending measures designed to narrow the market, and with that general tendency we would express no disagreement.

A related question, however, is whether to aim for a market which will be capable of absorbing the purchases and sales which the Federal Open Market Committee deems necessary or desirable to achieve a given effect on the reserve position of the commercial banking system with a minimum of price reaction in the Government securities market, or whether in some circumstances the System's major objectives may not be promoted by the effects of its open market operations on prices of Government securities and the resulting impact on financial markets generally. The inhibiting effect of price reductions for marketable Government securities since the "accord" on the tendency of savings institutions and banks alike to shift from Government securities to loans and investments for the financing of private activities is a case in point.

But even from the viewpoint of promoting the "depth, breadth, and resiliency" of the Government securities market, it may be questioned whether the program suggested by the subcommittee, involving as it does assurances that the System will reduce its intervention in the market to a minimum and that it will limit its operations to very short-term securities, will be the most effective in all circumstances. For example, the assurance<sup>1</sup> given by the System during World War II that it would maintain a fixed pattern of rates was probably more effective than any other that could have been given in promoting the "depth, breadth, and resiliency" of the Government security market at that time. Undoubtedly there are a variety of circumstances in which many individuals and institutions would be attracted to Government securities if they felt confident that the System would act to maintain the prices of such securities, but would not want to assume the risks of price fluctuations in a free market. Obviously, the subcommittee would not favor a return to such practices, even though failure to do so may sometimes result in a more limited market.

Furthermore, the idea that the dealers will be encouraged to take larger positions and to make broader and firmer markets, once the System gives assurance that it will stay out of all but the short-term sector of the market, deserves scrutiny. The argument is that "a disconcerting degree of uncertainty exists

<sup>1</sup> There was no formal, publicly announced, assurance of this kind, but the System's actions were tantamount to such assurance.



among professional dealers and investors in Government securities with respect both to the occasions which the Federal Open Market Committee might consider appropriate for intervention and to the sector of the market in which such intervention might occur, an uncertainty that is detrimental to the development of depth, breadth, and resiliency of the market." It is hard to believe that such a degree of uncertainty still persists after 2 years in which intervention by the System in the Government securities market has been progressively reduced and for some time has been limited almost exclusively to short-term securities. Perhaps to some considerable degree this aspect of the report may already have become outdated. In any event, it must be remembered that the dealers are operating primarily with a view to making profits, and consequently that their inevitable tendency is to sell short and back away from offerings in a declining market and to extend their positions in a rising market. Thus, instead of exerting a stabilizing influence on the market, they tend to accentuate its swings—at least over short periods. Clearly it is the appraisals of the outlook for interest rates and security prices by dealers and investors, much more than any fear (or hope) of intervention by the System in the market for particular securities, that determine the "depth, breadth, and resiliency" of the market at any given time. Fear of adverse trends, or uncertainty as to what the trend is likely to be, is the predominant reason for thin markets, rather than apprehensions concerning System intervention in particular sectors to limit price movements.

From all this, the conclusion seems inescapable that the operating policies of the System most conducive to the market characteristics emphasized by the subcommittee will not always be those most conducive to effectuate monetary and credit policies. And, where the two considerations conflict, it must be assumed that the Federal Open Market Committee will wish to follow the course of action most favorable to the latter. It is on the basis of this assumption that the specific recommendations of the subcommittee should be examined.

#### *Assurances or commitments*

The major commitment which the subcommittee suggests as a means of eliminating uncertainty in the market with respect to the operating policies of the Federal Open Market Committee is "an assurance from the Federal Open Market Committee that henceforth it will intervene in the market, not to impose on the market any particular pattern of prices and yields but solely to effectuate the objectives of monetary and credit policy, and that it will confine such intervention to transactions in very short term securities, preferably bills." With the first part of this assurance we can readily agree, provided the objectives of monetary and credit policy are not interpreted too narrowly. The last part of the suggested assurance, however, is much more questionable. It is quite likely that in most circumstances the System will be able to attain its policy objectives by operating only in the market for Treasury bills and other short-term securities. It is at least possible, however, that on some occasions the System might better be able to effectuate its policies by operating in other sectors of the market—even the longest maturities—depending on the economic conditions then prevailing, investor and market psychology and expectations, the structure of the public debt, etc. In most circumstances, when intervention in the long-term market by the System was considered appropriate or necessary, restriction of operations to short-term securities would probably either make the System's intervention ineffective or require larger scale intervention to achieve the objectives.

To illustrate the last point, a situation such as that created by the outbreak of war in 1939 may be cited. This would come under the heading of a potentially disorderly situation, of course, and the subcommittee would doubtless agree that the System could not then have corrected conditions in the market by operations limited to Treasury bills. The bill rate was already close to zero and the banks held large amounts of excess reserves, so that there was little likelihood that injections of Federal Reserve credit into the short-term market could have been effective in remedying the acute weakness in the long-term market. It may be conceded that the same conditions are not likely to recur in the foreseeable future, but in the event of a sudden shock to the long-term market of such a nature as to call for intervention by the System it is probable that the only effective form of action would be to make purchases in that sector of the market.

Furthermore, continuing operations to very short term securities might involve other problems. Frequently there is a heavy demand for such securities—for example, for temporary investment of corporation funds pending dividend and other disbursements—and System purchases in that sector of the market might cause distortions in the interest rate structure and interfere with the legitimate

investment operations of others. It is emphasized in the preface to the subcommittee report, "that the possibility be minimized of disruptive technical market repercussions from Committee transactions." Limiting the scope of System operations too narrowly might increase, rather than reduce, the likelihood of just such disruptive repercussions. Bearing in mind the unforeseen developments that may arise in the future, it would seem better to keep a free hand to conduct System operations in such a way as to avoid distortions in the market and in the interest rate pattern which would serve no good purpose.

Against the background of System account operations for some months past, the emphasis in the report on avoiding operations in longer term securities seems rather outdated. Probably some of those who appeared before the subcommittee and complained of various aspects of the System's open market operations were still thinking in terms of certain practices that were followed at the time when the System was endeavoring to maintain the stability of Government security prices with a minimum extension of Federal Reserve credit. Surely, "the market" has now had enough experience with the System's changed operating policies so that trading in the intermediate and long-term maturities is no longer appreciably affected by any fear (or hope) of System intervention.

But there are broader grounds for questioning the advisability of a commitment to operate only in the short-term market. First of all, there is serious question whether the facilities for market "arbitrage" are so highly developed, or could be, as to assure a smooth flow of reactions from any System action in the short-term area throughout the longer sectors of the market in all circumstances. The subcommittee refers to operations in the short-term market as traditional central banking policy, but one of the major questions raised concerning traditional central banking policy concerns its ability to achieve the general restraint or ease intended solely through action in the short-term market.<sup>2</sup>

The degree to which arbitrage operations between different maturities of Government securities or among different types of investments could be expected to prevent unnecessary price fluctuations or to encourage a freer flow of investor funds in the market for Government bonds is extremely uncertain. The record indicates that little may be dependably expected through movements of funds from short- to long-term Government issues. In fact, in the conditions of market uncertainty characteristic of an incipient disorderly market, short- and long-term rates might be expected to move counter to each other under the impact of a disequilibrating, rather than an equilibrating, movement of funds. At periods of temporary money-market ease or tightness, the resulting yield movements on short-term securities might encourage a trickle of funds into or out of longer maturities, but this marginal movement very probably would be insignificant in influencing long-term prices by contrast with the particular set of longer run expectations prevalent in the bond market at the time. These expectations might or might not be pushing long-term prices in the same direction of movement prevailing in the short market. At several places in the subcommittee's report a close positive correlation is described between very short and long-term yield movements; the fact that such a correlation would be least likely to exist at some times when it was wanted and would be fortuitous, at best, at others casts doubt on the wisdom of relying upon short-term securities, and "market arbitrage," to effectuate all phases of open-market policy.

#### *Outstanding commitments*

In connection with the major "assurance" which it recommends, the subcommittee refers to two outstanding commitments "that may require intervention by the Federal Open Market Committee in other than the very short-term sectors of the market, and that may add to or subtract from reserve funds available to the market for purposes other than the pursuit of monetary policies directed toward financial equilibrium and economic stability." These are the commitment to maintain orderly markets and the practices involved in aiding Treasury refunding operations. (The latter, however, can hardly be called a

<sup>2</sup> This criticism was made strongly, for example, by J. M. Keynes in *A Treatise on Money* (1931), particularly in vol. II, pp. 362-63. In the preceding pages he referred to evidence taken from W. W. Riefler, *Money Rates and Money Markets* (1930), showing that changes in the short market at that time did exert some effect on the long market, but he questioned whether such effects were adequate and dependable. Riefler himself said (p. 218), "Whether the effect of credit policy on money rates . . . could ever seriously affect the level of bond yields . . . raises a question . . . that does not lend itself either to categorical affirmation or denial."

commitment, since actual intervention by the System in connection with Treasury refundings has varied in recent months from very sizable operations to none.) With respect to the first, the emphasis within the System has already been shifting from maintaining orderly market conditions to preventing disorderly conditions, and formalization of the change, as suggested by the subcommittee, would seem quite appropriate.

Consideration of the course of action most likely to be effective in dealing with disorderly market conditions, however, provides a good illustration of the questionability of a commitment to confine the System operations to short-term securities. If the disorderly conditions developed at a time when the general policy of the System was to restrain credit expansion, it would be most desirable to hold the injection of Federal Reserve credit into the market to a minimum. But if the disorderly conditions were most acute in the long-term sector of the market, it is most likely that the greatest effect could be achieved with the smallest extension of Federal Reserve credit by operating directly in that sector of the market. In fact, it is questionable whether the desired results could be achieved at all by operating only in short-term securities. Furthermore, it is quite possible that the purchases of long-term securities could be offset by sales or redemptions of short-term securities. On the other hand, if an attempt were made to deal with the situation by buying only short-term securities, no offsets would be possible—at least until after some considerable lapse of time.

As the second so-called "commitment," involving support of Treasury refunding operations, the active participants in the market know by this time that intervention by the System cannot be counted upon, and presumably the Treasury has the same understanding. (In this instance, also, actual events may have overtaken the subcommittee's report.) Nevertheless, it may be worth considering in this case, specifically, whether it is desirable for the Federal Open Market Committee to make definite commitments as to what it will not do. In some circumstances the Committee might (provided the maturity distribution of securities in the Federal open-market account permits) find it advantageous to reduce attrition through swaps—on whatever price basis seemed appropriate—and to that extent reduce the need for subsequent Treasury financing and avoid unnecessary interference with the execution of the System's credit policy. In connection with certain refunding operations, it might conceivably be useful to have in the Federal open-market account more of a new issue than would be acquired through the direct exchange of existing holdings. Swaps to obtain the "rights" would not involve any extension of Federal Reserve credit and, unless they involved depletion of the System's holdings of maturities which might be needed later, would not interfere with the System's credit policy.<sup>3</sup>

#### *Repurchase facilities*

One recommendation of the subcommittee, which is classified among "operating techniques," but which involves a matter of System credit policy, is the proposal "that repurchase facilities at an appropriate rate and with appropriate limitation as to volume be made regularly available to nonbank dealers over weekends." To be of any material assistance to the dealers, and effective in enlarging the market for Government securities, presumably the repurchase facilities offered would have to be substantial. That might mean fairly regular extension of Federal Reserve credit at the option of the market, which would correspondingly increase member-bank reserves and reduce the need of member banks to borrow from the Reserve banks. In fact, the arrangement would probably be used frequently to enable the dealers to make temporary purchases of securities from banks and thus to bolster their reserves during tight-money periods. Consequently, it might tend to undermine the System's credit policy at times when the System was trying to restrain credit expansion by forcing member banks to borrow in order to maintain their required reserves. Furthermore,

<sup>3</sup> Incidentally, the danger that the open-market account might become frozen as a result of acquisitions of securities involved in refunding operations (discussed on pp. 35 and 36 of the report) raises the question of whether more could not be done toward redistribution of maturities in the account by responding to swap offers from dealers between Treasury offerings, if and when they suited our convenience. Such swaps (or practically simultaneous sales and purchases, sometimes involving different dealers) were made frequently in past years. Far from constituting undesirable intervention in the market, they frequently contributed to the "depth, breadth, and resiliency" of the market, and were advantageous to the System as well.

the fact should not be overlooked that extension of repurchase facilities to dealers constitutes, in effect, indirect intervention in the market and so tends to conflict with the objective of promoting as free a market as possible.

In general, it would seem more in keeping with the recommendation that intervention in the market be "solely to effectuate the objectives of monetary and credit policy," to reduce any form of automatic access to Federal Reserve credit to a minimum. Difficulties experienced by dealers in financing their portfolios on satisfactory terms and their consequent unwillingness to buy additional securities may, in fact, be helpful in making restrictive System policies effective. This is another illustration of the way in which the objective of promoting the "depth, breadth, and resiliency" of the market may be inconsistent with the objective of pursuing effective monetary and credit policies.

This discussion, however, should not be interpreted to mean that making repurchase facilities available to the dealers will never serve a useful purpose from the viewpoint of System policy. Unnecessary disturbances in the money market and wide fluctuations in interest rates caused by purely seasonal or other temporary phenomena serve no good purpose and can at times be avoided or minimized by opening the repurchase agreement window to dealers. But it would seem more consistent with the policy of limiting System intervention in the market "solely to effectuate the objectives of monetary and credit policy" that it be done deliberately on the System's initiative and not as a matter of routine.

#### *Ground rules*

The suggested "ground rules" to be made known to Government security dealers to clarify the System's relations with the market involve mainly the assurances or commitments discussed above as well as the matter of repurchase facilities. They also involve the specific relationships of the System with dealers which are discussed in section II which follows. Dealers, of course, would very much like the Federal Reserve System to telegraph its intended actions in advance, so that they could conduct their affairs in such a manner as to maximize their profits and minimize their losses. They would like to be in the position of "shooting fish in a bucket," but there is no obvious reason why the System should cater to that desire. The more understanding and self-reliant among them do not expect anything of the sort, but realize that they must draw their own conclusions as to what lies ahead and assume their own risks in return for the profits they hope to make. The advisability or inadvisability of promulgating any suggested ground rules will have to be decided, not on the basis of dealer preferences, but on the basis of the conclusions reached as to whether such rules would contribute to the effectiveness of the System's operations.

There are times when uncertainty in the market as to what the System will do may be helpful in promoting the System's credit policy objectives. To illustrate, if dealers are uncertain whether or not the Reserve banks will take Government securities from them under resale agreement—over weekends or at any other time—they will be more cautious in buying additional securities; potential sellers will find that they cannot so readily convert Government securities into cash; and the System will avoid opening its doors to ready access to Federal Reserve credit. Such effects of uncertainty in the Government security market may at times be highly desirable from the viewpoint of monetary and credit policy, even though they may limit the breadth and activity of the market for Government securities.

To the extent that is considered desirable to promote a better understanding of the general character of the System's operations that may be expected, may it not be better to convey to the market, through a consistent pattern of operations, a good understanding of the general principles and procedures of the Federal Open Market Committee than to make specific pronouncements which might, in some circumstances, be unnecessarily restrictive and embarrassing? If the recent operating policies of the System are continued, operations in the short-term sector of the market will soon come to be regarded as the normal expectation, and it will be observed that operations in other sectors are undertaken only for good reasons.

#### *Relations with the Treasury*

Mr. Sproull's notes on this subject were presented at the meeting of Reserve bank president with members of the Board of Governors on January 27. A copy of his notes is attached as an appendix.

## II. SPECIFIC RELATIONS WITH DEALERS

*General comment*

It is the view of the subcommittee report that, despite the presence of generally satisfactory organizational elements, the market currently lacks "depth, breadth, and resiliency" to the full degree that would be desirable for the efficient conduct of effective and responsive open-market operations. This condition, in the view of the subcommittee, is in part a product of the character of Federal Open Market Committee market relations which have, in the present context, become a barrier to the full development of the attributes considered necessary for an efficient market. The reasons for this, the subcommittee believes, are to be found in (1) the existing dealer-qualification procedures which, on the one hand, limit the advantages to the System accruing from the market's facilities and, on the other hand, inhibit the development and effective operation of dealer firms by denying to them the "privilege" and advantages of handling transactions for the System and obtaining credit through repurchase agreement, and (2) the operating techniques of the Federal Open Market Committee which involve paternalistic interference with dealer activities and an undue "personal" intrusion in their operations and business affairs.

The specific recommendations of the subcommittee for remedial action in these general areas are reviewed and examined in this section. A few broad observations appear to be in order, however, before turning specifically to individual recommendations. The Federal Reserve Bank of New York recognizes much that is sound in the detailed proposals covering our specific relations with the dealer market. Many of those proposals are an acknowledgment of a changed situation—a situation in which we have shed as much as possible of the role of price fixing in the Government securities market. Most of them are broadly consistent with the procedures followed over the past 20 months, since the "accord," by the Federal Open Market Committee and by the manager of the account in areas where he had discretionary authority. Hence, some of the practices and procedures singled out for review and corrections have already been modified or discarded in response to new conditions in the Government security market and to the requirements of a more nearly traditional approach in the application of a policy of general credit control. To some extent, therefore, actual events have overtaken the subcommittee's report. Other proposals of the subcommittee have not been tried, or recommended for trial by the Federal Reserve Bank of New York because they either present no clear-cut advantages or raise new problems requiring further examination and experience for solution.

It is important to bear in mind in considering this section of the report and the contributions to be expected from the proposed change in operating techniques that "breadth, depth, and resiliency" are not absolutely concepts as they relate to the Government securities market; they can at best be realized only in a relative sense and gains or progress to this end should not be bought at too high a price in terms of credit policy or by inviting new and possibly more difficult problems in market relationships and policy implementation. There must be assurance that the basis of the account's dealer relationship, if appreciably broadened, does not invite more, rather than less, activity in the System account by widening dealer access to Federal Reserve credit, that the System has the technical information necessary to enable it to render informed judgments as to the need and the character and timing of operations in the market, and that it avoids the dangers of extreme reaction in attempting to be too impersonal in a market that is itself personal in character, based on the principle of negotiated transactions.

*Dealer qualification*

The ad hoc subcommittee finds no present or prospective justification for continuing the present system of rigid qualification for dealers with whom the account will transact business and recommends that the system be dropped. As an alternative, the subcommittee suggests a revision in the list of qualified dealers and the abandonment of a policy of differentiating between qualified and other dealers in the case of repurchase agreements, purchases of "rights" (if any) in support of Treasury refunding operations, and transactions to correct disorderly markets. This is a case of Hobson's choice: to accept the second alternative is in effect tantamount to concurring on the first, or basic recommendation.

For a full understanding of the present qualification procedures a brief description of its antecedent is necessary. The whole question of dealer relations was reexamined by the Federal Open Market Committee in 1943. Early in 1944

the Federal Open Market Committee formally approved the procedure currently in effect governing System-dealer relations. In explaining that action in the Record of Policy Actions of the Federal Open Market Committee in the Annual Report of the Board of Governors of the Federal Reserve System for 1944 the following statement is made:

"The \* \* \* action of the Federal Open Market Committee followed a thorough study of the relationships with the dealers and brokers through which transactions for the System open-market account were executed. The Committee felt that, although the informal arrangement that had existed previously was satisfactory for a period when the volume and amount of transactions for the System open-market account were relatively small, the increase in the activity of the account, and the likelihood that operations in very large amounts would continue during the remainder of the war and into the postwar period, made it desirable to place the existing relationships on a formal basis. The terms of agreement represents in substance the informal agreement that had been in effect between the Federal Reserve Bank of New York, as agent, and the dealers and brokers with whom the Reserve bank previously had transacted business for the System open-market account."

Qualification procedures, involving dealer "recognition," in some form have always been used in dealing with the market. Formalization of those procedures in 1944, as the culmination of a thoroughgoing review in 1943 of the System-dealer relationship, was not consciously or deliberately related to, or developed as an integral part of, the whole apparatus of pegged markets which reached its zenith some 4 years later. It was, on the contrary, recognition of a need to lay down principles governing operating procedures which would be understandable and defensible in the circumstances then existing or likely to eventuate; and in serving that purpose it formalized and continued in operation a system of market contact that was originally set up at the Federal Reserve Bank of New York to serve the interests of credit policy.

The Federal Reserve Bank of New York holds no brief for the present qualification procedures or for their maintenance on a formal footing. They are admittedly imperfect procedures which have been under almost continuous criticism and review at the Federal Reserve bank since their formal adoption. In considering this aspect of the System's market relation the Federal Reserve Bank of New York does, however, start from the premise that some procedure for the designation or the qualification of dealers for transactions with the Federal Reserve banks is both necessary and desirable if our dealings with the market are to be handled in the most effective way. It is, therefore, no wholly constructive or final solution to advocate the dropping of current qualification procedures; for that course leaves unanswered more questions than it settles.

The basic recommendation on dealer relationships in the ad hoc subcommittee report points up the need for a redetermination by the Federal Open Market Committee, of its position on dealer qualification and a decision by it as to whether the details of System account contact with the dealer market are to be laid down by it, as a policy body, or are to be delegated to the Federal Reserve Bank of New York, chosen as the executive agent of the Federal Open Market Committee, and the officer of the bank selected to serve as manager of the account. Once that basic question has been answered, there remain the subsidiary matters of appraising the advantages and drawbacks of a formalized procedure whose inflexibility precludes operations, in special situations, with some of the smaller dealers, as against an informal procedure with latitude for discretion in action. Finally, the Committee itself or the Federal Reserve bank, acting as the agent of the Federal Reserve System as a whole with the aid of the manager of the System open-market account, would be still faced with the task of developing workable criteria governing the choice of dealers eligible for handling transactions with the System open-market account.

Either way, the "problems" of dealer-Federal Reserve System relations will not be easy. The Federal Reserve Bank of New York, as fiscal agent of the Treasury and in its agency capacity for various foreign central banks and others, will continue to be an important factor in the Government securities market and it will, through its directors, continue to make a determination with respect to those dealers through whom it is prepared, as agent, to execute orders in Government securities. Insofar as practicable, those procedures would have to be broadly consistent with those governing open-market operations if it were intended to screen from the market the account for which particular operations are carried out. On the other hand, if different procedures were used and if the market were

able to distinguish between transactions by the bank, as agent for the Federal Reserve System and transactions by it in its other agency capacities, dealers and others might continue to be dissatisfied and articulate in their criticism of the System on the grounds that its choice of dealers was a wholly capricious one. If any distinction is made between dealers serving the bank as it functions in its two leading capacities in the market, the question will inevitably arise in the public mind as to why two sets of standards are utilized.

Whichever way these decisions may go, however, difficulties in connection with the question of qualification will be faced by the Federal Reserve Bank of New York and the Federal Open Market Committee in justifying whatever procedure is adopted governing their relations with dealers; for no matter what their formality or their informality may be, or their criteria or the lack of them, those procedures will inevitably involve the recurring questions of the marginal firm and the equity or justification of excluding it. We shall always have the problem of differentiating between one set of dealers and another on some basis. For even if there is no list of qualified dealers, the bank cannot do business with everyone all the time. That would be an administrative impracticability. How, then, shall the bank distribute its business? There will have to be some principles, and their effect will have to be to include some dealers and exclude others, whether that is formalized as a qualification procedure or not.

The alternative to discarding existing qualification procedures presented by the subcommittee, i. e., revision of the list of qualified dealers, and limited qualification of "nonrecognized" dealers—presumably any dealer—for certain types of transactions, is not a promising line of approach. Under existing practice, the qualification procedures are applied by the manager of the account. By and large the factors to be taken into account in determining qualification have been applied with reasonable flexibility and all decisions by the manager have received Federal Open Market Committee approval. It is true that there is some room for revision of the list of presently qualified firms within the existing framework, but any such revision might, if based on stricter interpretation, result in a contraction rather than an expansion in the number of dealers serving the account, a course which would presumably be at cross-purposes with the objective of the ad hoc subcommittee. To do otherwise would be to vitiate the standards, and then new ones would have to be substituted. The subcommittee does not suggest any different standards. Consequently further study of that question will have to await the development of substitute criteria.

Related to the suggestion for a revision in the list of qualified firms is the recommendation that the account undertake transactions—to the extent that such transactions are called for—with dealers, other than those qualified, in the case of transactions in "rights" to support Treasury refunding operations and to correct disorderly markets, and to enter into repurchase agreements with all dealers who participate regularly in the weekly bill auction. Taken collectively, these are, of course, important areas of System intervention, although each is of shifting relative importance, repurchase agreements being currently the most significant. Viewing the use of repurchase agreements as an orderly market operation, this is little more than a recommendation that the System use various dealer groups on the basis of a functional distinction in System open-market operations which would limit outright transactions for purely credit purposes to qualified firms. This dual standard of qualification is questionable, for it breaches the qualification procedure not for the purpose of promoting the System's major policy objectives, but for the sake of secondary purposes—for what are, in effect, "orderly market" operations and support of Treasury financing. It would seem preferable from the standpoint of the market and the System to have a uniform, defensible, and easily understood procedure for all transactions under Federal Open Market Committee direction.

#### *Operating techniques*

Under the heading of "Operating Techniques" the subcommittee report recommends the discontinuance of the following practices:

1. "Reluctant buying";
2. Agency transactions for the System account;
3. Refusal to purchase "rights", to the extent that any "rights" are purchased, from dealer positions as well as from customers; and
4. Refusal to buy bills acquired by dealers on a cash basis.

These proposals for change in operating procedure are among those which have now been overtaken by actual events insofar as their immediate application



is concerned. The practices cited were initially undertaken at different times in the past for valid reasons with the knowledge or approval of the Federal Open Market Committee, but have since been virtually abandoned as operating techniques following "accord" with the Treasury and the subsequent development of a freer market for United States Government securities. In general, the recommendations in this section of the report represent desirable procedures at this time which are in conformity with current practice but it would seem that there are not, and probably cannot in practice, be any ironclad rules governing Federal Reserve System open market techniques under the full range of unpredictable market circumstances and credit policy problems arising out of alternating programs of restraint, neutrality and ease.

*"Reluctant buying."*—The subcommittee favors the complete abandonment of "reluctant buying." The practice of "reluctant buying" predates World War II although it found its most extensive use during the periods of heavy support of the long-term market at fixed prices in the early postwar years. It was used primarily in dealing with sophisticated investors who were large holders of Treasury bonds and who were anxious to sell but were not easily stampeded by rumors. Its use was based on the belief that it was the best way to hold the line on security prices without unnecessarily large expenditure of Federal Reserve credit. Support operations, to which this practice was primarily related, have long since been abandoned. If applied to operations undertaken to correct disorderly market conditions, the recommendation for "aggressive" as opposed to "reluctant" buying may require further consideration.

In certain types of situations "reluctant buying" rather than "aggressive buying" can be a technique which tends to support rather than defeat a restrictive or neutral credit policy. There would appear to be no immediate use for this device as an operating procedure in the context of current credit policy and prevailing market conditions and, therefore, it would seem unwise to advocate either "reluctant" or "aggressive" buying at this time. The use of either technique in the future, as in the past, should depend on the circumstances and on other System policies.

*Abandonment of transactions for the System account on an agency basis.*—The subcommittee recommendation that "agency transactions be abandoned and that the account conduct its transactions with dealers as principals on a net basis" seems appropriate so long as open market operations are limited almost exclusively to the execution of credit policy. When the System is undertaking to provide the banks with additional reserves through open market operations, there is no apparent reason why it should matter whether the securities come from the portfolios of dealers or from investors so long as the price is satisfactory. It is essentially a practice that has primary reference to price support activities and not the realization of credit objectives.

In the pre-accord years, the Federal Open Market Committee showed a pronounced preference for effecting transactions with dealers in United States Government securities acting as agents rather than as principals. The Committee's concern with the capacity in which a dealer acted in connection with a System transaction was an outgrowth of the increase in the public debt, an expansion in over-the-counter activity in Government securities and the need for more active participation by the System in the market in connection with wartime rate stabilization operations. It reflected, in part, an effort to limit dealer revenues arising from System operations and, to that extent, to encourage the conduct of business "away from the System" insofar as commissions might be an influence. The practice was continued in the postwar years along with market stabilization policies. At a meeting on June 10, 1946, the executive committee of the Federal Open Market Committee decided that transactions in which a dealer was acting as principal should be limited to exceptional cases. Two years later further consideration was given to the question of agency and principal transactions, and at the meeting of the Executive Committee on May 20, 1948, it was decided to permit transactions in Treasury bonds between the Federal Reserve Bank of New York and qualified dealers, with the dealers acting as principals rather than as agents in cases where it appears desirable, in the interest of maintaining an orderly market, to avoid identification by the market of System operations. The latter action reflected only a nominal relaxation in the Committee's preference for effecting transactions with dealers on an agency basis.

Agency transactions by the dealers worked well in a supported market when the System was dealing with a "residue" which was in reality a large part of one side of the market. But it has little relevance to the present market and the effort of the System to regain initiative over the availability and supply of re-

serves on the basis of its own criteria. Actually no transactions have been made on an agency basis for over a year except those connected with the support of certain Treasury refundings where it was desirable to limit the dealer incentive to buy "rights" for resale to the System account.

In line with the subcommittee's recommendation, it would appear desirable in terms of both policy execution and market mechanics that the current direction from the Federal Open Market Committee regarding transactions for the account on an agency basis be revoked and that in lieu of it the manager of the account be granted full discretion as to whether System open market account transactions are to be conducted with dealers acting as principal or as agent.

*Purchase of "rights" from dealer position.*—The subcommittee report recommends that if "rights" are acquired during Treasury refunding operations they be purchased from dealers without regard to whether or not they come from dealer positions. In considering this proposal it should be said that the manager of the account has never followed a specific policy of deliberately abstaining from purchasing "rights" from dealer positions. In fact, transactions in support of Treasury refunding operations have more often than not included purchases of "rights" from dealer positions, depending upon the particular circumstances governing the refunding operation. The manager has felt justified, on occasions, in refusing to relieve dealers of all "rights" offered to the account for sale in this situation where—

1. the dealers needed to be reminded of their stake in the market and of their responsibility as dealers to carry in position reasonable amounts of such "rights," and

2. it was necessary to avoid exploitation of System operations in support of Treasury refundings by dealers who had acquired "rights" on a speculative basis in advance of such refunding operations and later attempted to unload on the Federal those "rights" when the anticipated demand for the new securities into which the "rights" were exchangeable failed to develop.

Such occasions arose mainly when the System was pegging rates, and the dealers were understandably unhappy over the responsibility placed upon them for sharing the task of maintaining the market.

Recent practice of the System in supporting Treasury financing operations (when there has been such support) by either paying only par or a nominal premium for "rights," or by limiting such support to Treasury bills and the use of repurchase agreements, should remove any hope that the System will, in the future, buy "rights" on a basis that would guarantee a quick profit. In these circumstances it is not likely that the dealers would acquire substantial amounts of "rights" for their own accounts until it is clear that the new securities would sell at appreciable premiums within a reasonable period. Consequently unless some unforeseen development should occur to change that expectation, they would be unlikely to press their "rights" on the system and if such a development occurred there would seem to be no reason why the System should not take "rights" from dealer positions as readily as from anyone else.

It seems clear that a fixed refusal to buy "rights" from dealer positions is in principle an undesirable procedure at this time.

*Refusal to buy bills acquired by dealers on a cash basis.*—The subcommittee recommends the discontinuance of a refusal to buy bills acquired by dealers on transactions for cash delivery. This practice was adopted at a time when the System was supporting a fixed structure of rates based on transactions for regular delivery and attempting to maintain reserve positions conducive to market stability. It was, therefore, trying to avoid market practices which would tend to cause sudden fluctuations in bank reserves (particularly of the money market banks) to which open market operations could be adjusted only with a short timelag. Since the System is no longer supporting a structure of rates and attempting such day-to-day stabilization of reserve positions and money market conditions and, in general, buys securities only to meet somewhat longer run needs for reserves, the System account no longer refuses to buy bills on the grounds that they have been bought by dealers for cash delivery. Accordingly, the subcommittee's recommendation that this consideration now has no place in the conduct of the System open market account gives appropriate recognition to current practice.

#### *Information from dealers*

Another phase of dealer-Federal Open Market Committee relations which is the subject of criticism and of recommendations by the subcommittee con-

cerns the personal contact with, and the information obtained from, dealers in Government securities. It is the view of the subcommittee that the existing relationships between the System account and the dealers are not as impersonal as is desirable now that the Committee is no longer trying to peg prices and yields on Government securities and, further, that the manager of the account obtains from dealers information that is unnecessary in amount and too complete as to detail for his needs in the day-to-day operation of the account. As a corrective, the report recommends—

1. that the morning conferences with the dealers be abandoned,
2. that no effort be made at the trading desk to identify customers of dealers.
3. that independent reports of individual dealer positions and trading volume be prepared by some officer of the System other than the manager and only the aggregate of volume and position for all reporting dealers be turned over to the manager, and
4. that the present practice of asking dealers to report transactions in detail during the trading day be discontinued.

These proposals reflect the view that in the overall framework of the subcommittee's recommendations there is, or will be, less need for market information as a guide to the successful conduct of open market operations. There is also implicit in these proposals the belief that there is no need for more than a restricted contact on the part of the management function with dealers and that it would be desirable to eliminate any possibility of undue interference with or improper influence over the dealers, on the one hand, and the opportunity, on the other hand, for loose inferences by them regarding the policies of the Federal Open Market Committee. These recommendations are discussed in the following paragraphs.

*Morning conferences.*—An important phase of the bank's contact with the market consists of daily conferences prior to the opening of the market at 10 a.m. between representatives of qualified dealers, appearing on a rotating schedule, and those officers directly responsible for the conduct of open-market operations. At these conferences, the representatives review the more important developments in the market, summarize their transactions and pass on to the officers of the Reserve bank any comments they wish to make or any suggestions that they have gathered in their conversations and contacts with the investment public in general. These conferences serve to amplify the bare statistics of the written reports and offer a closer, somewhat more intimate sidelight on a firm's policy and on the market's general psychology. Recently attendance at these meetings has been curtailed and only one, or at most two, officers of the New York bank are in attendance. The fact that no notes are now made or kept of the interviews should help to allay possible feeling among the dealers (if it exists) that the information they furnish may be subject to improper use or incorporated in a formal record.

These meetings are of long standing—they were started many years before there was any thought of pegging the market for Government securities. Their original purpose was to keep the manager of the open-market account and the principal officers of the System well informed on developments in the market, and to enable them effectively to respond as fiscal agent to requests from the Treasury for advice concerning its public debt operations. There is no reason to believe that these morning conferences gave rise to objections from the dealers prior to the postwar period of support operations, and until the report of the ad hoc subcommittee appeared we did not know that they were resented in the more recent period. Presumably the officers of the System should continue to keep well informed, for the reasons mentioned above, if for no other.

In the absence of such conferences it is believed that dealers would, as in the past, call upon the manager of the account in person just as they now make regular calls at the offices of their customers and others in the pursuit of information and business. Such occasional informal and unscheduled interviews, while they have their place, would not seem to be an adequate substitute for regularly scheduled morning conferences of the kind now held. The question whether to discard or retain this point of contact with the dealers turns on whether the dealers wish voluntarily to continue the meetings and whether such meetings contribute enough in the way of market information and policy guidance to justify their continuance by the manager of the open-market account. The answer to the latter question will, in turn, depend on whether the operating officers of the System charged with the responsibility for the conduct of open-

market operations can keep easily and adequately informed through their other contacts with the dealers. It is the opinion of the operating personnel at the New York bank that these interviews serve a real purpose and meet a real need as a source of information for the execution of open-market policy and for reports of conditions in the money market and the Government securities market which are made on both a formal and informal basis to the Federal Open-Market Committee, the Treasury, and the Board's staff. They enable the officers to maintain contacts on a much more efficient and less time-consuming basis than would be involved if the sole source of contact were visits from individual dealers at various times during the working day. For these reasons, the bank cannot agree with this recommendation. It wonders how general was the criticism of the morning meetings and what were the specific grounds of criticism.

#### *Identification of dealers' customers*

The report recommends that the information concerning dealers' operations obtained at the trading desk be restricted so as to prevent identification of individual customers. This recommendation evidently refers to past operations by the System account during periods of fixed-price support when at times the System tried to avoid unnecessary purchases of large blocks of securities from individual investors. Under the policy of fixed-price support and a practice of "reluctant buying," occasional attempts were made by investors and by others to liquidate blocks of securities by dividing large offerings of such securities into smaller amounts among various qualified dealers. In a number of cases this led to the identification of customers by the manager through indirection; the name of the seller was not requested, but the identity was made clear by qualified dealers who were attempting to cooperate.

The needs of the System in this connection are adequately met by obtaining general information regarding classes of investors rather than the names of individual investors. As the subcommittee indicates, System personnel should not and do not currently ask for the latter type of information.

#### *Independent tabulation of reports of dealer positions*

The subcommittee recommends that reports on dealer positions be collected by an officer of the System, other than the manager of the account, and that only the totals of such positions be furnished to the manager. This is, like the question of dealer conferences, a matter of judgment as to the amount and character of information necessary for the effective conduct of open-market operations, whatever their specific purposes. The manager has received and compiled this information since the decade of the thirties from the dealers who were qualified or recognized, as well as from others who voluntarily submitted detailed data regarding their trading volume and position. The manager has found this information of basic value in the effective management of the account in the various circumstances and conditions prevailing in the past. It is important in judging the degree of self-interest in dealer opinions regarding the position of the market at any given time and in judging the need for repurchase agreements. And it is also helpful as a guide to future developments and a useful key to market psychology and the role of individual dealers in its formation. This is not to say that the information is needed and used daily, but only that there are times when it can be critically important.

Information on individual dealer positions is an integral part of the whole body of data intended to give an insight into the technical position of the money and Government securities markets. The aggregate of the dealer positions is not enough in itself, for such an aggregate is the sum total of net positions of each individual dealer. That necessarily means that the short position of one dealer and the long position of another in a given issue, or issue category, is netted, so that the account manager could only get from the totals either an incomplete, or a wholly misleading view of the position of market professionals. In the event of the need for System intervention in the market to correct disorderly conditions, it would be helpful for the manager to have information concerning individual dealer holdings in particular issue categories, the purchase of which, in whole or in part by the System, might help to relieve the situation quickly. Such information is also needed by the manager whenever extension of repurchase agreements is under consideration.

To withhold this kind of information from the manager would imply that he could not be trusted to use it impartially in the best interests of the market and in effective expression of System policy. If the information is to have any value to the manager and to the Federal Open Market Committee, it is inevitable

that at times it may be disadvantageous to the individual dealer to have his position known in detail; just as at other times it may be advantageous to him. But that does not mean that in a broader sense the market as a whole does not gain. The case against current practice with respect to the collection and use of data on dealer positions is essentially the risk that it will be misused. The case in favor of continuing the present practice is the demonstrated value of this information in providing one more element in a balanced and informed view of the underlying position of the market which is vitally necessary in connection with the administration of repurchase agreements and any operations intended to correct disorderly conditions.

*Detailed reports of transactions.*—The report recommends that we discontinue asking dealers to report their transactions in sufficient detail to permit the computation of current individual dealer transaction sheets. The origin and the nature of this recommendation is obscure. The Federal Reserve Bank of New York does not compute current transaction sheets for each dealer. It does maintain an informal record of the larger transactions reported so as to maintain a current picture of the supply and demand in the market but this record is not kept in such form as to show the activities of one dealer as compared with another. Any less information than we are now receiving would be clearly inadequate to form the basis for reports on market conditions. Sometimes the information about a sizable order received at the trading desk is compared as a matter of interest with the volume figures reported by a particular dealer—but this is not done on a regular basis.

It would appear that the subcommittee's recommendation is based on a misunderstanding.

*Information required by the Manager.*—The Federal Reserve Bank of New York believes that effective administration and execution of open market operations (even if more narrowly circumscribed than at present) require close and continual contact with the money and Government securities markets as necessary sources of technical information for the constant rendering of judgments regarding the timing, the form, and the amount of System intervention. Adequate information could not be obtained from statistical evidence alone. The most important aspects of the System's contact with the market and its primary source of market information are (1) the daily conferences with the representatives of the dealers in rotation, (2) the confidential daily written reports submitted to the Federal Reserve Bank of New York and (3) continuous contact maintained over the private wires between the bank and the dealer houses. Their purposes have much the same general objective but each complements the other making its own special contribution to a rounded integrated picture of actual and prospective developments in the market.

Such channels of information are a necessity if the System is to play an effective role in meeting its primary responsibilities for credit policy and its secondary responsibilities for preventing disorderly market conditions and for cooperation with the Treasury in its financing operations. The volume and character of information which the manager has sought and obtained through these channels has shown appropriate variation over the years with changes in policy. In general, it would seem preferable to maintain those contacts and those sources of information which have proved useful to the Federal Open Market Committee through the operating personnel in the field and to leave some discretionary latitude to the manager for appropriate and flexible variations in the operating relationship with dealers.

#### *Call money post*

The subcommittee recommends that the feasibility of reestablishing a central call money post for dealers be explored. This proposal has some attraction for, if successful, it would fill a gap that has been created in the money market by the demise of the call money market of earlier years.

If it worked as anticipated, the result probably would be for dealers to hold considerably larger amounts of Government securities and for corporations and other temporary investors to put at least some of their funds on loan instead of investing them directly. Whether or not that would result in a broader and more stable market for Government securities, however, is questionable; it is quite possible that dealers' holdings would prove to be more volatile than holdings of those who now invest directly instead of making call loans.

The availability of such a facility would probably be useful at times, but can we safely generalize for the future and say that an active call money market

would be helpful in all circumstances? Is there not the possibility that the volatility of such a market might sometimes become a disturbing influence?

In any event, it is not clear how the proposal can be implemented satisfactorily. It is very doubtful whether the New York City banks would be interested in promoting a mechanism which might take business away from them, and it is most unlikely that the New York Stock Exchange would be interested in re-establishing a money post which would largely serve nonmembers of the exchange. Government security dealers presumably would be interested, but would not care to have the money post in the hands of anyone who might be interested in their positions as reflected in their borrowings. The Federal Reserve Bank of New York might be accepted as a neutral spot, but it is not clear why we should undertake a function of this sort serving one particular type of private interest.

#### *Federal Reserve reports*

The subcommittee recommends that, with a view to improving the data it makes available to inform the public of its operations, the following information be shown in the weekly statement of condition of the Federal Reserve banks;

- (a) Securities held on repurchase agreements,
- (b) Special certificates of indebtedness held by the System,
- (c) Weekly averages of member bank borrowing.

It is presently possible for those who are skillful in interpreting Federal Reserve statements to get a fairly accurate idea of the amounts and types of securities involved in repurchase agreements. Nonetheless, there may be some question whether the System should facilitate a more complete and accurate determination of the amount of repurchase agreements on grounds that such a disclosure might be detrimental to the dealers at times of money-market stringency insofar as those agreements provide an accurate measure of dealer positions in short-term Government securities. The decision here thus seems to turn on whether the System should take any official action which would broaden public knowledge of the dealers' positions at times when credit is tight and repurchase agreements are outstanding in volume.

Information regarding Treasury use of special certificates of indebtedness is now carried in the Federal Reserve Bulletin with a considerable time lag and on a more current basis in the debt section of the daily Treasury statement.

How much interest there would be in the record of weekly averages of member bank borrowing is questionable. Apparently little attention has been paid to the figure now given on weekly average excess reserves.

All things considered there would appear to be no objection to the inclusion of all these items in the statement on a separate basis if it is concluded after full consideration that the matter of dealer positions raises no problem. If the decision is in favor of separating repurchase agreements from other security holdings, an alternative form of publication which might be considered would be to show them as "other loans." (They should not be included in "Discounts and advances.")

### III. "HOUSEKEEPING" IN THE FEDERAL OPEN MARKET COMMITTEE

Under present arrangements the responsibility for executing transactions of the Federal open-market account is delegated to the Federal Reserve Bank of New York, and one of its officers has customarily been appointed manager of the account subject to the approval of the full committee. The manager conducts operations under the general directives of the full committee and the specific articulation of those directives provided by the executive committee. The day-to-day performance of the manager is under the continuing surveillance of the president of the New York bank, both in his capacity as vice chairman of the Open Market Committee (and of the executive committee) and as senior executive officer of the bank which must answer to the committee for the satisfactory performance of the manager's functions.

The subcommittee considers these arrangements anomalous and proposes study of methods for separating the management of the account from the Federal Reserve Bank of New York. The subcommittee's report covering these matters raises three important questions. Question 1 is whether the present arrangements are in fact anomalous, or more broadly, whether they fail to conform with the letter and spirit of existing law. Even if there are in fact no anomalies, question 2 is whether the New York bank and its president should, for other

reasons, be relieved of direct responsibility for the conduct of the account. And question 8 is whether performance could be improved by making the account an independent entity within the System, separate from the Board of Governors and from all of the Reserve banks, with the manager of the account responsible only to the Committee as a whole.

#### *The anomalies*

An anomaly is something abnormal, peculiar, or in the historical sense, "out of date" or incongruous. But the subcommittee seems to mean even more than this—something which has grown into a form that no longer fits the intention of the law. Specifically, the subcommittee suggests as inconsistent with the statutory position of the Federal Open Market Committee:

- (a) The absence of a separate budget covering its operations;
- (b) The absence of a separate staff responsible only to the Committee; and
- (c) The delegation of the management function to an individual Federal Reserve bank.

It makes no firm recommendations as to changes, but suggests "that the Committee reexamine and review its present organization, and in particular that it consider the advantages and disadvantages that would ensue, were the manager of the open-market account made directly responsible to the Federal Open Market Committee as a whole, and not, as at present, responsible through the Federal Reserve Bank of New York."

This line of thinking seems to be predicated on the premise that the Federal Open Market Committee should be not only a policymaking body, but also an operating organization. There is no apparent basis for this premise in the provisions of the Federal Reserve Act governing the Federal Open Market Committee. Section 12A provides for the creation of the Federal Open Market Committee and specifies its membership, prohibits the Federal Reserve banks from engaging or declining to engage in open-market operations except in accordance with the direction of and regulations adopted by the Committee, and sets forth the governing principles of open-market operations. There is no suggestion, however, either in this section or in section 14 that the Federal Open Market Committee is itself expected to conduct open-market operations. The implication would seem to be that the Reserve banks are to perform these operations, but subject to the policies and regulations of the Committee.

Nor is there any suggestion that the Committee should be provided with funds with which to engage in operations or to set up a separate organization with a separate budget. On the contrary, the clear inference is that the Federal Open Market Committee was expected to be solely a policymaking body consisting of members with other primary duties in the fields of System policies and operations, and that the Reserve banks were expected to buy and sell Government securities in accordance with the discretion and regulations of the Committee. There is also at least an implication that the policymaking body was expected to fulfill its functions best if it were closely interrelated, through its membership, with all other policy and operating responsibilities of the System—rather than standing apart as an independent unit within the System.

The open-market account was created under the regulations of the Committee as a means of coordinating and centralizing the operations of the Reserve banks. Experience showed that as a practical matter these operations had to be closely coordinated as to timing and impact. Consequently, although all Reserve banks had the power to act, it was found administratively essential to pool all of their activities into 1 account, and to designate 1 Reserve bank to conduct all operations. The Federal Reserve Bank of New York was delegated the responsibility for executing transactions because it is the bank located in the central market for Government securities, and one of its officers has been appointed manager of the account subject to the approval of the Federal Open Market Committee. The intent and spirit of the law would seem to be that only the Reserve banks, or one acting for all, should conduct operations in Government securities. To take this function away from all Reserve banks and place it in a separate entity would seem to depart from the intent of the statute and also from the "Federal" structure of the Federal Reserve System. That is, instead of allocating System functions among the 12 Reserve banks as the operating arms of the System, the new procedure would be to create a unit of a different type, outside all of the banks—a "thirteenth" operating institution to handle some of the System's most important kinds of transactions.



Just why presently existing arrangements should now be regarded as in any way anomalous is far from clear both in view of their legal basis and because they have emerged in response to needs over a period of years, and are not in any sense an historical accident. Moreover, the usual practice in all the committee activities of the System is to draw on available personnel at the Reserve banks and the Board, rather than to set up separate staffs with separate budgets. That is the way to assure strong staffs at the Board and in the Reserve banks, and to assure the most efficient use of all of the talent available throughout the System. The Federal Open Market Committee does differ from other System committees in having been specifically set up by statute. But, as has been pointed out above, that very statute confirms the usual System practice by placing on the Federal Open Market Committee only members having other major responsibilities, rather than members having no other functions or responsibilities.

The report states that the Federal Open Market Committee "is especially charged, also, to use its powers to provide an elastic currency for the accommodation of agriculture, commerce, and business, i.e., to promote financial equilibrium and economic stability at high levels of activity." That stretches considerably the statutory provisions now governing the Committee. The statement better describes the responsibilities of the System as a whole, and even for the System as a whole it is based in part on inference rather than any specific provisions of the Federal Reserve Act. In any event, whatever the merits of giving new status to the Open Market Committee as the single embodiment of all System authority and there may be such merits, to be sure—the Committee does not have that comprehensive authority now. The proposals for a separate budget and separate staff thus rest on a false premise. The effect of creating a separate staff and separate budget might actually be to weaken the participation of the Reserve banks in the work of the Committee. This risk could only be justified, as the subcommittee seems implicitly to recognize, if a major change in the structure of the System were to be made—placing upon the Committee responsibility for all of the policy actions of the System.

Consideration of changes in the organizational arrangements for carrying out the policy decisions of the Committee, therefore, must depend primarily on the question of whether present arrangements have serious shortcomings and, if so, what arrangements might be made that would give assurance of substantially better results. The report points out that "It would be extremely difficult to build up a new and independent staff as qualified as the personnel which it now enlists to work on its problems." It goes on to state, "It would be equally unfortunate to lose the contributions of that staff to System problems that fall outside the limited area of responsibility of the Federal Open Market Committee. Yet there are equal dangers in a situation where the time of no one person on the whole staff of the Committee is wholly devoted to its responsibilities, where everyone wears two hats, and where each must fulfill duties separate and distinct from those imposed by the Federal Open Market Committee." Just what the dangers are, to which the last-quoted sentence refers, have not been specified in the report. The fact of the matter is that the manager of the open-market account and his principal assistants devote their attention and efforts almost exclusively to the interests of the System's open-market operations, and engage only to a minor extent in other activities. In any case, there is no conflict between their primary activities in behalf of the open-market account and any secondary responsibilities; the latter serve generally to broaden their knowledge and capabilities for performing their primary duties for the account.

#### *Removing the responsibility of the New York bank and its president*

Even though present arrangements are the consequence of statute and experience, and do not involve any apparent anomalies, it is nonetheless proper to inquire whether some changes in arrangements could materially improve the functioning of the Open Market Committee within its present range of responsibilities. The subcommittee does not ask whether some other Reserve bank might better manage the account. Presumably that is not suggested because the present organization of the Government security market makes it inevitable that the major point of System contact with the market must be in New York.

With respect to the delegation of the management of the open-market account to the Federal Reserve Bank of New York, the report points out that the present arrangement has the advantages of being able to use the personnel of the bank for all the operational aspects of open-market operations and of having the directives of the Federal Open Market Committee and its executive committee carried

out under the supervision of the president of the bank (who is also Vice Chairman of the Committee), thus assuring "that policy is made effective in operations."

The report goes on to suggest, however, that this arrangement "has the disadvantage that the president of the Federal Reserve Bank of New York sits at meetings of the Federal Open Market Committee and of the executive committee necessarily in a somewhat different role from that of his colleagues. He comes not only as a contributor to the discussion on policy formation but also necessarily as a protagonist for the actual day-to-day operations of the account. These operations are his responsibility. He cannot criticize them without criticizing his own staff. The Committee, therefore, in some part loses contact with the critical insight of its best-informed member. It has the disadvantage also that other members of the Federal Open Market Committee, reluctant to seem critical of a colleague, may hesitate to scrutinize adequately the technical operations of the account. This is a serious deficiency because the other bank president members of the Committee are usually scattered and out of intimate touch with one another as well as with the market. They must depend on give-and-take discussion at Committee meetings and at the meetings of the executive committee to sharpen their appreciation of the Committee's operating problems."

These statements are not intended, we know, to be critical of the individual who is now the president of the Federal Reserve Bank of New York, although they do seem to assume that through negligence or lack of capacity, he, as president of the institution delegated the responsibility for executing operations, is likely to be unable to live up to those responsibilities. They imply that he must always defend what has been done, cannot admit mistakes, or learn from them, and must be a "protagonist" rather than a full participating member of the superior body—the Open Market Committee. If that is true of the president of the Federal Reserve Bank of New York, situated as he is, who can be expected to do a better job? Is it to be assumed that the Committee as a whole, or its executive committee as a group, or some other individual can better supervise day-to-day and hour-to-hour operations? Or is it assumed that the manager of the account, if he were separated from the Federal Reserve Bank of New York and from the supervision of its president (and the Vice Chairman of the Federal Open Market Committee), could operate the account more competently? It would be helpful in giving further consideration to this part of the subcommittee's report, to have the answers to these questions.

Historically, it has been a source of strength for the Federal Reserve System that it possessed unique facilities for accomplishing an integration of the national and regional aspects of its overall policy. Through the Reserve banks, men of high competence are available in all parts of the country to carry out, or to report upon, the credit developments resulting from a unified System policy. To create a parallel organization outside the Reserve banks, for the particular problems that come into focus through the Government security market in New York, would risk impairing the strength and usefulness of the present regional organization. A conscientious president of the New York bank would continue to maintain close contact with the market, and with the account, regardless of any change in the New York bank's responsibilities for the conduct of the account, but he would not be in as good a position to apply his knowledge and ability to the formulation of System policy and to the operations of the Federal Open Market Committee if a separate organization were set up to execute transactions.

The position of the New York bank is the inescapable outcome of geography. A Reserve bank located in New York, if it is fully to discharge its responsibilities for special competence in the credit problems of particular importance in its area, must maintain close contact with the Government security market. To lose that contact would be as harmful to the System as for the Board of Governors deliberately to cut itself off from all political developments in Washington, for example, or for any Reserve bank to ignore the characteristics of borrowing member banks. Thus the New York bank should, by the sheer fact of location, always be the best informed unit of the System on developments in the Government security market. To lose any of that insight would be harmful to the System. To try to separate the president of the Federal Reserve Bank of New York from the operations of the Federal open-market account would only make it more difficult and more burdensome for him to do all that he could and should to contribute to the effectiveness of system policies and operations. There does not seem to us to be a practicable way, consistent with his duties either as a Reserve bank president and his location in New York, or as Vice

Chairman of the System Open Market Committee and its executive committee, to lessen the real and special responsibility of the New York president for system operations affecting the Government security market.

*A separate management for the account*

Even though the New York president should be encouraged to maintain a close watch on the System account, it is worth considering whether the account itself could function better under a separate management, instead of using officers and staff of the New York bank. How? Is it unwise to have the manager of the account under more or less continuous surveillance by the resident member of the Open Market Committee? Does the manager need independence from the experience and associations provided by his position as a senior officer of the New York bank? Does the New York president present an unwelcome buffer between the manager and other members of the Committee (or of its staff)? Has the New York president made less than a desirable contribution to open-market policy because of his assumed protective or defensive attitude, suggesting that his critical faculties have been impaired by a desire to rationalize mistakes in the execution of policy directives? These are the unspoken questions raised by the subcommittee report.

In the absence of these specifics, what about some of the problems of detail that would arise? If the manager of the account were to be separated from the organization of the Federal Reserve Bank of New York, presumably he would have to be supplied with assistants and staff to carry out all aspects of open market operations. If he alone were employed directly by the Federal Open Market Committee, it would become necessary to appoint a replacement for him every time he was absent for any reason, and presumably the alternate would have to be drawn from the staff of the Federal Reserve Bank of New York, which would involve the same questions that are seen in the present arrangements. The only real alternative would be to establish an entirely separate staff and that would undoubtedly involve additional expense, since the personnel engaged by the Committee presumably could not be used for any other work of the Federal Reserve Bank of New York, such as executing security transactions for foreign accounts or for the United States Treasury. To some extent, therefore, duplication of staffs would be unavoidable. From this narrow point of view, then, the question is whether there is sufficiently strong evidence of unsatisfactory results from the present arrangements (and sufficiently strong reasons for believing that a separate staff would produce much better results) to justify the duplication and additional expense. The expense aspect, however, while probably considerable, would be a relatively minor consideration if it would assure substantially better results. But the subcommittee report has not provided the basis for such assurance.

In any case, this would appear to be a good time to settle the question of how the policies of the Federal Open Market Committee and the directives of its executive committee are to be carried out. The manager of the account cannot be expected to take instructions as to specific transactions from several different individuals, although he may reasonably be expected to listen to suggestions from those who have a proper concern and to supply information on market conditions and on the details of his operations to the members of the Committee on request. Should he operate only under the direct supervision of the president of the Federal Reserve Bank of New York, acting as the chief executive officer of the institution delegated the responsibility of carrying out for all Reserve banks the directives of the committee, so that the president can be held responsible for the way he operates? Should he be autonomous and operate according to his best judgment, without interference or supervision from anyone, and be answerable only to the Committee or the executive committee as a whole for the manner in which he carries out its directives? Should he operate directly and solely under the supervision of the chairman of the executive committee? If so, would not the Chairman be placed in the same position as the Vice Chairman under the present arrangement, but without the same advantage of proximity to the manager of the account, the operating staff, and the market? (Presumably under either the second or third of these possible arrangements the manager of the account would operate independently of the Federal Reserve Bank of New York, which would then assume no responsibility for his acts.) These are the kinds of questions that should be faced, considered carefully, and decided upon.

In so deciding consideration should also be given to the possibility that the suggested change might create an undesirable island of autonomous or independent authority within the System. The high degree of complexity in Government security market operations, and the need for some dependence upon judgments that can only be formed on the basis of actual operating experience, make it unlikely that a successful transference of authority for hour-to-hour surveillance of the manager's performance can be made to someone located outside New York. The transfer could be attempted, of course, but would the recipient be able to maintain the kind of intimate, continuous knowledge of the market that is needed for best exercise of such surveillance in the System's interest? The result might well be a less effective ("remote control") conduct of System account operations. And in that case the System might find that, instead of the present medium of reliance on the New York bank, it had created a "free planet" in the form of an independent manager of the account. Such a manager, while not a member of the Federal Open Market Committee, and not in a position to share the full breadth of responsibility for overall System policy, might be able (if he chose) to "make a lot of policy on his own."

#### SUMMARY AND CONCLUSIONS

The study conducted by the ad hoc subcommittee provides a useful review of past workings of the market for Government securities, and of the System's open market organization and its relations with the market. On the basis of its study the subcommittee has made a number of recommendations dealing with matters of general policy, relations with the market, and details of operating practices and organization in conducting open market operations.

With some of the recommendations we think there will be general agreement. The most important of these is that the Federal Open Market Committee give further assurance "that henceforth it will intervene in the market, not to impose on the market any particular pattern of prices and yields, but solely to effectuate the objectives of monetary and credit policy \* \* \*" (provided that assurance is interpreted broadly enough to cover the item mentioned next). Another is the recommendation that the emphasis in one phase of System open market operations be changed from maintaining orderly market conditions to correcting disorderly conditions. Still another is that the Committee henceforth "refrain, as an official body, from initiating regularly proposals with respect to details of specific Treasury offerings." We can also agree that in most circumstances transactions in short-term securities will probably be found the most appropriate form of System open market operations (although a commitment to make such transactions the sole form is decidedly questionable). The Federal Open Market Committee has, in fact, been moving progressively in the directions suggested by these recommendations.

One of the most important questions raised by the report of the subcommittee is how far the Federal Open Market Committee should go in promoting the "depth, breadth, and resiliency" of the market by making commitments as to what it will or will not do in its future operations. Part I of the preceding discussion suggests that efforts to promote these market characteristics may not always be helpful in achieving the System's major policy objectives, but may at times conflict with those objectives. Especially questionable is the proposed assurance that the Federal Open Market Committee henceforth will confine its intervention in the market "to transactions in very short-term securities, preferably bills." Restriction of operations to short-term securities, while appropriate as the normal practice, might in some circumstances interfere seriously with the effectiveness of the System's operations. There is, as yet, no valid basis for the assumption that the market has attained, or will soon attain, such a degree of fluidity as to assure dependable effects in the long-term sector of injections of Federal Reserve credit in the short-term sector. Furthermore, undue emphasis on operations in very short-term securities might at times cause the very distortions in the market which the subcommittee seeks to avoid.

The Federal Open Market Committee has already gone a long way toward carrying out the recommendation of the subcommittee that direct support by the System of Treasury refunding operations be discontinued. The only remaining action that might be taken would be a formal commitment that the System open market account would not in the future purchase "rights," when-issued securities, or outstanding issues of maturities comparable to those of the new securities. It is here suggested that any such commitment is unnecessary

and undesirable; that in this case, as in others, the Federal Open Market Committee might better keep a free hand to take such actions as it considers best designed to promote the System's major policy objectives in the light of all the circumstances at any given time. It is further suggested the Committee consider the feasibility and desirability of "swap" operations—either in connection with Treasury refinancing operations or at other times—when it appears that such transactions would be useful in achieving a better maturity distribution in the open market account and in avoiding a "frozen" condition in the account.

Another questionable point is the recommendation that repurchase facilities be made regularly available to nonbank dealers over weekends (and the related proposal that dealers be notified in advance when repurchase facilities would be made available to them). These proposals appear to be in conflict with the basic recommendation that intervention by the System in the market be "solely to effectuate the objectives of monetary and credit policy," as they would constitute an indirect form of intervention designed to facilitate the functioning of the Government security market, rather than to effectuate the objectives of monetary and credit policy. They would also conflict with the tendency of the past 2 years to reduce any form of automatic access to Federal Reserve credit to a minimum. The desirability of making repurchase facilities available to dealers in certain circumstances on the initiative of the System, however, is recognized.

The question of promulgating "ground rules" which would henceforth govern transactions with dealers is closely tied in with the whole question of how far the Federal Open Market Committee should go in giving public assurances as to what it will or will not do in its future operations. The dealers would, of course, like to know in advance what the System can be expected to do in its dealings with the market. It is quite possible, by following a consistent pattern of operations, to convey to the market a reasonably good understanding of the general character of the System's policies and operations that may be expected under various types of circumstances, without making specific commitments which, at times, might prove to be a serious handicap to effective operations. In other words, action rather than words is considered the better way to convey to the market an adequate understanding of the general operating policies of the System. It avoids the constriction of the scope of action available to the System that is involved in the enunciation of any definite set of "rules."

In fact, the general conclusion suggested by part I of this discussion of the subcommittee's report is that it is likely to be most conducive to effective implementation of the System's monetary and credit policies if the Federal Open Market Committee avoids commitments which would tend to tie its hands in dealing with whatever situations may arise in the future. There is always danger in attempting to formalize for all time the principles and procedures that have grown out of current experience. There is particular danger for a central bank, which depends for its effectiveness upon psychological as well as direct influences, in making formal and comprehensive public declarations on such matters.

#### *Relations with dealers*

There is much that is sound and constructive in the discussion in the report of the subcommittee of the specific relationships of the Federal Open Market Committee with the dealer market. Many of the recommendations put forward have already been applied in our market relationships as an aid to the expression of current open market and credit policy. These changes have been made over the period since March 1951 and have been appropriate to the circumstances of this period. It would be a mistake, however, to go so far as the subcommittee in presuming that the new procedures should have universal application under any and all sets of circumstances. Some of them might better be subject to continuous consideration in the light of credit policies adjusted to a constantly changing economic and credit situation; it is conceivable that revival of some of the now abandoned procedures might be found advisable at some future time, depending on the current aim of the account's operations.

In other aspects of the System's market relationships, especially those dealing specifically with the information obtained from, and contacts maintained with, Government securities dealers, some dissent is taken from the recommendations of the subcommittee. The Federal Reserve Bank of New York believes that this information does, and should, vary in both amount and content with the changing requirements of policy and market conditions, and it believes that appropriate adjustments in these respects have been made in response to recent developments.

These channels of communications and sources of information should be kept open and operative and used with discretion. Disagreement here between the bank and the ad hoc subcommittee as to the amount and content of information is primarily a matter of degree rather than of kind, and involves questions of judgment as to what is needed by the operating personnel in the conduct of open-market operations under the direction of the Federal Open Market Committee. The bank considers the information it now receives to be necessary for the effective execution of Open Market Committee policy, and at the present time this is particularly so in connection with the judicious use of repurchase agreements. We do not consider that current practices with respect to information and dealer contacts are an unjust personal intrusion into dealers' affairs that threatens to exercise a harmful influence on the efficiency of the Government securities market; or that they are not warranted by the System's responsibility to and position in the market and the personal character of the market. The matter of market information would seem to be an area where the System might well have and use its own criteria rather than those of the dealers. The components of the dealer market are apt to see the problem of the manager of the account and the Federal Open Market Committee more in terms of the relationship of the individual firm to the System, than of the dealer market as a whole to the System, and of the System to the Nation.

The most difficult problem of Federal Reserve-dealer relationships that is a subject of subcommittee recommendation concerns existing qualification procedures for dealers in Government securities. The System has not in the past found it feasible or desirable to deal at random with any and all of the dealers specializing in Government securities, but has limited its transactions to certain firms which, by meeting specific standards, become qualified. These procedures are of long standing and reflect principles which have been considered necessary in governing the relationships between the Federal Reserve Bank of New York, as agent of the Federal Open Market Committee and of the other Federal Reserve banks, and the market for Government securities. They were not designed specifically as part of the rate-stabilizing operations which the System undertook during the Second World War and continued into postwar years.

Certainly the System should avoid any action which would justify a charge of conferring "privilege" on any group of Government securities dealers, and it would seem that qualification of dealer firms for transactions with the System open market account on the basis of demonstrated performance, trade position, integrity, and financial resources, if fairly and honestly administered, would preclude any valid accusation of that sort. At the same time, however, it is clear that mere abandonment of the present system would constitute no solution of the problem; criticism of the distribution of the System's transactions among dealers might be accentuated, rather than reduced, if there were no "recognized" dealers and no definite criteria for the selection of dealers. The central problem is that of determining the most effective basis on which the System can make contact with the dealer market in the expression of credit policy; what principles should govern and how they are to be implemented. The subcommittee is silent with respect to these aspects of the problem, limiting its comments largely to the expression of dissatisfaction with existing qualification standards and procedures.

#### *"Housekeeping"*

The subcommittee makes no firm recommendations as to changes in the organization arrangements for carrying out open market operations, but suggests that the Federal Open Market Committee reexamine and review the present arrangements and specifically that it consider making the manager of the account directly responsible to the Committee as a whole, rather than indirectly through the Federal Reserve Bank of New York. The report characterizes the present arrangements as anomalous for reasons which include: (a) The absence of a separate budget covering its operations; (b) the absence of a separate staff responsible only to the Committee; (c) the delegation of the management function to an individual Federal Reserve bank.

This approach to the problem of the System's organizational arrangements for the determination and execution of open market policies raises the fundamental question of whether the Federal Open Market Committee was intended to be, or should be, an operating body as well as a policymaking body, and the further question of whether the open market organization should be something apart from either the Board of Governors or the Federal Reserve banks. Careful examination of the provisions of the Federal Reserve Act governing open market operations reveals no basis for the assumption that the present arrangements

are anomalous. On the contrary, section 12A and 14 clearly suggest that the Federal Open Market Committee was intended to be solely a policymaking body and that actual operations were intended to be conducted by the Reserve banks in accordance with the direction and regulations of the Committee. There is at least an implication that the policymaking body was expected to fulfill its functions best if it were closely interrelated, through its membership, with all other policy and operating responsibilities—rather than standing apart as an independent unit within the System.

As a practical matter, most of the actual transactions in Government securities have necessarily, from the earliest development of open market operations as an instrument of monetary and credit policy, been conducted for the Reserve banks by the Federal Reserve Bank of New York, since it is located in the central market for Government securities. This inescapable fact of market location is the historical reason for the designation of the Federal Reserve Bank of New York as the institution assigned the responsibility for executing transactions and for the appointment of an officer of that bank as manager of the open market account.

It is, of course, entirely appropriate for the Federal Open Market Committee (or for the System as a whole) to review its organizational arrangements from time to time and to make such changes as appear to offer definite prospects of improved performance. In considering changes, however, it is important to make sure that any assumed deficiencies in existing arrangements do, in fact, exist, and that there are sound reasons for expecting that alternative arrangements will offer real advantages. The statements and inferences in the report of the subcommittee concerning present arrangements for open market operations do not seem to us to give such assurance.

The subcommittee recognizes the advantages to the System in being able to use the staff of the Federal Reserve Bank of New York not only in executing purchases and sales of securities, but also in conducting all the other operating details incident to management of the open market account. But the report sees dangers (unspecified) in the fact that members of the staff have other duties. And most important of all, it implies that the president of the Federal Reserve Bank of New York comes to the meetings of the Federal Open Market Committee and of the executive committee not with an objective approach to the problems of the Committee, but as a biased protagonist of the operating staff. The obviously unconscious inference of such statements is that the president of the Federal Reserve Bank of New York is likely to be compromised by being at the same time Vice Chairman of the Committee and head of the institution to which is delegated the responsibility for carrying out the directives of the Committee. If the president of the New York Reserve Bank, with his intimate knowledge of the objectives and intentions of the Committee, his close relationship to the operating staff and his proximity to the market, and his consequent ability to keep fully informed on current developments, is unable to provide a connecting link between policy formulation by the Committee and the operations for the account, who is in a position to do so? Is not such a connecting link necessary or at least desirable?

The answer to these questions which seems to be suggested by the Ad Hoc Subcommittee for consideration by the full Committee is that the manager of the account operate under the direction of the Federal Open Market Committee at a whole or its executive committee. Careful consideration of just how these committees might direct the daily or hour-to-hour operations of the manager of the account will demonstrate, we believe, the impracticability of such an arrangement. As part III of the preceding discussion points out, the result might be to make the manager of the account a "free planet" without effective supervision either by the Committee or by anyone else, and consequently to place him in a position to "make a good deal of policy on his own." And while the duplication of expense that would be involved in setting up an entirely separate operating staff, paralleling the staff which the Federal Reserve Bank of New York would have to maintain to execute transactions for foreign accounts, for Treasury accounts, and for others, is not the most important consideration, it would be difficult to justify such duplication in view of the statutory basis for the Federal Open Market Committee and for open-market operations, unless serious deficiencies in the existing arrangements can be demonstrated and alternative arrangements offer definite prospects of superior performance.

We do not think the report of the Ad Hoc Subcommittee has demonstrated deficiencies in the present organization or offered suggestions for a better organization which would provide the basis for a change. It is true that it makes no