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The First Time the Fed Bought GSE Debt

By Renee Haltom and Robert Sharp

In 1966, Congress gave the Federal Reserve authority to purchase the debt of agencies guaranteed or owned by the federal government. This same authority has enabled the Fed's purchases of mortgage-backed securities (MBS) and debt of government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac since 2008 in support of the housing market. In a little-known episode, the Fed shied away from exercising this authority in the 1960s but eventually conceded under political pressure and perceived threats to its independence.

On November 25, 2008, the Federal Open Market Committee (FOMC) announced it would begin purchasing debt issued and MBS guaranteed by GSEs Fannie Mae and Freddie Mac to provide monetary stimulus to the housing sector and broader economy. These purchases were notable because the Fed normally conducts monetary policy by transacting exclusively in U.S. Treasury securities, which are thought to have a relatively benign effect on the relative prices of other assets.

Congress gave the Fed the authority to purchase agency debt in 1966, after members of the legislative and executive branches grew concerned about the effect of tighter Fed policy on the housing industry. The episode is a telling display of the political pressure to use monetary policy tools to achieve social objectives, an issue the Fed has faced many times during its 100-year history.

Economic and Political Environment

Prior to 1951, the Fed's monetary policy was effectively determined by fiscal policy. That is, the Fed formally agreed to hold interest rates down to facilitate the Treasury's financing needs during World War II. This policy ended with the Fed-Treasury Accord of 1951, enabling the Fed to focus solely on monetary policy objectives.

Despite the Accord, many policymakers favored coordination between the Fed and Treasury in achieving the economic objectives then ascribed to both institutions under the Employment Act of 1946. Some Fed critics, such as U.S. Rep. Wright Patman from Texas, continued to pursue legislation limiting the Fed's independence into the 1970s. Such efforts ensured that the Fed did not forget the fledgling and tenuous nature of its independence.¹

The tension rose during the mid-1960s when the Board of Governors raised the discount rate against the wishes of Congress and the Johnson Administration. These hikes set off unprecedented warnings from elected officials and resulted in proposed legislation that would have eroded the Fed's independence by forcing it to seek appropriations from Congress.² Despite this pressure, after holding the discount rate steady at 4 percent throughout 1965, the Board raised it again by 0.5 percent on December 3, 1965. Governor George Mitchell warned at this meeting that the Fed "appeared to be on a collision course with the administration."³ Indeed, the decision unleashed considerable backlash against the Fed. In a *New York Times* article four days later, Patman called for Congress to end Fed Chairman William

McChesney Martin's term. Senator Paul Douglas from Illinois called the action "as brutal as it was impolite," and Senator William Proxmire from Wisconsin demanded hearings.⁴ Political tensions contributed to the Board's decision not to raise the discount rate again until April 1967, despite what some FOMC members viewed as strong economic rationale for doing so.⁵

Focus Shifts to Housing

Rising market interest rates hurt the thrift industry relative to commercial banks. The greater maturity mismatch on the balance sheets of thrifts, whose assets consisted mainly of long-term mortgages, made it more difficult for them, relative to banks, to attract deposits in a rising-rate environment.⁶ Homebuilding activity plummeted to record lows in 1966, and thrifts and homebuilders made their discontent known to Congress and, as a result, the Fed.

In its June 6, 1966, meeting, the Board contemplated the extent to which the Fed ought to support the housing industry. Most of the discussion centered on whether the Fed should lend in the event of a liquidity crisis to savings and loans, savings banks, and insurance companies. This was the first time the Fed explicitly considered acting as lender of last resort to the broader financial system.⁷ There was also limited discussion of legislation that would allow the Fed to directly purchase debt issued by mortgage agencies to funnel credit to the housing industry. According to the minutes, "Governor J.L. Robertson expressed the view that if Congress was thinking in terms of making additional funds available to the Federal Home Loan Bank System, it should be done directly rather than through the Federal Reserve."⁸

May and June saw congressional hearings over the legislation. On June 16, Martin was called before the House Committee on Banking and Currency to discuss the effects of Fed policy on the thrift industry. Martin noted that the apparent intent of the legislation was to make Federal Home Loan Bank (FHLB) and Fannie Mae obligations eligible for Fed purchase to support the housing industry, an effort that he argued should be achieved through fiscal rather than monetary policy. Martin also raised concerns about a

provision of the bill under which the secretary of the Treasury, in consultation with the secretary of Housing and Urban Development, would advise the FOMC on such purchases:

"The result, I believe, would be to increase pressures to divert open market operations from general economic objectives to the support of specific markets for credit. As a consequence, the effectiveness of monetary policy as a general instrument for economic stabilization would be threatened ..."

On August 4, newly appointed Board Vice Chairman Robertson testified before the Senate Committee on Banking and Currency in favor of other provisions in the legislation. On the authority to purchase agency debt, Robertson said only that it would "increase the potential flexibility of open market transactions and could also serve to make [agency] securities somewhat more attractive to investors," generally helping to promote a deeper market in such securities. He cautioned, however, that purchases would have to be consistent with the stance of monetary policy, and that it would be important "to avoid any semblance of 'rigging' the markets or 'pegging' the interest rates for agency issues."

Slow to Act

Congress passed the Interest Adjustment Act on September 21, 1966. The legislation stated that the Fed and other regulatory agencies "shall take action to bring about the reduction of interest rates to the maximum extent feasible in light of prevailing money market and general economic conditions." The main items of the law related to the Fed's regulations on deposit interest rate ceilings and reserve requirements at deposits and thrifts.

An additional provision of the law, which had received relatively little emphasis in hearings and public statements, amended section 14(b) of the Federal Reserve Act, the section that governs open market operations. The amendment gives the Fed the authority:

"To buy and sell in the open market, under the direction and regulations of the Federal Open Market

Committee, any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States.”

This amendment introduced the possibility that monetary policy would no longer be conducted exclusively with Treasury securities. The authority was initially granted for one year but was extended in 1967 and made permanent in 1968.

The FOMC did not immediately act on the new authority, however. At the November 1966 FOMC meeting, the committee authorized the New York Fed to engage only in repurchase agreements against agency issues, rather than outright purchases, in order to accustom the market to such operations. The FOMC memoranda of discussion from the meeting a full year later notes that the Committee remained divided on the question of whether to make outright purchases.

The Board addressed agency purchases again at its February 29, 1968, meeting when members discussed a proposal by the California Savings and Loan Commissioner to require Federal Reserve purchases of FHLB issues. Governor Sherman Maisel suggested that “the more important question was the intent of Congress” in amending 14(b). What remained unclear, he said, was: (1) whether the Fed had a *responsibility* to improve the market for housing agency obligations and, if so, to what extent; (2) what course of action the Fed should pursue in the event of further movement of credit away from the thrift industry; and (3) whether the Fed itself favored supporting the housing market. After discussion, Governor Andrew Brimmer said that some members of Congress appeared to favor Fed support of housing, but the Fed did not have an explicit mandate to do so. Regardless, the Board concluded that the Fed was likely to be called upon to testify on these matters soon.

As expected, there was a hearing before the Subcommittee on Financial Institutions of the Committee on Banking and Currency on April 3–4, 1968. Citing the FOMC’s lack of clarity on congressional intent, Senator Proxmire stated in no uncertain terms that, “The aim of this [14(b)] authority was to *require* [emphasis

added] the Federal Reserve Board to support the mortgage market during periods of severe monetary restriction.” He said some members of Congress were “extremely critical over the Board’s failure to utilize more substantially its authority to purchase agency issues.”

Proxmire was aware of the Fed’s reasons for hesitation. The Fed, he said,

“has argued that there was no clear congressional intent to use the authority to deliberately peg interest rates on mortgages or to provide any fixed flow of funds into housing... The Board also argues it is inappropriate for the central bank to attempt to influence the structure of interest rates. ... The Board claims that the [Treasury] bills-only doctrine insures the overall neutrality of monetary policy on specific sectors of the economy.... Its basic posture is that it affects monetary policy only in the aggregate and that the impact of this policy should be allocated to different sectors by natural market forces. To interfere with these market forces would, according to this argument, distort the allocation of capital.”

Vice Chairman Robertson replied that Proxmire had summarized correctly the views of the Fed. He further stated that the FOMC had declined to make outright purchases because “we also have to worry very much about going into these markets—which are relatively small markets—in a manner which will affect the price” because doing so could “diminish the desire of outsiders to come into that market.” The exchange continued:

PROXMIRE: You recognize, I take it, that the Federal Reserve Board is a creature of the Congress?

ROBERTSON: Very much so.

PROXMIRE: And that it pursues the policies—rather, the Congress can create it, abolish it, and so forth?

ROBERTSON: Absolutely.

PROXMIRE: What would Congress have to do to indicate that it wishes the Board to change its policy

and give greater support to the housing market? Would you recommend a change in law or would committee report language and subsequent legislative history be sufficient to have an impact on the Board?

Making clear that he opposed such an action, Robertson replied that the former would be required since the Board already thought it was exercising its best judgment, which was “that you should not use monetary policy in a selective way to take care of agriculture, housing, or any other specific area.”

The Board interpreted these events as a threat in its meetings on April 16 and May 10. If the Fed did not commence with purchases on its own accord, members feared Congress might rewrite the Federal Reserve Act to make such purchases mandatory, thereby diminishing the Fed’s independence. The Board’s legislative counsel Paul Cardon reported “widespread Congressional interest” in such an act. “The question of urgency in transmitting a reply was raised, and in light of information supplied by Mr. Cardon it was judged advisable to send a reply without further delay.” The Board expressed its concerns to Chairman John Sparkman of the Senate Banking and Currency Committee in a letter dated May 13, 1968.

The Board’s concerns were validated. The Senate Committee on Banking and Currency approved legislation that would express Congress’s will that the agency purchase authority should be used “when alternative means cannot effectively be employed to permit financial institutions to continue to supply reasonable amounts of funds to the mortgage markets during periods of monetary stringency and rapidly rising interest rates.” The FOMC noted in its June 18 meeting that Congress would, in effect, “utilize the Federal Reserve System to subsidize the housing industry.” The Senate later voted against the measure.

As an analogous bill moved before the House, Martin again summarized the Fed’s concerns in June 27 testimony before the House Committee on Banking and Currency: It would take very large purchases of housing agency securities to have any effect on mortgage rates. But, to make these large purchases of housing

agency securities while maintaining its overall monetary policy stance, the Fed would necessarily have to restrict credit to other sectors of the economy, such as state and local governments, businesses borrowing in money and capital markets, small businesses hurt by banks’ tighter lending policies, and other financial intermediaries, such as mutual savings banks. In other words, it could help housing only by hurting other sectors. Martin stated that the legislation would “violate a fundamental principle of sound monetary policy, in that it would attempt to use the credit-creating powers of the central bank to subsidize programs benefiting special sectors of the economy.”

Over the next few years, the FOMC considered whether to exercise the 14(b) authority to head off future political tensions. In the October 29, 1968, FOMC meeting, Robertson argued:

“Those of us who were involved in fending off a determined Congressional effort to make us buy large amounts of agencies this summer have a lively recollection of how sensitive some Congressmen were to our inaction. I think we would be inviting even more strenuous criticism if, when the legislation comes up for review next year, we still have not lifted a finger to test the response of the agency market to our operations in at least a small way.”

The FOMC explored the technical aspects of agency purchases in the coming months. Some members worried that “experimental” purchases would be a slippery slope and would expose the Fed to even more pressure. Generally dismayed that political pressures seemed close to determining monetary policy, Martin remarked in the May 1969 meeting that “the Federal Reserve had to try to do a more effective job of convincing Congress that there were appropriate and inappropriate objectives for a central bank.”

After replacing Martin as Fed Chairman in February 1970, Arthur Burns reiterated that the FOMC did not support extending Fed credit to the housing agencies. Burns changed his position somewhat in the summer of 1971. Though noting in the July FOMC meeting that he had not made up his mind, he now leaned in the direction of commencing outright

agency purchases. According to the minutes, “While he suspected that that action would not result in any great benefit to housing, it would demonstrate a cooperative attitude on the part of the System.” The FOMC voted affirmatively in the subsequent meeting to so direct the New York Fed, with many members noting they did so reluctantly. On October 19, 1971, the FOMC noted that the System had made its first purchase under the new authorization.

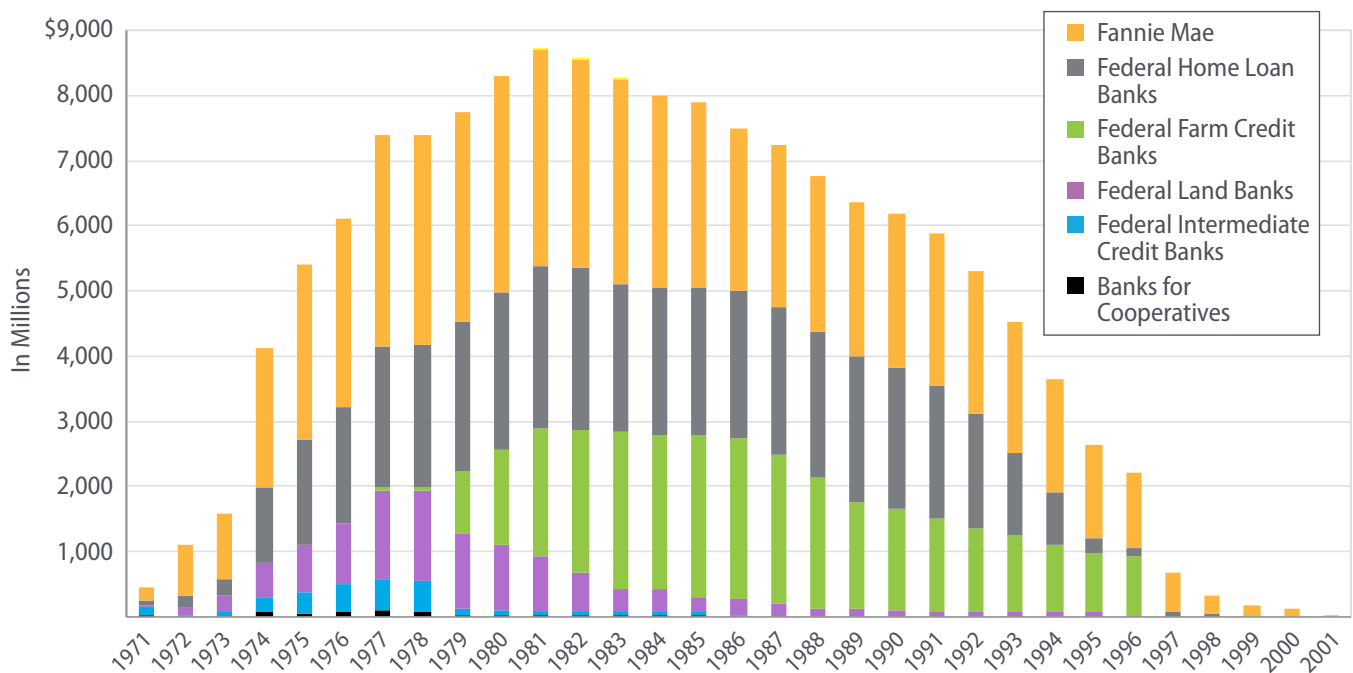
Exit until 2008

By the mid-1970s, the System held 10 percent of Fannie Mae’s total debt obligations, constituting more than 40 percent of the agency securities held by the System. (See Figures 1 and 2). At the peak in 1977, the System’s outright holdings of agency debt reached 7.4 percent (\$8 billion) of its entire outright securities holdings. By this time, the Fed’s purchases included \$117 million in debt issued by the Washington Metropolitan Area Transit Authority (WMATA), which had been established in 1967 to fund construction of the D.C. Metro system using federally guaranteed bonds. At the March 1976 FOMC meeting, Governor Philip

C. Jackson and New York Fed President Paul Volcker expressed concern that agency holdings of this magnitude would distort the market, and Chairman Burns commissioned a study to evaluate the issue. FOMC members were especially concerned that the WMATA purchases would lead other municipalities to expect Fed assistance. Some congressmen had cited those purchases in their unsuccessful request for Fed assistance on behalf of New York City when it faced bankruptcy in 1975.⁹

Volcker’s subcommittee reported its findings to the FOMC on February 15, 1977. Volcker recommended using the creation of the government’s Federal Financing Bank (FFB) as an excuse to exit the market for some agencies. The FOMC simply could change its directive to the New York Fed to exclude securities eligible for FFB purchase, leaving only the securities of federally sponsored agencies, which were not eligible for FFB loans because of their private ownership. That would leave primarily debt issued by Fannie Mae, the Federal Home Loan Banks, and the Farm Credit System as eligible for Fed purchase.

Figure 1: The Fed’s Outright Holdings of Federally Sponsored Agency Debt, 1971–2001



Source: Annual Reports of the Federal Reserve System, Statistical Tables 3 and 4.

Note: Federally sponsored agencies are nongovernment agencies whose debt is guaranteed by the government. These agencies are not eligible for Federal Finance Bank funding, and thus remained eligible for Federal Reserve System outright purchases after 1977.

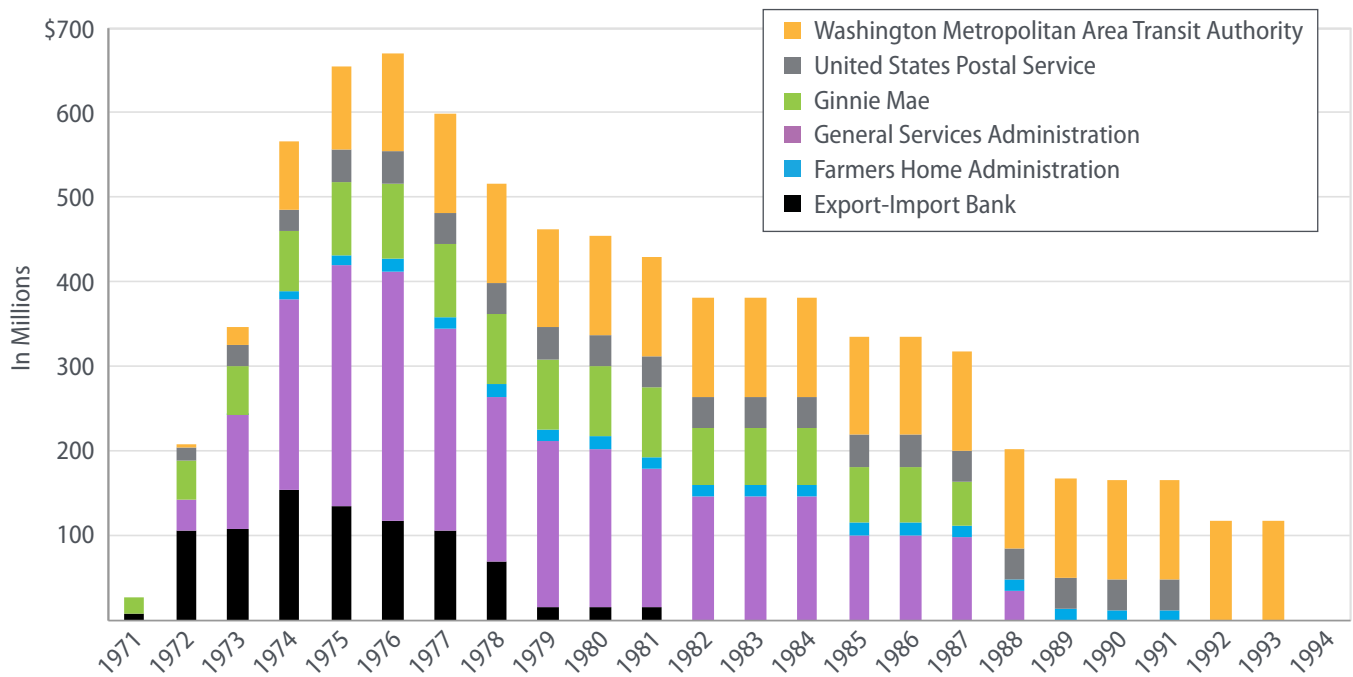
The FOMC agreed on June 20, 1978, to let expiring agency debt roll off its balance sheet. In 1981, the Fed made its last purchases of federally sponsored agency debt until the 2007–09 recession.¹⁰ Holdings of agency debt declined to zero in the early 2000s and remained there until mid-2008.¹¹

On November 25, 2008, the Fed announced that it would once again purchase agency-related debt contracts through what has become known as “quantitative easing,” a policy of expanding the central bank’s balance sheet in order to stimulate the economy. The Fed’s agency holdings as a result of this effort—which included both direct agency obligations and agency-backed MBS—easily eclipse its holdings in the 1970s. Holdings of sponsored agency debt began in late 2008 and reached a peak of roughly \$170 billion in March 2010 but had fallen to \$47 billion as of March 2014 after new purchases ceased. The Fed made its first outright purchases of MBS guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae in January 2009, and continues to expand its holdings each month. Holdings were \$1.6 trillion as of March 2014.

One difference between the purchases of the 1970s and those of the past several years is that the latter marked the first time the Fed incorporated securities other than Treasuries in active monetary policy decisions. In quantitative easing, the Fed has mixed monetary policy (expanding its balance sheet) with credit policy (allocating credit to mortgage markets).

The FOMC’s guidelines for agency purchases, established in 1968, indicate that purchases “are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.”¹² In the December 2008 FOMC meeting, the first after quantitative easing was announced, Richmond Fed President Jeffrey Lacker noted that the FOMC’s guidelines seemed inconsistent with the large-scale purchases of agency debt, which the November press release stated were intended “to reduce the cost and increase the availability of credit for the purchases of houses, which in turn should support housing markets and foster improved conditions in financial markets more generally.” In January 2009, the FOMC voted to suspend the guidelines indefinitely. Lacker

Figure 2: The Fed’s Outright Holdings of Federal Agency Debt, 1971–1994



Source: Annual Reports of the Federal Reserve System, Statistical Tables 3 and 4.

Note: Federal agencies became eligible for Federal Financing Bank funding (and thus ineligible for Federal Reserve System outright purchases) after 1977.

dissented on that decision, as well as the decision to purchase agency obligations. His dissent used many of the same arguments against Fed credit allocation expressed by FOMC members in the 1960s and 1970s.¹³ ■

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Endnotes

¹ Fed historian Allan Meltzer had worked with Patman and commented that he personally believed Patman never expected his measures to pass. They were meant instead to intimidate Fed leaders. See Meltzer, Allan H., *A History of the Federal Reserve. Volume 2, Book 1, 1951–1969*, Chicago: University of Chicago Press, 2010.

² H.R. 11, 89th Congress, 1st Session (1965). The text of the proposed bill, which was not passed, is available at http://fraser.stlouisfed.org/docs/historical/fr_act/hr11_hr_19650104.pdf.

³ Meltzer, p. 455.

⁴ Meltzer, p. 455.

⁵ Meltzer, p. 505. For example, the July 1966 Board meeting minutes said of Governor J. Dewey Daane, “Every economic ground said to increase the rate; his reluctance was because such an action would be harmful to relationships with the Administration.”

⁶ See Cook, Timothy Q., “Regulation Q and the Behavior of Savings and Small Time Deposits at Commercial Banks and the Thrift Institutions,” *Federal Reserve Bank of Richmond Economic Review*, November/December 1978, vol. 64, no. 6, pp. 14–28.

⁷ Meltzer, p. 505.

⁸ Except where noted, Board minutes were accessed by the authors in the Board of Governors physical archives in Washington, D.C. Archived FOMC minutes and transcripts are available at www.federalreserve.gov. All other testimonies, hearings, and documents cited here are available at FRASER, Federal Reserve Archive, <http://fraser.stlouisfed.org>.

⁹ The prospect of New York City’s bankruptcy prompted Burns to speak on several occasions against the possibility of the Fed extending assistance to bankrupted municipalities. See, for example, Burns, Arthur F., Statement before the Subcommittee on Economic Stabilization, Committee on Banking, Currency and Housing, U.S. House of Representatives, October 23, 1975.

¹⁰ The authors of this *Economic Brief* have found no evidence that the Fed was pressured or considered invoking 14(b) to extend support to housing agencies in 1981, when tight monetary policy incited considerable criticism for its adverse effects on the housing industry.

¹¹ The discussions, legislation, and hearings described in this *Economic Brief* are only a sample of those that took place during the episode. One hypothesis for why elected officials pressured the Fed to allocate credit to targeted industries, rather than supporting such sectors themselves with appropriated funds, is that the Fed’s financial independence might provide an easier route to providing subsidies. The Fed does not receive appropriations from Congress, and its asset purchases do not require democratic approval and do not directly affect the fiscal deficit. However, the fact that open market operations are not determined through a democratic process is why some Fed policymakers and other observers have argued that subsidies to certain sectors ought to come from Congress, not the Fed. See, for instance, Goodfriend, Marvin, “The Elusive Promise of Independent Central Banking,” *Monetary and Economic Studies*, November 2012, vol. 30, pp. 39–54.

¹² See “Guidelines for the Conduct of System Open Market Operations in Federal-Agency Issues” under the FOMC’s Rules and Authorizations, available at www.federalreserve.gov.

¹³ For example, see Lacker, Jeffrey M., “Government Lending and Monetary Policy,” speech to the National Association for Business Economics 2009 Washington Economic Policy Conference, March 2, 2009.

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