Yale University
EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Documents (Series 1)
Browse by Media Type

3-24-1971

Arthur L. Broida Letter to Federal Open Market Committee, March 24, 1971

Arthur L. Broida

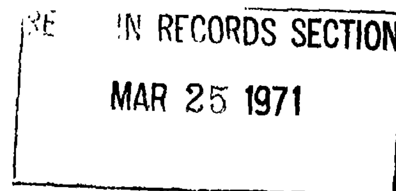
Follow this and additional works at: https://elischolar.library.yale.edu/ypfs-documents

Recommended Citation
Broida, Arthur L., "Arthur L. Broida Letter to Federal Open Market Committee, March 24, 1971" (1971). *YPFS Documents (Series 1)*. 9532.
https://elischolar.library.yale.edu/ypfs-documents/9532

This Document is brought to you for free and open access by the Browse by Media Type at EliScholar – A Digital Platform for Scholarly Publishing at Yale. It has been accepted for inclusion in YPFS Documents (Series 1) by an authorized administrator of EliScholar – A Digital Platform for Scholarly Publishing at Yale. For more information, please contact elischolar@yale.edu.

Authorized for public release by the FOMC Secretariat on 8/21/2020

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551



CONFIDENTIAL (FR) March 24, 1971

To: Federal Open Market Committee

From: Mr. Broida

Enclosed is a copy of a memorandum to the Committee from the staff dated March 23, 1971, and entitled "Federal Reserve Open Market Operations in Federal Agency Issues." Among the appendixes to the memorandum are tentative guidelines for such operations and a related draft amendment of the continuing authority directive. Also enclosed is a copy of a memorandum from the Committee Counsel, dated today and entitled "Exchange of maturing Federal agency issues for new issues."

As indicated in Mr. Holland's wire of March 22, it is contemplated that the subject of operations in agency issues will be discussed at the meeting of the Committee to be held on April 6.

Arthur L. Broida
Deputy Secretary
Federal Open Market Committee

Enclosures

Authorized for public release by the FOMC Secretariat on 8/21/2020

REC'D IN RECORDS SECTION
MAR 25 1971

CONFIDENTIAL (FR)

March 23, 1971

TO: Federal Open Market Committee

FROM: The Staff

SUBJECT: ~~Federal Reserve Open~~ Market Operations in Federal Agency Issues

At the meeting of the Federal Open Market Committee on March 9, 1971, it was proposed that consideration again be given to outright Federal Reserve operations in Federal agency issues.[1] The reason for initiating such operations at this time would presumably be to supplement operations in U. S. Treasury coupon issues as a means of avoiding downward pressure on Treasury bill rates, recognizing that there might also be some beneficial effects on the capital markets.

At a meeting on November 17, 1970, the Committee had considered initiating such operations on an experimental basis as described in a memorandum dated November 10, 1970. That memorandum brought up to date the main points considered by the Committee in its earlier discussions of the subject. The Committee also had before it a memorandum dated June 18, 1969, setting forth tentative operating guidelines for experimental outright operations in agency issues. These guidelines were based on the view that agency operations should not be undertaken in special support of any particular area of the agency market but should conform to the reserve and other objectives of System policy, and that the System should not become the dominating factor in the agency market. While the Committee took no action at

1/ The System has conducted operations in Federal agency securities under repurchase agreements since December 1966.

Authorized for public release by the FOMC Secretariat on 8/21/2020

the November 1970 meeting to initiate experimental operations, it was apparently the consensus that if such operations should be undertaken, they should conform to the above objectives.

Operations in agency issues at this time would presumably be undertaken on an experimental basis with guidelines similar to those proposed earlier except for adjustments to allow for changes in objectives and for market developments since mid-1969.. A restatement of the main arguments for and against such operations is given in Appendix A to this memorandum and guidelines in the form now proposed are shown in Appendix B.

Little has occurred since November 1970 to change the situation described in the November 10 memorandum except that the System Open Market Account has become considerably more active in buying U. S. Treasury coupon issues. Such purchases have been undertaken both to encourage declines in longer-term rates and to diminish downward pressure on Treasury bill rates by reducing the amount of System bill purchases needed to supply reserves. It should be noted that outright operations in agency issues on the scale contemplated are not likely to have significant effects on longer-term interest rates. It is unlikely that many longer-term agency issues would be purchased in the normal course of System operations since the outstanding volume is relatively small and longer-term agencies are not as readily tradeable as shorter maturities. Purchases of shorter-term

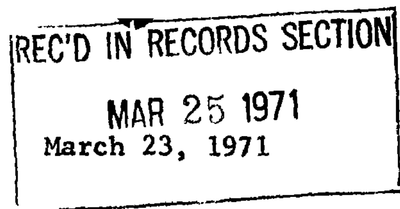
Authorized for public release by the FOMC Secretariat on 8/21/2020

issues could serve as a partial substitute for Treasury bill purchases, but any resulting indirect effects on the capital markets would probably be minor.

Under the proposed guidelines the System would deal in about 80 Federal agency issues, the outstanding volume of which now totals about $32 billion. A summary table in Appendix C shows that about $8.7 billion have a current maturity over five years. The average size of the individual issues is about $170 million. Only 13 issues totaling $3.1 billion have maturities over 10 years, mostly Federal National Mortgage Association Participation Certificates, the market for which is quite thin.

To authorize operations in Agency issues as described above, an amendment to the continuing authority directive would be needed. Suggested wording is indicated in Appendix D.

Authorized for public release by the FOMC Secretariat on 8/21/2020



APPENDIX A

March 23, 1971

PROS AND CONS OF SYSTEM OPERATIONS IN AGENCY ISSUES

I. The Case in Favor of Federal Reserve Operations in Agency Issues

1. Federal agency issues are, for all practical purposes, obligations of the U.S. Government, in effect as risk-free as direct U.S. Government debt, and therefore should be treated by the Federal Reserve System on the same basis as direct debt.

2. The Congress specifically provided authority for the Federal Reserve to undertake open market operations in agency obligations and while the Congress did not make such operations mandatory or require that any particular volume be purchased, the legislative history suggests that some degree of usage of this authority would be in keeping with Congressional intent. (Thus far, the authority has been used only for System acquisitions of agency issues under short-term repurchase agreements.)

3. Federal Reserve willingness to undertake outright transactions in agency issues would tend to increase the marketability of these issues, and would tend to reduce the yield spread between these issues and direct Treasury debt.

Authorized for public release by the FOMC Secretariat on 8/21/2020

4. Federal Reserve purchases of agency issues can thus help to channel credit into uses deemed socially desirable and facilitate the flow of funds to sectors of the economy particularly disadvantaged at times of general credit restraint.
5. Agency issues are sometimes in such relatively large supply as to be a source of over-all credit market pressure, which might be moderated most effectively through direct Federal Reserve operations in the agency market.
6. When there is general credit market congestion for reasons other than an over-supply of agency issues, purchases of the latter issues may still be helpful in relieving the over-all congestion and pressures on interest rates. For example, in some circumstances purchases of longer-term agency issues along with Treasury coupon issues could help to alleviate pressures in capital markets.
7. Purchases of agency issues would broaden the alternatives open to the System when supplies of Treasury bills are relatively low and it is considered desirable to moderate downward pressure on bill rates.
8. The market in agency issues, while generally less broad than that in Treasury coupon issues, has grown substantially in recent years and can accommodate a significant volume of System open market operations without being unduly dominated by those operations.

Authorized for public release by the FOMC Secretariat on 8/21/2020

II. The Case Against Federal Reserve Operations in Agency Issues

1. Any precedent for outright System operations in agency securities initiated at this time could be expected in future periods of tight money to intensify political pressures on the Federal Reserve to provide special relief for housing and other selected areas of activity. If forced to respond too actively to these pressures, the System's ability to realize the broader goals of general monetary policy could be significantly impaired. The instruments of general monetary policy are not well adapted to selective credit allocation. Any modification of the market's allocation deemed to be desirable in the public interest would best be accomplished through specialized credit agencies established by Congress to improve the flow of credit to housing, small business, farmers, etc.

2. By participating in the agency market and increasing the marketability of agency issues, the Federal Reserve might encourage the development of additional specialized credit agencies. It is easy to envisage a proliferation of programs seemingly worthwhile individually but aggregating to an unmanageable whole. The Administration has been trying, with little success so far, to improve its coordination of and control over Federal credit programs, and any fresh encouragement of new programs could be a backward step.

Authorized for public release by the FOMC Secretariat on 8/21/2020

3. The agency market has developed well without System participation and it is not obvious that System entry would promote its improvement. System entry could even be detrimental if Desk operations tended to dominate the market, perhaps setting up expectations of System assistance that could only be fulfilled by sacrificing the broader and more important general objectives of monetary policy.

4. In providing discretionary authority for the Federal Reserve to operate in agency issues, the Congress left it to the System's judgment whether outright participation would be desirable. Hence, it is reasonable for the System to continue to refrain from outright operations in agencies if such operations seem likely to prove unsettling to the functioning of the agency market and/or to complicate the effective implementation of open market policy.

5. The effectiveness of System purchases of agency issues in relieving over-all credit market congestion may be questioned. Most of the outstanding agency issues are short-term, and their purchase would mainly affect shorter rates. System purchases of the relatively small longer-term issues could easily dominate markets in such issues and pull down their rates without having much impact on flows to longer-term capital markets in general.

6. There are significant technical problems entailed in outright System operations in agency issues. For example, since one or another agency is almost always either just coming to

Authorized for public release by the FOMC Secretariat on 8/21/2020

market or has just completed a financing, it might be difficult to avoid the appearance of providing special System support to the new offerings of particular agencies. Also, the large number and relatively small size of agency issues could create technical operating problems. While the average size of individual issues has increased in recent years, it is still much smaller than for Treasury issues. And even though trading volume figures for agency issues look rather substantial, much of this activity occurs while the issues are undergoing initial distribution by members of the selling group--a period in which the Desk would refrain from operations under the proposed guidelines.

7. Another technical problem is the absence of a roll-over arrangement at maturity, similar to the one now available to the System with respect to most direct Treasury issues.[1/] If System holdings of particular agency issues were sizable, there would be a question when such issues matured whether the System could acquire enough of any new issue that might be offered at the time to avoid a significant reserve drain.

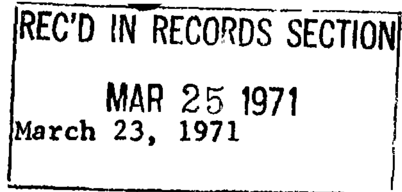
1/ Committee counsel has expressed the opinion that, on the basis of analogous precedent and assuming that the form of the agency offering permits such exchange, it would be legal for the System to exchange holdings of maturing agency issues directly for new issues without going through the market, in line with the current practice in Treasury refinancings. The proposed language for the continuing authority directive shown in Appendix D would permit the Desk to make the exchanges, if arrangements for such exchanges can be worked out with the various agencies involved.

Authorized for public release by the FOMC Secretariat on 8/21/2020

8. Since ownership of many of the so-called Federal agencies has been wholly transferred to the private sector of the economy,[2/] question arises whether the Federal Reserve should operate in the debt of these agencies. In these changed circumstances System transactions could lead to special benefits for selected private stockholders.

2/ These agencies include the Federal National Mortgage Association, Federal Home Loan Banks and Federal Land Banks.

Authorized for public release by the FOMC Secretariat on 8/21/2020



APPENDIX B

March 23, 1971

GUIDELINES FOR CONDUCTING
OPERATIONS IN AGENCY ISSUES

In a memorandum dated June 18, 1969 to the Federal Open Market Committee the Manager of the System Open Market Account suggested certain guidelines for experimental open market operations in Federal agency issues designed to minimize the technical problems involved in such operations, assuming that they were to be undertaken as an adjunct to and for the same purpose as outright purchases and sales of U. S. Treasury issues. This memorandum updates the guidelines to bring them in line with the discussion at the March 9, 1971 meeting of the Committee. While the guidelines are essentially unchanged from the earlier version, some modifications have been made to accommodate the use of agency issues as a substitute for Treasury bill purchases and as a supplement to the purchase of coupon issues at times when the Committee is concerned about the term structure of interest rates. To help facilitate these objectives, the new guidelines increase the initial portfolio objective to a $200-$500 million range from the $100-$250 million range in the earlier version, and reduce from $300 million to $200 million the minimum size of individual longer-term issues eligible for System purchase. The provision contained in the earlier guidelines limiting System operations initially to agency issues maturing in less than two years has been dropped.

As the earlier memorandum indicated, outright System open market operations in agency issues will be more complicated than

Authorized for public release by the FOMC Secretariat on 8/21/2020

operations in U. S. Treasury issues, because of the fragmented nature of the market, the frequent financing operations of the respective agencies, and the special concern of each agency for marketing its own new issues to best advantage. To minimize these problems the guidelines suggest confining System operations to individual issues above a specified minimum size, with a view to restricting the number of issues with which the Desk would have to deal. At the same time, this limitation might encourage agencies to increase the size (and reduce the number) of individual offerings, a procedure endorsed in the April 1969 Report of the Joint Treasury-Federal Reserve Study of the U. S. Government Securities Market.

The guidelines assume--in line with Governor Robertson's memorandum of May 5, 1969--that the Federal Reserve would be entering the agency market as an adjunct to, and for the same purposes as, its outright purchases and sales of direct U. S. Treasury issues rather than to support any particular sector of the market. Because of uncertainties about the ability of the Federal Reserve to roll over its holdings of agency issues at maturity, the guidelines provisionally suggest that issues held by the System be allowed to run off at maturity. This in turn leads to the suggestion that the holding by the System of any individual issue be strictly limited in order to avoid an unwanted impact on bank reserves and also to avoid forcing onto the private market a large volume of agency securities that the System cannot roll over at maturity. There are a number of practical problems that

Authorized for public release by the FOMC Secretariat on 8/21/2020

would have to be worked out with the agencies involved if rollovers are considered desirable. Explanatory comments are included in the guidelines to clarify the technical reasons for these and other features of the proposals.

It should also be noted that the guidelines assume that tax-exempt Government agency issues--either direct or guaranteed--would not be appropriate vehicles for System open market operations. This assumption is based partly on the inadequacy of secondary markets for such issues, and partly on the conclusion of a 1963 inter-Governmental committee (on which the Federal Reserve participated) questioning the desirability and propriety of Federal Government guarantees of tax-exempt issues. Additional study would be needed if the Open Market Committee wanted to explore the possibility of open market operations in such tax-exempt issues.

Finally, it should be made clear that while technical problems can be surmounted, operations in Government agency securities cannot--at least under present circumstances--be as neat and simple as operations in direct Treasury securities. While the guidelines attempt to minimize the technical problems, there are many possibilities for misunderstanding both by the market and by the individual agencies. This suggests that, if the Committee decides that it is desirable to undertake outright operations in Government agency securities, the approach be cautious with special attention to avoiding any disruptive effects on either the secondary market or the marketing of new issues.

Authorized for public release by the FOMC Secretariat on 8/21/2020

It further suggests that before operations are undertaken the principles underlying the conduct of open market operations in agency issues should be made clear to the individual agencies, to the dealer market, and to the general public. Because of the need to feel our way if the FOMC should decide affirmatively to undertake operations in agency issues, the guidelines adopted should be regarded precisely as guidelines rather than as rigid rules. They should be subjected to constant review and revision as the experiment proceeds.

The eight suggested guidelines follow:

1. System open market operations in Government agency issues are an integral part of total System open market operations designed to influence bank reserves, money market conditions, and monetary aggregates.

Comment

Outright operations would normally be conducted in conjunction with similar operations in direct Treasury issues, with amounts purchased or sold depending upon availability or demand and upon the amount of reserve injection or withdrawal desired. In circumstances where the FOMC is especially concerned about the interest rate on Treasury bills, or about long rates, purchases of Agency issues might serve as at least a partial substitute

Authorized for public release by the FOMC Secretariat on 8/21/2020

for purchases of Treasury bills and as a supplement to the purchase of Treasury coupon issues. Whether operations would be conducted at the same time and in the same way as operations in Governments would depend on prevailing market conditions or other circumstances.

2. System open market operations in Government agency issues are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.

Comment

The amount of agency issues bought or sold would depend on availability or demand. Since supply or demand is apt to be spotty, the proportion of agencies included in any day's operation would vary, and careful attention would have to be paid to the price effects of System transactions. The principle of purchase and sale at best price would prevail and care would be taken to avoid undue price effects, to the end that System operations would not become the dominant factor influencing any sector of the agency market.

3. As an initial objective, the System would aim at building up a portfolio of agency issues of from $200 to $500 million over a period of two to three months, with the amount and timing dependent on the ability to make net acquisitions without undue market effects.

Authorized for public release by the FOMC Secretariat on 8/21/2020

Comment

The range mentioned provides enough scope for System purchases at the start to be a helpful adjunct to other open market operations, but it must be recognized that such magnitudes may not be achieved because of market conditions. Also, allowance should be made for maturity of some of the holdings, and for sales to establish the principle of System sales of agencies when reserves are being absorbed.

4. System holdings of maturing agency issues will be allowed to run off at maturity, at least initially.

Comment

Current procedures involved in the marketing of new agency issues do not provide for the exchange of maturing issues on the basis that the System now exchanges its holdings of Treasury issues. Committee counsel has expressed the view that the law would permit special arrangements with fiscal agents, selling groups or syndicates whereby new issues may be channeled into the System portfolio on an exchange or similar basis. If such exchanges are deemed desirable and are acceptable to the borrowing agencies, discussion of practical procedures should be undertaken with those agencies.

Authorized for public release by the FOMC Secretariat on 8/21/2020

5. Purchases will be limited to fully taxable issues for which there is an active secondary market. Purchases will also be limited to issues outstanding in amounts of $300 million or over in cases where the obligations have a maturity of five years or less at the time of purchase, and to issues outstanding in amounts of $200 million or over in cases where the securities have a maturity of more than five years at the time of purchase.

Comment

This guideline would limit the number of agency issues to be purchased to 79 issues totaling about $32 billion. (See Appendix C.) Generally speaking, these issues would be more readily tradeable than the smaller issues. The lower limit of $200 million for issues over five years might permit somewhat more purchases in that area, which would offer few opportunities at best. Farmers' Home Administration Insured notes, which are longer-term obligations, would not be purchased as they are not actively traded because of their unorthodox features.

6. System holdings of any one issue at any one time will not exceed 10 per cent of the amount of the issue outstanding. There will be no specific limit on aggregate holdings of any one issuing agency.

Authorized for public release by the FOMC Secretariat on 8/21/2020

7. No new issue will be purchased until at least two weeks after the issue date.

Comment on Guidelines 6 and 7

The purpose of these two guidelines is to try to minimize the impact of System purchases and holdings of individual agency issues on the market price of those issues, to minimize the replacement problem at maturity, to avoid affecting--insofar as possible--the pricing of new issues, to avoid either the appearance or the fact of direct System support of any new issue, and to ward off possible pressures from borrowing agencies, Fiscal agents, selling groups or syndicates. We have no way of telling in advance whether operations based on market supply and demand would result in a balanced System portfolio of issues of the several borrowing agencies, although System repurchase agreements involving agency issues have resulted in a reasonably good distribution of agreements among the issues of the various agencies. We shall have to be alert to the possibility that the timing of purchase and sale operations may inadvertently discriminate among agencies. The frequency of new agency issues will also represent a continuing problem of minimizing or avoiding operations in closely competitive outstanding agency issues in order to avoid charges that the System either "cleaned up" the market to help the new issue, or that it "wrecked" the market by selling.

Authorized for public release by the FOMC Secretariat on 8/21/2020

8. Initially, all purchases, sales, and holdings of agency issues will be for the Account of the Federal Reserve Bank of New York.

Comment

The recommendation that operations in agency issues initially be undertaken for Account of the Federal Reserve Bank of New York is made solely to simplify accounting procedures in the initial stage of operations. It will take some time to implement computer accounting procedures to handle the distribution of agency holdings in the System Open Market Account. After a suitable program has been worked out, there would be no problem in including agencies in the Open Market Account. Even before this is done, it would be possible, if the Committee so desired, to participate earnings or losses (monthly or quarterly) among the Reserve Banks on the basis of their participation in the System Open Market Account.

Authorized for public release by the FOMC Secretariat on 8/21/2020

...S SECTION
MAR 25 1971

APPENDIX C

March 23, 1971

Table 1

Summary of Outstanding Marketable Agency Issues
By Size of Issue and Current Maturity
(amounts in millions)

	Under 2 Years		2-5 Years		Over 5 Years	
	#	Amount	#	Amount	#	Amount
Size Categories						
0-$199 million	18	$1,213	21	$1,507	33	$2,171
200-299 million	21	4,935	14	3,248	9	2,075
300 and over	41	18,492	19	6,884	10	4,492
	80	24,640	54	11,639	52	8,736

NOTE: The above tabulation does not include discount notes of FNMA and TVA, and tax-exempt housing notes and bonds backed by the full faith and credit of the U. S.

Authorized for public release by the FOMC Secretariat on 8/21/2020

APPENDIX C

Table 2

Distribution of Outstanding Marketable Agency Issues
By Agency, Size of Issue, and Current Maturity

	Maturity					
	Under 2 Years		2 to 5 Years		Over 5 Years	
	#	Amount	#	Amount	#	Amount
Federal Intermediate Credit Banks-debentures						
0-$199 million						
200-299 million	2	485	2	424		
300 and over	8	4,171				
Federal Home Loan Banks(a)						
0-$199 million	1	175	1	185	1	140
200-299 million	4	950	4	1,004	1	200
300 and over	9	4,800	5	1,750	1	350
Banks for Cooperatives						
0-$199 million			1	100		
200-299 million	1	268				
300 and over	4	1,453				
FNMA - bonds, notes & debentures						
0-$199 million	5	507	1	146	1	198
200-299 million	7	1,550	5	1,200	5	1,150
300 and over	12	4,850	10	3,800		
GNMA - PC's and debentures						
0-$199 million	9	290	11	300	19	710
200-299 million	2	525			2	475
300 and over	2	785	1	330	6	3,015
Federal Land Banks-bonds						
0-$199 million	3	241	3	476	3	443
200-299 million	5	1,157	2	420		
300 and over	5	1,933	3	1,004	1	427
Ex. - Im. Bank PC's and debentures						
0-$199 million			1	150		
200-299 million					1	250
300 and over	1	500			1	400
TVA notes and bonds						
0-$199 million			2	150	8	525
200-299 million						
300 and over						
Farmers Home Admin. - Insured notes						
0-$199 million					1	150
200-299 million			1	200		
300 and over					1	300

(a) include mortgage backed bonds

Authorized for public release by the FOMC Secretariat on 8/21/2020 RECORDS SECTION
MAR 25 1971

APPENDIX D

Possible amendments to paragraph 1(a) of the Committee's continuing authority directive

(a) To buy or sell U.S. Government securities AND OBLIGATIONS THAT ARE DIRECT OBLIGATIONS OF, OR FULLY GUARANTEED AS TO PRINCIPAL AND INTEREST BY, ANY AGENCY OF THE UNITED STATES in the open market AT MARKET PRICES, from or to ~~Government~~ securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, ~~for the System Open Market Account at market prices~~ and~~, for such Account,~~ to exchange maturing U. S. Government securities AND FEDERAL AGENCY OBLIGATIONS with the Treasury OR THE INDIVIDUAL AGENCIES or allow them to mature without replacement; provided that TRANSACTIONS IN U. S. GOVERNMENT SECURITIES SHALL BE FOR THE SYSTEM OPEN MARKET ACCOUNT AND TRANSACTIONS IN AGENCY OBLIGATIONS SHALL BE FOR THE ACCOUNT OF THE FEDERAL RESERVE BANK OF NEW YORK; AND PROVIDED FURTHER THAT the aggregate amount of such U. S. GOVERNMENT securities AND AGENCY OBLIGATIONS held in such AccountS at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $2.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

Authorized for public release by the FOMC Secretariat on 8/21/2020

RECORDS SECTION
MAR 25 1971

March 24, 1971.

To: Federal Open Market Committee

From: Mr. Hackley

Subject: Exchange of maturing Federal agency issues for new issues.

In a memorandum to the Federal Open Market Committee from the Staff dated March 23, 1971, regarding proposed open market operations in Federal agency issues, reference was made to the possibility of exchanging such issues at maturity for new issues. Question arises whether such exchanges would be legally permissible.

Section 14(b)(2) of the Federal Reserve Act authorizes a Reserve Bank -

> "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 authority to buy and sell agency issues only in the open market is in contrast with the authority of the Reserve Banks, under section 14(b)(1), to buy direct obligations of the United States and obligations guaranteed as to principal and interest by the United States _either_ in the open market or directly from the United States, subject to the condition that the aggregate amount acquired directly from the United States and held at any one time by all of the Reserve Banks shall not exceed $5 billion. There is no express authority in the statute for the

Authorized for public release by the FOMC Secretariat on 8/21/2020

direct purchase of agency issues from the issuing agency.* The question here, therefore, is whether the acquisition of agency issues from the issuing agency in exchange for maturing ones would constitute a "direct" acquisition or whether it could properly be regarded as an acquisition "in the open market".

The situation here is comparable to that that existed between 1935 and 1942, when the Reserve Banks were permitted to purchase U. S. obligations only in the open market. In 1937, however, the then Assistant General Counsel of the Committee held that maturing securities could be exchanged by the Reserve Banks directly with the Treasury for new securities; and the Board's Annual Report for 1937 (p. 211) contained the following statement:

> "The Committee was of the opinion that the provision contained in section 14(b) of the Federal Reserve Act that bonds, notes and other direct obligations of the United States may be bought or sold without regard to maturities but only in the open market does not prohibit the exchange of maturing Government securities for an equal amount of new securities carrying the conversion privilege, ..."

---

* If an "agency issue" is fully guaranteed by the United States as to principal and interest, it may be argued that the Reserve Banks may purchase such issues for cash directly from the issuing agency pursuant to subparagraph (1) of section 14(b), provided the total amount so purchased and held at any one time, along with direct obligations of the United States and other agency issues fully guaranteed by the United States, does not exceed the prescribed amount limitation. It appears to have been assumed that the authority for direct purchases in the proviso in subparagraph (1) refers to such purchases from the Treasury; but one could argue that the authority extends to purchases from other agencies of the United States as well as from the Treasury Department. In such a case, a cash purchase of a fully guaranteed agency issue directly from the issuer would have to be counted in applying the $5 billion limitation.

Authorized for public release by the FOMC Secretariat on 8/21/2020

In effect, acquisitions of securities in exchange for maturing issues were regarded as "open market" acquisitions.

After the law was amended in 1942 to authorize the Reserve Banks to purchase Government obligations directly from the Treasury up to a specified amount, the then General Counsel of the Committee concluded that obligations acquired through exchange for maturing obligations need not be counted in computing the amount subject to the limitation on direct purchases. A similar opinion was subsequently rendered in 1942 by the then Assistant General Counsel of the Committee. This position was reaffirmed by Mr. Vest, then General Counsel, in 1947 and again by Mr. Frederic Solomon and me in a memorandum dated October 16, 1958. The clear implication of this position is that, when securities purchased in the open market are exchanged at maturity _directly_ with the Treasury for new securities, the new securities nevertheless are _not_ "acquired directly from the United States" within the meaning of section 14(b)(1). It follows that they have to be treated as having been acquired in the "open market".

It appears that this position has been supported in the past on the grounds that the power to exchange maturing securities bought in the open market for new securities of the issuer in a direct transaction with the issuer is "incidental" to the basic authority of the Reserve Banks to purchase Government obligations and that such a transaction does not violate the intent of the statutory prohibition

Authorized for public release by the FOMC Secretariat on 8/21/2020

against direct purchases from the Treasury, i.e., to prevent the Treasury from acquiring unlimited new funds by borrowing them from the Reserve Banks without going to the public.

The validity of these arguments is at least questionable. It is difficult as a matter of logic, for example, to conclude that securities are bought directly from the issuer when they are paid for by cash but are not bought directly from the issuer when paid for by other securities. It may be argued also that the acquisition of new securities directly from the issuer, even though in exchange for maturing securities, does not fully meet the "test of the market". Moreover, it is not clear that the statute was intended only to limit the direct acquisition from the Treasury of new securities that represent new financing and that it was not also intended to preclude the refinancing of existing outstanding indebtedness.

Nevertheless, the fact remains that the position that acquisition of Treasury securities directly from the Treasury in exchange for maturing securities is not a "direct" acquisition within the meaning of section 14(b) has been sanctioned by long administrative practice without challenge by Congress. In principle, I see no sound reason for not applying the same position to acquisitions of new agency issues directly from the issuing agency in exchange for maturing issues. To take any other position would cast serious question upon the legality of the practice followed over the years with respect to exchange of maturing Treasury issues for new Treasury issues.

Authorized for public release by the FOMC Secretariat on 8/21/2020

Accordingly, on the basis of analogous precedent, it is my opinion that the exchange by the System of maturing agency issues for new agency issues would be legally permissible under section 14(b)(2) of the Federal Reserve Act.

This conclusion assumes that the form of the agency offering is such as to permit the exchange of maturing issues for new agency issues. If the exchange privilege should be given only to the Federal Reserve, it might be argued that the transaction is not at "arms length"; but, in my opinion, this fact would not affect the legal authority of the System to acquire new issues in exchange for maturing ones.

It should be noted that legal questions might arise as to whether securities issued by certain agencies constitute "agency issues" within the meaning of section 14(b)(2) of the Act.