FEDERAL RESERVE BANK OF NEW YORK

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This should be argument logic

Personal and Confidential

June 8, 1955

Hon. Wm. McC. Martin, Jr., Chairman,
Board of Governors of the
Federal Reserve System,
Washington 25, D. C.

Dear Bill:

Enclosed are my notes for the meeting of the Special Committee of the Federal Open Market Committee held on June 6, 1955, which I was asked to send to the members of the Committee.

It seems to me that the deliberations of the Special Committee would be furthered if the alleged defects of the present arrangements with respect to the conduct of open market operations, directed by the Federal Open Market Committee, could be set down in black and white in some orderly manner and distributed among the members of the Committee prior to its next meeting. We could then reexamine these alleged defects and compare them with the possible defects of alternative proposals, none of which, it can be assumed, will be perfect. So far, most of what we have concerning the alleged defects of the present structural arrangements are scattered statements made in oral discussion.

I also think it would be helpful to the Committee to have the benefit of counsel's consideration of the problem of employment of a Manager of the System Open Market Account by the Federal Open Market Committee. It has been my understanding that it is the opinion of counsel that there would be certain practical difficulties attendant upon trying to change present arrangements without legislation, that the matter is open to some troublesome questions, and that the most clean cut method and the only method that would be certain of avoiding various practical difficulties would be to obtain legislation. If the problems with which we are struggling are as important as has been suggested, and if understanding of our procedures by the Congress and by the public is one objective of the proposed changes, a clean cut method of effecting these changes would seem to be desirable. And yet, I would assume, that no one of us wishes to go before the Congress on a matter of this sort at this time if it can be avoided.

Yours faithfully,

Allan Sproul

P.S. I suppose that the preparation of such a list of alleged defects of present arrangements, as I have suggested, would fall naturally to you since it was largely upon your insistence that the present Special Committee was appointed and given its assignment. A.S.

Special Committee, FOMC
6/6/55
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Confidential

1. In terms of the proposal presented by the Chairman at our last meeting ("Status of Manager of System Open Market Account" - May 10, 1955) what we are now discussing is vastly more important than the form of appointment of the Manager of the System Open Market Account, or his status vis-a-vis the Federal Open Market Committee. We are now involved in the whole problem of the purpose and functioning of the arm of the Federal Reserve System in the principal national and international money market of the country. Perhaps this was inevitable in our assignment, although it goes well beyond what was discussed when that assignment was given to us. In any case, it demands the greatest objectivity, the least personal bias, and the most thorough study we are able to give to it. It is in that way that I have tried to analyze the proposal of the Chairman. Briefly I don't think it would work well, and I don't think it would be desirable from the standpoint of the Federal Reserve System, the Federal Open Market Committee or the Federal Reserve Bank of New York.

2. The analogy. Suggested that what is now proposed is somewhat comparable to the Chairman of the Board and Federal Reserve Agent of pre-1935.

(a) Office of the Chairman of the Board and Federal Reserve Agent was a statutory one and there was provision in the statute for method of fixing his compensation. Proposed office of Manager of System Open Market Account not provided by statute and there is real question as to whether statute intended Federal Open Market Committee, which was derived from earlier forms of open market committees, to have a paid staff and to direct, in this way, the detailed operations of Federal Reserve Banks in the open market. There is pretty clearly a question about payment of the salary of the Manager of the Account as proposed. The statute provides a specific method of payment of compensation by Federal Reserve Banks to directors, officers, and employees, and the proposed Manager and his staff would be none of these. Under the proposal the Federal Reserve Bank of New York would be drawing its check to pay salaries and expenses to be determined by another body, without legislative sanction.

(b) The old style Chairman of the Board and Federal Reserve Agent, as a director of the Bank, had statutory responsibilities relating to the administration of the Bank and its affairs, quite apart from his responsibilities to the Board as Federal Reserve Agent. There was an attempt to tie him into both the Board and the Bank. The present proposal attempts to avoid this straddle, but it would be inherent in the situation created. In many if not all cases the original arrangement with respect to the Chairman of the Board

and Federal Reserve Agent was a continuing source of friction and administrative difficulty at the Federal Reserve Banks, at least until one man had assumed the dominant position, whatever the ambiguities of the law.

(c) In my judgment what has been suggested with respect to the Manager of theSystem Open Market Account cannot find a happy forerunner in the old arrangement with respect to the Chairman of the Board and Federal Reserve Agent, but the comparison does point to the sources of administrative and operational friction which are the likely outcome of such arrangements, and raises a real question as to whether legislative action would be necessary to accomplish what is suggested.

3. So much for the analogy. Now to concentrate on the substance of the proposal. In my opinion it has three fundamental and overlapping weaknesses. One is its substitution of individual responsibility for institutional responsibility. The second is its attempt to separate and segregate open market operations directed by the Federal Open Market Committee, from all other forms of central banking operations in the central money market of the country. The third is the impetus it would give to administrative friction, and the obstacles it would place in the way of executive recruitment, training and development.

4. In the discussion of this problem which took place at the meeting of the Federal Open Market Committee in March, I expressed certain views on institutional versus personal responsibility and I need not repeat them here. The present proposal tries to retain some semblance of institutional responsibility. It aims to make use of the necessary facilities of the Federal Reserve Bank of New York, but to shift operational direction of part of those facilities into the hands of a separate Manager of the System Open Market Account. This is not the kind of institutional responsibility I have talked about and which I think is an integral part of our regional reserve system. To preserve the kind of institutional responsibility I think is necessary, the directives of the Federal Open Market Committee and its Executive Committee should run to the Federal Reserve Bank of New York, as they do now, and the Federal Reserve Bank as an institution must be responsible for carrying out those policy directives; not merely responsible for the mechanics of transactions directed by an outside Manager of the System Open Market Account. The latter arrangement shifts the main burden of responsibility from an institution to an individual.

5. The deeper but related defect of the proposal lies in its narrow definition of the functions of the Manager of the System Open Market Account and in its attempt to separate his operations from the operations now performed by the Federal Reserve Bank of New York, as the Federal Reserve Bank representing the System in the principal money market of the country. The money market is not a collection of water-tight compartments which can be separated in this way, and the responsibilities of the System in the money market are no less resistant to such separation. The System's

responsibilities in that market are all inter-related. They include, among other things, not only open market operations for System Open Market Account, but loans made by the New York Reserve Bank to money market banks, the analysis and careful monitoring of the reserve position of the money market banks, the consultative handling of Treasury depositary arrangements, the substantial transactions funneled through the New York Bank for investment accounts of the Treasury, and the large operations undertaken for the account of foreign central banks and governments. These are a principal part of the complex of forces which, as they affect the flow of funds into and out of the banking system, and the residual settlement of reserve needs at the money center, have to be administered consistently with one another and with the policy directives of the Federal Open Market Committee, if the central banking system is to do its job. The operations of the Federal Reserve Bank of New York which are not under the direction of the Federal Open Market Committee cannot arbitrarily be separated from the open market operations which are directed by the Federal Open Market Committee, without serious loss of effectiveness. To cite but one example our operations for System Account (outright purchases and sales) totaled $4,257 million in 1954 and our operations in Government securities for others (purchases and sales) totaled $3,895 million. All of these operations need unified direction.

It is not too much to say, in fact, that the new proposal would threaten to destroy the coordination of money market instruments that has evolved over the past forty years, and been used by the Federal Reserve Bank of New York, as an institution acting for the whole Federal Reserve System, both in fulfilling the System's responsibilities in the money market, and in accordance with the general directives of the Federal Open Market Committee. To be most effective the coordination must be centered in the institution, and in men working as a team within the institution, so that without loss of motion, or the need to pass through separate channels of authority, all or any of the several instruments available to the Bank, in any of its capacities, can be brought to bear on the problem.

The common use of one trading desk for the mechanics of open market operations, as proposed, and assuming as we must the best will in the world on both sides, would still not achieve maximum coordination of operating decisions made by two separate entities having authority in two separate areas. This would seem to be an obvious lesson of administrative experience. Nor could relations with all of the various factors in the market be maintained on a coordinated basis if there were dual controls at the Federal Reserve Bank. It would be possible under present arrangements, of course, to indicate to dealers the origin of orders which we place with them, but I question whether even this is desirable as a matter of central banking practice and whether we would be justified in giving such information to individual dealers when it is not available to the whole market.

A stated reason for the suggestions contained in the proposal is to eliminate an "anomalous situation". I should say that the proposed arrangement would create a more anomalous situation and one less easily explainable to the Congress or to the public than what we now have.

6. I need not say much about the third weakness of the proposal. I have already mentioned it - the tendency to administrative friction and the weakening of executive recruitment, training and development. In my opinion, it would probably create an unsustainable administrative situation and would certainly be charged with a high friction potential. You may say the present operational structure has that also, but it is the product of long historical evolution. We have learned to live with it, and it shouldn't be put aside in the interest of a new scheme whose defects we can only imagine, particularly if our real objectives can be achieved in some other way.

On the matter of recruitment, training and development, we would have two lesser jobs taking the place of one key job. Lesser men, over the years, would be attracted to these jobs. One of the jobs, that of Manager of the System Open Market Account, would be outside the regular orbit of System organization and operation, a bob-tailed thirteenth Federal Reserve Bank. As has happened often in the past, there might be long periods when the System Account would be inactive, when the Manager of the Account would lose that touch with the whole money market (not just the Government securities market) which can come only from participating in actual transactions, and when the making of studies and writing of reports would not be enough to maintain interest and keep faculties sharp. Similar difficulties would face the small staff of a separate Manager; lack of sufficient continuity, breadth and scope of operations to insure suitable recruitment, training and development, because of an invisible wall between the Manager and his staff and the staff of the Federal Reserve Bank of New York.

The possibility of adequate high level coverage also enters here. That coverage needs to have depth, to take account of administrative requirements and vicissitudes of health. Under the present institutional arrangement the Manager of the Account is backed up by the President of the Bank who is a member of the Federal Open Market Committee, the First Vice President who is an alternate member of the Federal Open Market Committee, as well as by the Manager's own subordinate staff. A separate Manager would have only a small subordinate staff, presumably of lesser caliber than the Manager himself, and high level coverage in depth through an institutional chain of command would be lacking.

7. Would not be so free to condemn what has been suggested in this proposal, if I did not think real objectives of the Federal Open Market Committee could be attained in other ways.

The matters of concern which seemed to underlie the discussion of the Federal Open Market Committee at its March meeting were:

(a) The method of appointment of the man who serves, in effect, as chief operating officer of the Committee in carrying out the institutional responsibilities assigned to the Federal Reserve Bank of New York by the Committee.

(b) The fact that expenses relating to open market operations carried out under direction of the Committee are not reviewed by the Committee before they are incurred, and are not clearly anddirectly shared by all of the Federal Reserve Banks, with the possible implication that he who pays the piper may call the tune.

(c) The place of the Federal Reserve Bank of New York in the Federal Reserve System. Whether or not the assignment to the bank of responsibility for the open market operations directed by the Committee, along with all of its other duties and responsibilities, doesn't upset the balance among national and regional representation in policy formation which is essential for good central banking in this country.

To try to remove or allay these concerns, which have grown, at least in part, out of past shortcomings, I suggest an extension of the tentative proposals I submitted at our last meeting.

8. (a) Prior to each annual reappointment of the present Manager of the Account, the Assistant Vice President and the two Managers of the Securities function of the Federal Reserve Bank of New York, a meeting of member representatives of the Federal Open Market Committee and the Board of Directors of the Federal Reserve Bank of New York be held to discuss the appointments so that a process of joint consultation, before appointment by the Bank and approval by the Committee, would be established while retaining the institutional responsibility of the Federal Reserve Bank of New York.

(b) If and when it becomes necessary to appoint a new Manager of the Account, a list of possible appointees containing the suggestions of members of the Federal Open Market Committee and of the Board of Directors of the Federal Reserve Bank of New York would be prepared and their qualifications studied by member representatives of the Federal Open Market Committee and the Board of Directors of the New York Bank. Those who survive the preliminary examination of qualifications would be interviewed by the joint committee. This committee would be charged with agreement on a candidate who would then be named Manager of the Account by the Federal Reserve Bank of New York subject to the approval of the Federal Open Market Committee.

(c) Whenever it is proposed to make changes in the incumbents now serving as Assistant Vice President, and as Managers in the Securities function of the Federal Reserve Bank of New York, the changes could be discussed with the member representatives of the Federal Open Market Committee on the joint committee before actual transfers are made.

(d) There could be reaffirmation of the provision of the by-laws of the Federal Open Market Committee that the Manager of the Account serves at the pleasure of the Committee which, with the change in the method of selection, should remove whatever basis there is for feeling that the Committee does not in fact retain that power if needed. If the power were exercised, the tenure of the principal assistants of the Manager, of course, would come up for review.

(e) In accepting the designation of the Federal Open Market Committee as the Federal Reserve Bank selected to execute transactions for System Open Market Account, and in assuming the end responsibility for the appointment of the Manager of the System Open Market Account, subject to the approval of the Federal Open Market Committee, the directors of the Federal Reserve Bank of New York would continue to commit themselves (as they have in the minutes of the Bank in the past) to the understanding that the Manager of the Account would not be expected to and should not report to them on operations of the Account, other than to present the facts and figures of past transactions, which are regularly published, such transactions to be ratified and approved.

9. Budget and Allocation of Expenses

(a) At the same time that the total budget of the Federal Reserve Bank of New York is prepared, a separate budget relating to open market operations to be carried out under the direction of the Federal Open Market Committee would be prepared and sent to the members of the Federal Open Market Committee for their review and suggestions. As submitted, or later revised, this budget would, of course, be part of the total budget of the bank which is finally passed upon by the Board of Governors.

(b) The expense of operations carried out for the Federal Open Market Committee under the budget would be allocated among the twelve Federal Reserve Banks, at appropriate intervals and in accordance with an acceptable formula of allocation such as has been used in connection with other System matters.

(c) A statement of performance under the budget including comparison of expenditures with estimates - would be submitted to each member of the Federal Open Market Committee after the end of the year.

10. The position of the New York Bank in the Federal Reserve System has always been a matter of some political suspicion and some internal friction, beginning with the steps leading up to the establishment of the System and the establishment of district boundaries, and continuing up to the present day. It appears to be an inescapable fact growing out of the economic and political geography of the country, as well as out of the structure of the System. There will probably always be a problem of keeping Washington, New York, and the rest of the System in properly balanced relationship. We might as well face it. But both analysis and experience should teach us that the problem can't be solved by one-shot cures. And we shouldn't attempt to solve it by chipping away the powers of the Federal Reserve Bank of New York and weakening its ability to do its job as an arm of the Federal Reserve System, without, at the same time, adding to the total powers of the System or strengthening its capacity for effective performance of its duties. The answer, which will probably never be complete, lies rather in an attempt by all concerned to study continuously and discuss fully the policy implications of action which may be contemplated or taken under changing economic conditions. In the area of those open market operations which are under the direction of the Federal Open Market Committee, the steps which the Federal Reserve Bank of New York has recently taken to improve the character and quality of its reports to the Committee, and the suggestions which it has made for further improvement of communications between the Management of the Account and the Committee, seem to me to indicate the direction to be followed in ameliorating this problem.

I cannot accept the assumption that the change which the Chairman's proposal suggests inthe structure of our open market arrangements would not have serious repercussions on the position of the Federal Reserve Bank of New York. I believe that it would cast doubt on the performance of the Federal Reserve Bank of New York, a doubt which some in the market have sought to create and exploit for their own reasons. And by casting doubt on the performance of the New York Bank we run a serious risk of damaging the prestige of the whole Federal Reserve System. This is a hazard which should be risked, if there is warrant for charging the New York Bank with failure to meet its responsibilities. This charge has not been made. The hazard could be risked, I suppose, if there were no other way of meeting the concern of some members of the Federal Open Market Committee with present arrangements. In my opinion, however, whatever real basis there is for concern about these arrangements can be met by the adjustments which I have suggested.

11. To summarize

(a) The experience of the Federal Reserve System with a full-time Chairman of the Board and Federal Reserve Agent does not recommend the adoption of similar arrangements with respect to the Manager of the System Open Market Account and his immediate staff. It led to

administrative difficulties, internal friction, and the eventual dominance of one side of the dual monarchy over the other. In addition, the adoption of a similar arrangement with respect to the Manager of the System Open Market Account and his immediate staff, as proposed, would seem to require legislation, if "practical difficulties" and "troublesome questions" are to be avoided.

(b) In essence, even though not in appearance, the proposal would substitute individual responsibility for institutional responsibility in an operational matter. Institutional responsibility is a part of the fabric of our Federal central banking system, with its division of most powers between policy making bodies at the center and operational units at the regional Federal Reserve Banks.

(c) The proposed segregation of duties of the Manager of the Account and the Vice President of the Federal Reserve Bank of New York in charge of its Securities function would be an attempt to divide something which, in terms of central bank operation in the principal national and international money market of the country, is inseparable. There are two aspects to the principal task of the Federal Reserve Bank operating in this money market.

One aspect of the job is to keep the money market functioning smoothly from day to day and week to week so that temporary flows of funds into and out of the market, from whatever cause, will not tie knots in the market and cause trouble for the whole economy. The other aspect of the job is the more dramatic one of influencing the general trend of bank reserves and money market conditions in accordance with the overall policies adopted by the Federal Open Market Committee which are, in turn, part of the general credit policy of the whole Federal Reserve System, whether that be ease, neutrality or restraint in all of their various manifestations.

These two aspects of one task involve, at various times, the discount window, transactions for Treasury accounts, the consultative timing of Treasury calls on depositaries, transactions for foreign governments or central banks, and transactions for international accounts, all of which should be fitted in with transactions executed for the Federal Open Market Committee. The key individual part in discharging this responsibility of the central banking system of the country, in New York, is played by the Vice President in charge of the Securities function of the Federal Reserve Bank of New York. The institutional responsibility is that of the Federal Reserve Bank of New York acting in behalf of the Federal Reserve System. It is claiming a great deal for cooperation and coordination to insist that the job could be done better under the proposed division of responsibility between an institution and an individual. The operations of the Federal

Reserve Bank, wholly as Bank, are inextricably tied in, it seems to me, with the special open market operations directed by the Federal Open Market Committee which are now executed by the Bank. To try to separate them, and to try to operate them under two heads, cannot help but lead to a loss of effectiveness and efficiency of our whole central banking mechanism.

(d) The separation of one key job into two lesser jobs, over time, would attract lesser men, and the division of responsibility and authority between two men would create more internal administrative and operational friction than we now have. The separation of the Manager of the System Open Market Account from the Federal Reserve Bank of New York would also weaken the senior coverage in depth which can now be provided for transactions undertaken for System Open Market Account.

Conclusion: It is not necessary to create these hazards, run these risks, whittle down the position of the Federal Reserve Bank of New York, nor weaken the effective functioning of our regional central banking system, in order to relieve the real concern of those within the System who have doubts about our present arrangements, and to rebut the attacks of those outside the System who, for political, or other reasons have been trying to create a schism between Washington and New York - between New York and the rest of the country.