[redacted]

July 21, 1961

The Honorable Wright Patman,
Chairman,
Joint Economic Committee,
Congress of the United States,
Washington 25, D. C.

Dear Mr. Chairman:

With my letter of July 11, 1961, I transmitted the replies to 12 of the 13 questions that you presented to me at the Hearing before the Joint Economic Committee on June 1 and 2 this year.

There is now enclosed the reply to the thirteenth question that you asked at that time, as well as a joint reply by Mr. Hayes, President of the Federal Reserve Bank of New York, and myself, to the question that you asked of each of us regarding the question of effects of changes in reserve requirements and open market operations.

Sincerely yours,

(SIGNED) WM. McC. MARTIN, JR.

Wm. McC. Martin, Jr.

Enclosure

MS:me

13. For each of these actions (1) what combination of economic indicators prompted the action, (2) what evidence is there of market response, and (3) did the response match, fall short of, or surpass expectations or aims?

In answering these questions, it needs to be recognized that formulation and execution of monetary policy is a continuous process that requires constant review of economic and financial developments and adaptation to such developments. Consequently changes in the directive do not necessarily represent a sharp change in the direction of policy. Moreover, within a given directive there is room for variation in policy execution in response to changes in credit conditions and market behavior. Such variations are generally reflected in the consensus of the Committee that is reached at each meeting as to the course of policy execution in the period ahead.

Broad economic objectives of the Committee are by their nature expressed in general terms. The processes and procedures through which policy is executed in the short-run are necessarily more specific and concrete. Monetary policy exerts its influence most immediately and directly upon the volume of commercial bank reserves, the amount of which can be promptly and accurately measured and can be largely controlled by Federal Reserve actions on its own initiative. This control is not complete because member banks may on their initiative borrow reserves or use reserves to reduce borrowings at the Reserve Banks. Through the medium of bank reserves, policy actions influence the amount of credit that commercial banks extend and thereby influence the money supply. These secondary effects are in turn strongly affected by the attitudes and actions of banks in adjusting to changes in reserves and in their willingness to borrow from

the Reserve Banks. They are also affected by the decisions of borrowers with respect to the use of bank credit.

Ultimate consequences of changes in the money supply upon general economic activity, employment, and prices are determined by eventual holders of funds, who are motivated by many factors other than cash holdings. More especially, the bulk of current financial transactions reflects the use of existing funds rather than changes in the total volume of cash balances and these uses are likewise influenced by many factors of a nonmonetary nature. All of this means that, although monetary policy actions have marginal effects of significance, assessment of these consequences is generally difficult and sometimes impossible. It must be to some extent a matter of judgment.

Answers to the first section of this question, namely what indicators prompted the Committee's actions, are fully, though briefly, set forth in the record of policy actions for the meeting at which the new directive was adopted. This record gives the essential points of the Committee's discussions that formed the basis for the decision as to the directive and that served as a guide for subsequent operations by the Account Management. Material presented in this answer represents principally a summary of the points set forth in the policy record.

Answers to the second section of the question, relating to market response to System actions, require an analysis of events that followed each change in the wording of the directive, as well as an appraisal of actions by the Account Management in carrying out the directive, in light of more specific instructions growing out of the Committee's deliberations and also in the light of changing money market conditions.

Answers to this question can also generally be found in the records of deliberations at subsequent meetings of the Committee. These records contain brief analytic descriptions of economic developments that accompanied or followed preceding System actions. They often specifically point out relationships between these events and System aims and actions.

The third section of the question, which would relate response to expectations, requires a hindsight analysis and is most difficult, if not impossible, to answer in any concrete terms. As noted above, monetary policy execution is a continuous process, one which usually involves probing or testing actions. If in the course of events these actions do not seem to be obtaining the desired results or seem to be unnecessary or in the wrong direction they are modified or discontinued. A process of constant adaptation to current developments is a part of the task of conducting current System operations to promote the desired aims.

More importantly, it is not to be expected that Federal Reserve actions alone can assure the attainment of ideal economic conditions. The effects of other factors are difficult to appraise. It is possible to determine quickly the amount of bank reserves that were available, and information as to changes in the volume of bank credit and the money supply can be had fairly readily and accurately. It is a matter of judgment, however, rather than of precise measurement, to make an assessment of the secondary effects of these direct and measurable consequences of monetary policy, relative to the effects of various other factors, in determining the course of interest rates, prices, employment, and general economic activity. To make such a judgment it is essential to consider and appraise not only monetary policies but also other significant influences, including private actions, as well as various Government policies.

Five versions of clause (b) in the Open Market Committee's policy directives, including the one in force at the beginning of the year, governed Federal Reserve operations in the course of 1960. The three parts of this question are discussed separately with respect to each of these directives.

I.--January 12, 1960

Directive, clause (b): "to restraining inflationary credit expansion in order to foster sustainable economic growth and expanding employment opportunities."

(1) What combination of economic indicators prompted the action?

This particular directive had been first adopted on May 26, 1959, and had been continued since that time. The principal factors providing the basis for this directive, as set forth in the policy record for May 26, 1959, included: expanding productive activity; a growing belief that creeping inflation was inevitable and actions to hedge against its results; highest level of construction contracts on record; rising industrial prices; robust expansion in consumer instalment credit; other unseasonably large private credit demands, accompanying heavy Treasury borrowing; further significant expansion in the money supply and in the turnover of deposits; and increased borrowing by member banks at the Reserve Banks to sustain bank credit expansion.

As these or other similar forces continued to be evident with some variations in degrees of intensity or in composition during the rest of 1959, the policy directive remained unchanged. The steel strike in this period was an especially potent and disturbing influence both in limiting resources and in creating uncertainties as to future commitments.

At times there were variations in the conduct of policy with respect to the degree of restraint or ease, but the general aim continued to be one of restraint on inflationary bank credit expansion in the face of vigorous current and prospective private credit demands, along with heavy borrowing by Federal, State, and local governments and an increased flow of individual savings. Expansion in total credit in 1959 was larger than in any previous year, with bank loans contributing to the growth. Because of restraint on bank credit expansion, banks obtained funds to increase their loans by selling securities to nonbank investors. The bulk of the growth in credit was supplied directly or indirectly by nonbank lenders making use of available funds.

At the beginning of 1960, principal economic indicators were moving up, and settlement of the prolonged steel strike was believed to remove a major element of uncertainty. Increases in interest rates and severe pressures on the money market in December were attributed to inventory restoration and to widespread market expectations of a forthcoming boom, as well as to usual seasonal factors that generally involve very large cash needs at that time. Declines in interest rates in January were due in part to seasonal influences but also to some slackening in credit demands and to anticipations of a Federal budgetary surplus. The prevailing view as to economic prospects, however, was one of great optimism, with expectations of continued expansion in activity and pressure on resources. Although there was some sentiment in the Committee at the time for a slight lessening of the degree of restraint, the consensus was that, in view of the prevailing attitude of extreme optimism, relaxation of restraints would be likely to stimulate excessive reliance on credit financing, particularly from banks.

(2) What evidence is there of market response?

Federal Reserve policies under this directive, which was in force from late May 1959 until March 1, 1960, were directed toward restraint on bank credit and monetary expansion in view of vigorous credit demands and limited resources. Response is indicated by the moderate rate of total bank credit expansion in the period. The record increase in total credit--bank and nonbank--and the rise in interest rates that occurred in 1959 are indicators of the vigor of credit demands in that period. The total of funds advanced in all credit and equity instruments exceeded $60 billion in 1959, compared with an average for previous years of around $40 billion. The Federal debt increased $11 billion and other debt increased by a record $50 billion. Growth in bank credit was a moderate $5.5 billion and the money supply, which had expanded abruptly during 1958 and the early months of 1959, declined somewhat in the latter part of 1959 and in early 1960. The turnover of money increased throughout the period and other liquid asset holdings of the nonbank public continued to increase at a rapid pace.

Vigor of over-all credit demands, together with restraint on bank credit expansion, resulted in rising interest rates, which in turn helped to bring forth savings to meet credit needs without undue monetary expansion. The limited increase in total bank credit and the money supply and the drawing in of such large amounts of savings to meet the large credit demands that developed in 1959 reflected the influence of Federal Reserve policy. The resulting rise in interest rates served to draw savings into use and made unnecessary the creation of additional money to finance the high level of economic activity that prevailed.

In the early weeks of 1960, increased supplies of steel and other products became available, while the Federal budget developed a surplus. Savers continued to invest in securities; they bid securities from banks to such an extent that interest rates declined, while the money supply decreased. Although private credit demands were well sustained and total liquid assets of the public continued to increase, total loans and investments of banks and the money supply showed a greater than seasonal decline. It began to become evident that there could be some relaxation from the degree of restraint on bank credit that had been necessary in 1959. At successive meetings of the Committee in January and February, sentiment for relaxation of credit restraint increased.

(3) Did the response match, fall short of, or surpass expectations or aims?

In 1959, the aim of monetary policy was to limit the creation of additional money at a time when credit demands were exceptionally strong, while liquidity in general was large and the resources available for further expansion in output were limited. In view of the steel stoppage, which placed a limit on available productive resources, a higher level of economic activity could hardly have been attained in 1959. Under the circumstances, unrestrained expansion in credit-financed demands would no doubt have exerted strong inflationary price pressures with little or no sustainable contribution to increased employment. Had bank reserves been more readily available, it is reasonable to conclude that credit and monetary expansion would have been much greater with more unstabilizing consequences.

It cannot be inferred that credit restraints in 1959 were the sole or even the principal factor moderating inflationary developments or that the downturn that developed later was due to shortage of credit. It might be concluded, rather, that monetary policy by helping to prevent excesses made a positive contribution to avoiadance of a more severe and prolonged recession. A key influence in stopping further expansion in economic activity was the failure of consumer buying to keep pace with potential or even actual output of consumer goods or with consumer income. This was in large part due to factors other than credit availability, such as resistance to prices, uneven distribution of increase in income, and shifts in consumer tastes. It is possible that by early 1960 the higher interest rates and resulting stimulus to saving may have been a factor in limiting consumer buying.

The lag in consumer buying, relative to output, was reflected in business inventory accumulation, which was the most outstanding element of instability in 1959 and 1960. Disturbances in the pattern of normal business expansion that were forced by the prolonged steel stoppage, with a tentative resumption of operations while negotiations were in process, also exerted an unstabilizing influence with respect to inventories and to business plans and commitments. For example, early in 1960 it began to be apparent, to the surprise of many, that inventories of steel and steel products had been built up to a much higher level than would be needed with resumption of productive operations. The continued large Federal budget deficit during the period of expanding private activity in 1959 and the quick shift to a moderate surplus was also an element of instability.

Early in 1960 the slackening of credit demands and a general market re-evaluation of the business outlook, with continued strong nonbank demand for securities, obtained an immediate market response in a decline of interest rates. The money supply also declined somewhat more than seasonally, reflecting in large part continued purchases of Government securities from banks by nonbank investors. Thus total nonbank holdings of liquid assets continued to increase, even though the money supply declined. This was reflected in a greater than seasonal decline in required reserves. The reserves released were not fully offset by Federal Reserve actions, and there was a moderate decline in net borrowed reserves. This brought about an easing of the credit situation before there was any indication of an economic downturn.

In summary, it may be said that Federal Reserve policy under this directive served in 1959 to prevent excessive bank credit expansion at a time of relatively full utilization of resources that were limited by the steel strike and when there were strong credit demands with widespread expectations of inflationary tendencies. Early in 1960, for a variety of reasons, the underlying forces changed--contrary to prevailing expectations at the time--and it gradually became increasingly evident that credit restraints could be relaxed.

II.--March 1, 1960

Directive, clause (b): "to fostering sustainable growth in economic activity while guarding against excessive credit expansion."

(1) What combination of economic indicators prompted the action?

Although reports of economic developments at this time indicated continuance of underlying economic strength, it appeared that some earlier exuberant expectations were not being fully realized and that there was less need for restraint to guard against credit excesses. Resumption of inventory expansion seemed to be an indication of a slackening of demand relative to output rather than a factor of strength. Although the increase in bank loans was substantial, particularly to finance the increase in business inventories and also to finance consumer purchases on credit, the increase was exceeded by bank sales of Government securities to nonbank investors, and total bank credit and the money supply were decreasing. Accordingly the Committee concluded it would be appropriate to supply reserves more readily and to follow a policy of moderately less restraint.

In view of these developments, the Committee decided to eliminate from the directive the reference to inflationary credit expansion. Retention of safeguards against permitting excessive credit expansion were deemed essential, however, as the basic situation seemed to be strong, particularly in other countries, and there was some uncertainty as to how much the slowdown in trade might be due to the temporary influence of severe weather conditions.

(2) What evidence is there of market response?

During the two months or more following adoption of this directive, economic activity was generally maintained at a high level with little or no further growth. With more favorable weather conditions in April, there were some evidences of a resumption of upward tendencies, but with no pronounced upturn or shift in tone. In the financial area, although private credit demands were moderately strong, bank holdings of Government securities and the seasonally adjusted money supply continued to decline. Growth in nonbank holdings of liquid assets other than money tended to level off, reflecting in part a reduction in the volume of short-term Government securities outstanding. Turnover of demand deposits continued at a higher level than during the preceding year.

Federal Reserve operations added to the availability of reserves, supplementing amounts released through the more than seasonal decline in required reserves. Member bank borrowings were reduced from over $800 million in February to about $500 million in May, and net borrowed reserves declined to a small amount. Interest rates showed marked declines, in reflection of both reduced credit demands and increased availability of bank reserves.

(3) Did the response match, fall short of, or surpass expectations or aims?

Federal Reserve operations under this directive increasingly moved in the direction of supplying more reserves to banks but the response was not altogether satisfactory. One of the most striking developments of this period (March to May 1960) was the sharp decline in interest rates, along with the maintenance of a fairly high level

of economic activity and moderately strong private credit demands. This course of events may be attributed in part to a shift in the Federal Government's fiscal position from large net borrowings to net retirement of debt. It may also have reflected the effect of the previously higher interest rates in drawing savings from cash-type assets into income-yielding liquidity instruments and other investments and perhaps stimulating additional saving. This decline in interest rates was enhanced by the Federal Reserve policies and actions during this period.

Neither borrowers nor lenders, however, responded with alacrity to increased availability of credit. The Federal Government was reducing debt and private credit demands did not increase sufficiently to offset the decline. Interest rates declined, but showed tendencies to fluctuate widely in reflection of actual or anticipated variations in supply or demand conditions in credit markets. Although availability of bank reserves increased, many banks still found it necessary to borrow reserves either from the Reserve Banks or from each other.

In this period, although consumer incomes continued to increase and consumer credit extensions were at a high level, consumer spending failed to keep pace with actual or potential output. It was becoming apparent that the net accumulation of business inventories had been excessive. This period was characterized by a lag in spending relative to current income as well as to resource availability. It was apparent that there were important factors other than the availability of bank credit that shared responsibility for this lag and for the shifts in attitude, which together provided the basis for subsequent downward adjustments in output and employment.

Directive, clause (b): "to fostering sustainable growth in economic activity and employment by providing reserves needed for moderate bank credit expansion."

(1) What combination of economic indicators prompted the action?

Information available at the time of this meeting, partly preliminary, suggested that gains in economic activity that seemed to be developing in April may not have been realized and in any case were not general. Although System operations under the former directive had increasingly moved in the direction of supplying more reserves to banks, total credit demands were moderate and the seasonally adjusted money supply was tending to decline. In addition, there had been a pronounced relaxation of the inflationary psychology prevalent earlier.

Under the circumstances, it was evident that the directive needed to be revised to call for a further supplying of reserves with a view to fostering moderate expansion in the bank credit and encouraging an increase in the money supply that might be needed for sustainable growth.

(2) What evidence is there of market response?

Under this directive, operations were more vigorously conducted toward increasing the availability of bank reserves, enabling banks to reduce their borrowing, and bringing about declines in interest rates. Federal Reserve holdings of securities increased by over $1 billion from May to August; Federal Reserve Bank discount rates were lowered from 4 per cent to 3-1/2 per cent in June and to 3 per cent in August, and action was announced in early August to release reserves

by authorizing member banks to count additional amounts of vault cash as reserves and reducing reserve requirements at central reserve city banks to become effective late in August and on September 1. Also in late July margin requirements on stock market credit were reduced moderately from 90 per cent to 70 per cent, following a decline in stock prices, relatively low trading activity, and a reduction in stock market credit.

Member bank borrowings at the Reserve Banks decreased from an average of $500 million in May to less than $300 million in August, with net free reserves averaging about $250 million in the latter month. Interest rates declined sharply in all sectors of the market. Both loans and investments at banks increased, and the seasonally adjusted money supply turned up in June and continued to increase in July. Long-term borrowing by corporations and by State and local governments increased.

Outside the financial area, economic activity, although continuing into the summer at a high level, was evidencing no upward momentum. Uncertainty regarding future trends was becoming more widespread and there was a gradual increase in unutilized plant capacity and manpower. Reports from business corporations indicated a decline in profits. While consumer demand was a sustaining influence, it was not providing a stimulus for economic expansion. Final sales of goods were running short of output and inventories continued to expand.

(3) Did the response match, fall short of, or surpass expectations or aims?

In reviewing developments from May to August, it would appear that in the financial area the response to shifts in Federal

Reserve policies and operations was in the desired direction. Credit and monetary contraction ceased and there was in fact some monetary expansion. Interest rates declined. Although economic activity in general seemed to be continuing at a relatively high level with no evidence of a downturn, the lack of growth and the underutilization of resources were matters for concern. Failure of the economy to expand could appropriately be attributed to factors which caused spending and investment not to increase, while production was maintained and incomes continued to expand. As a result, inventories were accumulating, although they did not appear to be excessive relative to sales, and unemployment of labor and idle resources were tending to increase. Under the circumstances, although the lag in spending could not be attributed to shortage of credit, it appeared that availability of credit could be made easier with little risk of excess and with possibly some stimulating effect.

IV.--August 16, 1960

Directive, clause (b): "to encouraging monetary expansion for the purpose of fostering sustainable growth in economic activity and employment."

(1) What combination of economic indicators prompted the action?

This new directive was designed to give greater emphasis to the need for operations that would help stimulate expansion, by removing the limiting words "moderate" and "needed" from the directive previously in force. The reason for its adoption was principally the failure of the economy to expand in preceding months, with a resulting widening of the gap of unutilized resources and unemployment. Action had just been taken to release additional reserves and to lower discount rates.

It was the Committee's intention that these measures be strengthened by operations that would further expand the availability of reserves and give greater encouragement to bank credit and monetary expansion. It was also thought possible that reserves supplied through the release of vault cash might not be fully utilized promptly and that, therefore, somewhat larger amounts of excess reserves would be needed to obtain the desired stimulus.

(2) What evidence is there of market response?

Following adoption of this directive, rather large amounts of reserves were made available through increases in Federal Reserve holdings of Government securities, as well as through the previously announced action with respect to vault cash and reserve requirements. The reserves thus made available were adequate to cover heavy seasonal needs and to offset an accelerated gold outflow as well as to make possible greater than seasonal additions to the volume of reserves. Member bank borrowings declined, with some weekly fluctuations, to a negligible figure by the end of the year, and net free reserves rose to an average of nearly $500 million in October and to over $600 million in November.

Although banks responded rather slowly to the increased availability of bank reserves and there was no credit growth in August, bank loans subsequently increased more than seasonally, especially business loans, and banks also added to their investments. The money supply, though leveling off in August, increased moderately in September and October, but declined in November. The principal counterpart to the expansion in total loans and investments of banks

was an exceptionally rapid growth in time deposits. Nonbank holdings of Government securities declined somewhat. Long-term financing by corporations and by State and local governments continued moderately heavy.

Notwithstanding the easing in the banks' reserve positions interest rates showed little or no further decline after mid-August. This leveling out of interst rates may be attributed in part to the continuation of private demands for credit at fairly good levels and the reduced liquidity position of corporations. Interest rates were also maintained to some extent by large-scale advance refunding operations by the U. S. Treasury, when institutional investors made significant readjustments in their holdings of Government securities. A technical market factor was a reduction in the inventories of securities dealers, following a buid-up during the summer.

One new factor of particular importance in maintaining interest rates, in the face of declining economic activity and an easy money policy, was the flow of funds abroad that accelerated in September and resulted in exceptionally heavy drains on the country's gold stock during the remainder of the year. Although the drain on bank reserves exerted by these gold movements was offset by Federal Reserve actions, the shifting of funds incidental to the movement had a disturbing effect on credit markets. This flow of funds abroad was also an influence toward holding down the expansion in the domestic money supply. Since this outward flow of funds was due in part to the lower level of interest rates in this country than in foreign money markets, as well as to confidence factors, more vigorous action on the part of the Federal Reserve to supply additional reserves would have incurred the risk of accelerating the gold outflow and thus would not have served the intended purpose.

In September and October, moderate recession in economic activity became increasingly evident. Although aggregate final takings of goods and services were maintained or increased somewhat, inventory contraction and some curtailment in purchases of durable goods resulted in a moderate decline in total production. The accompanying increase in unemployment was more marked. There were also decreases in residential construction and curtailment in business plans for plant and equipment expenditures.

(3) Did the response match, fall short of, or surpass expectations or aims?

In this period, as in the preceding one, monetary policy was directed toward encouraging credit expansion in order to foster growth in the economy. The adoption of more vigorous measures was inhibited and the effectiveness of the action taken was diminished by the outflow of funds to foreign markets. This movement, which caused a drain on United States gold reserves, was induced by interest rate differentials and uncertainties as to future developments. Interest rates stopped declining, though they remained much lower than in previous months; further measures to lower rates, it was believed, would accelerate the gold outflow. Moderate expansion of bank credit and the money supply did occur, although the rate of expansion was sometimes disappointing. Nevertheless, largely for reasons other than credit availability, recession in economic activity developed.

V.--October 25, 1960

Directive, clause (b): "to encouraging monetary expansion for the purpose of fostering sustainable growth in economic activity and employment, while taking into consideration international developments."

(1) What combination of economic indicators prompted the action?

The only change in the directive from that previously in force was the addition of the clause with respect to international developments. Deepening of economic recession in the United States called for continuation of action to maintain ready availability of bank reserves. Yet the persistent outflow of capital abroad, induced in part by interest rate differentials and confidence factors, precluded policies that would vigorously push down interest rates, particularly short-term rates, or that would raise fears abroad that inflationary policies were being adopted during a period of serious balance of payments stress. It was to indicate recognition of this situation that the new clause was added to the directive.

Specific action to implement this directive taken by the Account Management was to extend open market operations to the purchase of short-term securities other than Treasury bills. There seemed to be a particularly strong demand for Treasury bills in the market but a more abundant supply of other short-term issues available for purchase. In view of the imminent very large seasonal needs for bank reserves to cover currency demands and credit expansion, as well as the gold outflow, the System Account faced the need for making very heavy purchases of securities in the weeks ahead. It was desirable that these be acquired with a minimum of downward pressure on the short-term Treasury bill rate, which occupies a key position with reference to international money flows.

Sugsequently, action was taken to release a large amount of reserves by authorizing banks to count all of their vault cash holdings in meeting reserve requirements and at the same time making some partly offsetting adjustments in reserve requirements. This action, which was taken to put into effect legislation adopted in 1959, provided another means of supplying reserves while minimizing Federal Reserve purchases of Government securities and consequent effects on interest rates.

(2) What evidence is there of market response?

In order to carry out this directive, while meeting seasonal currency demands and increases in required reserves as well as a continued heavy outflow of gold, heavy purchases of securities were made by the Federal Reserve in late October and during November, including Treasury bills and other short-term issues, as well as some repurchase contracts. In December, reserves were plentifully supplied by the release of vault cash, and System sales of securities exceeded purchases. In this period member bank borrowings declined to a relatively negligible amount and free reserves exceeded $600 million.

Interest rates did not show the increase usual in the December period of heavy liquidity demands, and in fact some rates declined--in the medium- and long-term sectors, as well as in the short-term area. Bank credit increased more than usual, chiefly through acquisition of Government securities, and the seasonally adjusted money supply, after declining in November, turned up again in December. Total liquid asset holdings of the nonbank public, after showing little change during the first half of 1960, increased somewhat

in subsequent months. Bank liquidity had also improved, with increases in holdings of short-term Government securities and in time deposits, while bank borrowings were reduced, but the banks' loan-deposit ratios were higher than in earlier years.

The moderate downdrift in economic activity continued during the last quarter of 1960, with unemployment rising to a seasonally adjusted rate of 6.8 per cent of the labor force. Prices of sensitive materials showed further declines. Consumer buying decreased somewhat, after seasonal adjustment, but most of the curtailment in output continued to be accounted for by inventory curtailment, particularly in the manufacturing sector. Trade inventories rose throughout the year. Personal incomes were well maintained, in part through transfer payments, but corporate profits were estimated to be relatively low. Government expenditures were tending to increase, while revenues remained at a high level, continuing to provide a seasonally adjusted cash surplus in the Federal budget.

(3) Did the response match, fall short of, or surpass expectations or aims?

Again it might be said that, under the circumstances prevailing with respect to nonmonetary forces and the international situation, the response in the financial area to Federal Reserve policies and operations in the late months of 1960 was about as much as could have been expected. Borrowing demands were light because of inventory curtailment and uncertainty as to future prospects. Yet total bank credit increased more than seasonally, as banks added to their holdings of Government securities and their loans to dealers in such securities. Demand deposits increased no more than seasonally, but time deposits showed a rapid rate of expansion.

While a greater increase in the money supply would have been desirable, any more vigorous measures to supply banks with reserves so as to encourage them to expand investments and thereby increase the money supply might have resulted in a further gold outflow, either because of low interest rates or for confidence reasons. In that event, such measures would not have served the intended purpose of promoting monetary expansion and stimulating domestic activity. Interest rates remained steady, and there was some expansion in over-all liquidity. These achievements no doubt had some effect in moderating the intensity of the recession, which soon after came to an end.

July 18, 1961.

Reserve Requirement Changes and Open Market Operations: Quickness of Effects

When the Federal Reserve System is considering the choice of one instrument or another as the means for increasing the availability of bank reserves and fostering monetary expansion, one of the considerations is the speed and thoroughness with which the influence will be transmitted throughout the banking system, although this consideration may or may not be of prime importance in any given situation. It has been pointed out that a reduction in reserve requirements can have a widespread effect very quickly and that this may at times be a reason why such a reduction, rather than open market purchases, would be the preferable form of action.

The purpose of the present note is to discuss the quickness of effects of these kinds of Federal Reserve actions. The discussion is restricted to a comparison of alternative means of <u>increasing</u> the availability of reserves, especially since Federal Reserve actions to reduce reserves are practically always directed toward absorbing redundant reserves being made available by market developments and never toward forcing a net contraction in credit.

It is impossible to trace exactly the effects of any particular System action affecting the supply of reserves, because the secondary and subsequent consequences of the flow of reserves and money throughout the financial structure are very much greater than the immediate effect of the initial action upon the banks

first affected. Most Federal Reserve open market operations, furthermore, are in response to short-run market developments or pressures and are thus directed toward offsetting fluctuations in reserve availability that would otherwise have occurred due to market forces.

A change in their reserve requirements affects with unquestioned speed the reserve position of all member banks to which it is applicable. An open market operation also tends to affect the reserve positions of a great many banks rather quickly. It reaches most country banks indirectly, however, and there is room for difference of opinion as to the speed and pervasiveness with which the effects are transmitted to them.

Open market operations ordinarily affect, in the first instance, the reserve balances of so-called "money market banks" in New York and other financial centers. Through them the effects are quickly transmitted to the money market in general. This is true because these larger banks, which deal actively in money market instruments such as Federal funds, Treasury bills and other highly liquid paper, undertake to keep their available funds fully invested by buying such instruments whenever other credit demands do not completely use up their available funds. Many banks, especially country banks, do not attempt to keep all their funds continuously invested in this manner. Hence, changes in their reserve position may have less immediate impact on the market, although such banks, in adjusting their reserve positions, may affect the money market, particularly

through shifts in their balances with city correspondents. The flow of reserves to or away from country banks is determined largely by the activities of their customers -- depositors and borrowers -- rather than by money market developments.

When a reduction occurs in reserve requirements for all classes of member banks, every member bank immediately has more funds available for lending or investing (or for reducing its indebtedness to the Federal Reserve System). In the case of money market banks, this tends to produce an extremely rapid response in terms of expansion of their loans and investments -- as would also be the case if the Federal Reserve action took, instead, the form of open market purchases.

On occasions when it is especially important that the effects of a Federal Reserve action influence the reserve positions of country banks as rapidly and as pervasively as possible, this would be a factor that would favor a change in the reserve requirements. On the other hand, country banks do not put newly released reserves to use as rapidly as money market banks, so that if a quick money market response is needed, open market operations would be preferred. Of course, the matter of relative promptness is only one consideration, and not necessarily the decisive one, dictating the choice of instrument.

There are three main ways in which a country bank may respond to a reduction in reserve requirements. The bank may, of course, immediately make new loans (if there is a demand for loans)

or acquire additional investments. Second, it may increase its balances with its city correspondent banks. The city bank receiving such deposits would typically be one that is active in the money market; it could therefore more readily put the additional funds to work until such time as the country bank might withdraw them in order to increase its own loans or investments. In either of the foregoing cases the total loans and investments of the banking system, and hence normally the money supply, are increased. Third, the country bank may simply leave its funds temporarily in the form of excess reserves at its Federal Reserve Bank or it may use the funds to repay indebtedness at the Reserve Bank. If it does either of these, there is no immediate increase in bank credit or money.

Analysis of member bank data indicates that on each occasion when the reserve requirements of country banks have been reduced, there has been a substantial temporary increase in their excess reserves. In the case of some banks, there were periods ranging up to several months during which the reduction in requirements was reflected mainly in excess reserves rather than in actual expansion of loans or investments.

Nevertheless, in this case as in the cases where the funds were immediately invested (either directly or through correspondent banks), the banker had a feeling of greater "ease" because he was in a position where he could more readily expand his loans or investments whenever any attractive opportunity might present itself.

Furthermore, despite the temporary increases in the total excess reserves of country banks at times when reserve requirements have been decreased, more than half of the reserves released to these banks have usually gone into loans or investments or correspondent balances within a month from the date of each release.

If the additional lending power is made available instead by means of Federal Reserve open market purchases, rather than by reducing reserve requirements, the additional reserves tend to flow initially into money market banks, because these banks buy and sell money market instruments themselves, carry the accounts of other large investors whose transactions are important in this market, and also handle the financing of the securities dealers (to whom the Federal Reserve makes payment in the first instance). The money market banks tend to put their added reserves to use quite promptly, either by reducing their borrowings or by expanding their loans and investments from the level that would have prevailed in the absence of such Federal Reserve operations.

Such speedy response is facilitated by the normal channels of operations of the financial system, which tend to funnel net excesses of supplies or demands for funds from all parts of the country into the money centers. Added reserves that are received by money market banks are thus redistributed to other banks. This may occur directly, if the money market banks repay borrowings or buy securities from other banks or increase loans to them. Otherwise, the reserve redistribution will be indirect, as the money market banks

increase loans to, or purchase securities from, nonbank customers, with a resultant prompt increase in the deposit liabilities of those banks and hence in the total money supply.

Such an increase in the money supply is normally accompanied or followed by an outflow of funds from money market banks to the rest of the banking system. These payment flows increase bank balances of many persons and firms engaged in economic activities everywhere, and hence affect all the banks in which they keep their accounts. The effect on individual banks, especially country banks, is indirect and not susceptible to accurate measurement, nor does it necessarily affect every bank. When a country bank's position becomes "easier" due to its having an inflow of deposits, the banker himself is normally unaware that this condition may be related to the Federal Reserve operation.

Because of this, the banker would not know whether or not he could expect the added funds to stay in his bank, and hence he might be hesitant about investing them in anything that could not be liquidated quickly if necessary. If his condition of relative ease had arisen instead from an announced reduction in reserve requirements, he might expect that this would not be reversed soon by an increase in the requirements and might therefore expand his loans with more confidence.

The foregoing discussion relates mainly to System moves to supply reserves for the purpose of exerting direct influence on bank credit in the direction sought by System policy. In other

words, if the System's over-all policy should call for monetary expansion this would presumably be accomplished under varying circumstances by open market purchases or, alternatively, by lowering reserve requirements with the results described, or by coordinated use of both. Consideration must be given, however, to the System's objective of smoothing out the peaks and valleys in reserve availability so as to keep bank reserve positions and the tone of the money market consistent with the System's broader objectives of ease or restraint. This may at times require short-run moves in a direction contrary to longer run System objectives. For example, when market factors temporarily supply excessive amounts of reserves, the System may sell securities to mop up some of the excess, even though basic policy calls for monetary ease.

This continuing objective is carried out through day-to-day open market operations. Such operations provide the requisite flexibility in direction and timing, in addition to which it is possible, through judicious use of repurchase agreements, as well as outright purchases and sales, to direct operations toward particular areas of the money market as conditions may require.

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