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April 17, 1967.

Mr. Solomon --

Bob,

I have been asked to make some comments on the following two questions:

1. Has the Federal Reserve changed its views in recent years as to the relative importances of changes in the volume of bank credit and the money supply?
2. Has the growth of the Euro-dollar market appreciably weakened the control of the Federal Reserve System over the U. S. banking setup?

Any comments will be appreciated.

WMM
(Chairman)

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 19, 1967.

To Chairman Martin

Subject: _____

From Robert Solomon

Here are some comments on the two questions put to you. If you would like something more extensive, I'll be glad to prepare it.

1. The answer is "no" to the first question--namely has the Federal Reserve changed its views in recent years as to the relative importance of changes in the volume of bank credit and the money supply. This question may have been stimulated by the recent ABA Symposium and by Jim Tobin's article in the Sunday Washington Post on Milton Friedman's money supply approach.

The Federal Reserve Board and its staff have never been close adherents of the quantity theory as preached by the Chicago School. While we are conscious of the importance of changes in demand for money, the traditional approach to monetary analysis and policy here has been via the supply of bank credit and interest rates. There has been no significant shift toward or away from this approach in recent years.

2. Regarding the second question--has the growth of the Euro-dollar market appreciably weakened the control of the Federal Reserve System over the U.S. banking setup--it may be said that though the relationship of U.S. banks to that market ~~is~~ in process of evolution, Federal Reserve control has not been weakened.

Last year, under conditions of tight money, U.S. banks borrowed a substantial amount of Euro-dollars through their branches abroad. Although this had a significant effect on our balance of payments, the domestic monetary effect was very small and cannot in any sense be said to represent a weakening of monetary policy. Even at their maximum, liabilities to branches represented only 1-1/2 per cent of total deposits of U.S. banks.

Similarly, as monetary policy has eased since the autumn, there has been a return flow of some of these funds to Europe. But the extent to which this outflow offset monetary easing here has been minimal.

To: Chairman Martin

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Another interpretation of the question is that the development of the Euro-dollar market imposes an additional balance of payments constraint on the freedom of the Fed to ease monetary conditions here, for fear of a sizable return flow of funds to the Euro-dollar market from U.S. banks through their branches. What is relevant here is that these flows of short-term funds do not represent a basic change in our U.S. balance of payments. Last year's inflow was not interpreted as a basic improvement and this year's outflow is not a basic deterioration.

It should be noted that the IET and the voluntary programs tend to limit other forms of flow between the U.S. and other money markets, including the Euro-dollar market.

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