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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date: October 1, 1964

To: Board of Governors

From: Governor Mills

Subject: Proposed revision of open market policy directive

At two recent meetings, the Federal Open Market Committee has discussed a proposal that would revise the form of directive from the Committee to the Manager of the System Open Market Account. The revised form of directive reviews the current economic situation at some length, with the thought that the interested public would be better informed as to policy decisions on the occasion of the publication of the Board's Annual Report. In my opinion, the economic material proposed for inclusion in the directive is too extended, but not objectionable.

However, the directive concludes with specific instruction to the Manager of the System Open Market Account to maintain a prescribed level of interest yields on Treasury bills and a denominated volume of reserves. In effect, the directive, if adopted, would commit the Federal Open Market Committee to set a predetermined level of interest rates on U. S. Government securities through the vehicle of prescribing the level of reserves that would be intended to accomplish the interest-fixing process. Adoption of such a policy would further embed the Federal Reserve System in a manipulated control of the U. S. Government securities market and a fixing of an interest rate structure by artificial means. Such a policy would be a clear contradiction of free market principles, by virtue of which interest rates, although influenced by and responding to a level of reserves supplied by open market policy actions, fundamentally would be determined by the market and not by official intervention and artificial controls.

The shift that has taken place in the direction of an artificially controlled U. S. Government securities market has proceeded over the last four years with gradually rising intensity. In consequence, the market has become more attentive to open market policy actions affecting interest rates than to naturally generated factor movements in the market per se. In over-all result, initiative has been taken from the market and placed in the Federal Reserve System, which has the undesirable effect of making changes in open market policy more difficult to accomplish than in the case of the free market development of interest rates, in that any slight shift in the observable direction of open market policy has a wide-ranging and serious impact on participants in the market. This kind of policy has been responsible in large part for dealers in U. S. Government securities carrying excessively heavy positions, being confident of no change in official policy, and thereby unduly compounding the undesirable and disturbing effects of a change in policy.

In conclusion, adoption of the proposed directive would completely destroy the principle that the objective of Federal Reserve System policy-making is to regulate the availability of credit, incident to which interest rates will fluctuate in accordance with the supply and demand for credit and subject only to the influence brought to bear on these two factors through Federal Reserve System arm's-length open market policy actions. In my opinion, the sacrifice and subordination of the policy principle of providing appropriate credit availability to a policy that is tantamount to pegging the prices of U. S. Government securities is not only undesirable in the light of past unsatisfactory experience, but contrary to the purposes and functions of the Federal Reserve System.