

*Lagged Reserve
Accounting*

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

B- k12
Friedman, M. (4)

Office Correspondence

Date August 20, 1970

To Chairman Burns

Subject: Comments on Friedman

From S. H. Axilrod

letter

*Friedman comments on reserve accounting
and Axilrod responds.*

(1) I think the main point to be made with respect to Milton's

*Friedman wants to
return to contemporaneous
accounting and he
wants reserve
settlement periods
staggered.*

letter on various changes in reserve settlement and computation techniques is that they are minor matters in relation to the conduct of monetary policy. He makes the point that they are not of "decisive importance"

but would make an "appreciable contribution toward more precise control of monetary aggregates". I would downgrade them in importance more, though I am sympathetic to some aspects of them. You might like to know, however, that some of these same proposals were considered by a staff ad hoc subcommittee on reserve proposals, whose report (dated May 13, 1966) was unsympathetic to points 2 and 3 in Milton's letter. This subcommittee was the source of the proposal on lagged reserve accounting.

(2) With respect to lagged reserve accounting, my impression from watching the money market day to day, is that there has been more fluctuation in (say) the Federal funds rate since the new accounting procedure was put into effect. At the beginning, this would have been related to transitional problems as banks' money managers became used to the new methods. But I believe that a certain amount of greater variation has persisted. One would expect somewhat more variation because, with required reserve fixed by lagged accounting, any unexpected deposit flows at a bank would not be associated with an accompanying fractional change in required reserves during the statement week; as a result, a bank would have

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somewhat larger reserve surpluses or deficiencies than otherwise. It is difficult, however, to isolate this source of variation in day-to-day money rates from changes in the pattern of Desk operations as a result of greater emphasis on the aggregates in open market operations. As a highly significant factor, this greater emphasis on the aggregates would not be dated much, if any, before the early part of this year.

The supposed advantages of lagged reserve accounting are a long story. For a while they had to do with reducing the potential revisions in the published net borrowed, or free reserve, number. Toward the end of the debate in the System, greater emphasis was put on enhancing the ability of banks to manage their reserve positions more efficiently. Banks would know for certain, so the argument went, at least one important element--required reserves--in judging their demand for or supply of money market funds.^{1/} Many banks, particularly country banks and banks with large branch systems, did feel that lagged reserves would in fact be of help to them in that respect. We have not followed up systematically to see if feelings have changed as a result of experience, but I would suspect that they haven't changed much, partly because it's really a pretty minor matter to have strong feelings about.

As to the relation between lagged reserves and control of monetary aggregates, I would think that they do not hamper our ability,

^{1/} Banks would also know vault cash for certain, since this too is lagged two weeks, a point that was of particular importance for large branch systems.

such as it is under current institutional arrangements, to control the money supply over the intermediate- or longer-run. But lagged reserves probably do loosen the already loose relation between money and reserves in the short-run. For example, if the System reduces the reserve supply through open market operations, banks without lags would adjust by reducing loans and investments and thus deposits and required reserves, assuming excess reserves are already at a minimum and the discount window rate and administration provide no incentive to increase borrowed reserves. Even with lags, banks may still reduce deposits currently, and required reserves two weeks hence, as the System holds back on reserve provision, but they do have more options open; an individual bank, for example, can delay its adjustment for two weeks partly because it now may think there is some probability that reserve costs would not be so high two weeks hence. In general, uncertainty becomes a larger factor in bank reserve adjustments, and this reduces the short-run predictability of the deposit-reserve relationship.

(3) A working day basis for reserve computations (i.e. a five instead of seven day basis) has its appealing aspects now that practically all banks are open only five days a week (although Saturday openings would present a complication). But I'm not sure that it too might not introduce a Friday distortion, although the special importance of Fridays has been, in my view, long over-estimated as a problem for open market operations or for the money market itself. However that may be, a five day calculation would enhance the value to banks of larger deposits on Friday relative to the rest of the week. Under such conditions,

if deposits bulged on Friday, the bank could invest for a three day rather than a one day return though the effect on required reserves would be no different from a bulge on any other weekday. The opposite would be the case for another bank who lost the deposits on Friday, but for the banking system as a whole there would be some incentive to attempt to obtain deposit funds on Friday to the extent this was in their control. Whether Friday would be any more or less of a problem (it would probably be a different kind of problem) under these circumstances seems open to question.

(4) Staggered reserve settlements have always seemed to be a pretty good idea to me, although again it is a minor aspect of reserve control and operations. But any such staggering need not be done on the five working day basis suggested in Friedman's letter. For example, if we lengthened the reserve period to two weeks, half the banks could settle one week and half the next. This simple proposal would reduce some of the need for Federal Reserve intra-monthly "defensive" operations. However, the whole issue of defensive operations requires a much broader analysis, including their role when the System is on an aggregate target and an appraisal of the market's capacity further to develop a mechanism to provide for day-to-day variations in money market demands without excessive short-term interest rate fluctuation. There is no way to find this out without beginning to test the water, though.

(5) Forcing banks to meet required reserves daily would seem to introduce an unnecessary rigidity into the banking system. And, in

practice, such a method of reserve computations and maintenance might very well increase the need for Federal Reserve daily open market operations as banks each day scramble for reserves because deposit funds (which to an individual bank are a source of reserves) fall short of expectations, or in the opposite case dispose of unexpected surpluses. Such a daily reserve requirement would probably require, for efficiency, a large allowance for carry-over reserve surpluses and deficits and easier access to the discount window.

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DEPARTMENT OF ECONOMICS

November 26, 1970

Dr. Arthur F. Burns
Federal Reserve System
Washington, D. C.

*Series of correspondences: (read back to front)
Friedman accused Burns of betrayal
for favoring wage & price controls, and then later
writes a very emotional apology.*

Dear Arthur:

*Note also on this page the harsh statements about
Paul Samuelson.*

First and most important, let me report progress on Rose's eye problem. We are by no means out of the woods as yet, and I still have my fingers crossed, but they have adjusted the contact lens, used drops eec., so that she has been able to tolerate the lens for some days and is gradually lengthening the period of use. So we are hoping for the best with somewhat more reason.

Second, I am enclosing a second letter dealing with the suggestion that I madd re revising operating procedures at the desk, because I thought you would rather have that separately.

Third, I have been scratching my head about a less misleading term than "incomes policy" for what you have in mind. Re the meaning of that term, a particularly clear indication of how misleading for your purposes it is came out in Henry Wallich's Newsweek column of Nov. 23, when he wrote: "The fact is that incomes policy is a catchall phrase for everything from guideposts to jawboning to a temporary freeze to permanent ~~income~~ wage and price controls," not even mentioning market-oriented policies.

Market-oriented policy is perhaps most descriptive but not very catching. Of the other alternatives I have thought of "free market policy" seems to me the best, though it still does not quite ring the right bell. The others that I toyed with and that I might list just in case one sets you off are: Structural Policy; Market-flexibility policy, which has a Japanese ring ("income-doubling policy". Somehow, one would like to get in the idea of breaking roadblocks, removing frictions, greasing the ways, etc., but I have been able to come up with no ~~new~~ catchy slogans that do so.

Yesterday, I attended part of a consultants' meeting at the Treasury (the first one of the last four I have been invited to). Despite your good efforts, one of the other academics invited, though he did not ~~attend~~ attend, was Paul Samuelson. He was on the list of those expected, so must have cancelled at last minute. How suicidal can we be?

Rose joins in sending our best to you and Helen.

Cordially yours,

Milton

Milton Friedman

*P.S. In addition to the approval suggested in the attached letter, I remain
persuaded of the desirability of two other steps on which I know you
have moved to some extent: ① Careful study of best definition of monetary aggregates
② Improved quarterly estimates of mon. aggregates.*

SEVENTY-FIFTH ANNIVERSARY YEAR

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