FEDERAL RESERVE BANK
OF NEW YORK

NEW YORK 45, N.Y.

September 6, 1949.

Hon. Marriner S. Eccles,
Board of Governors of the
Federal Reserve System,
Washington 25, D. C.

Dear Marriner:

Enclosed is a copy of a letter which I have today written to Chester Morrill, Secretary, Federal Open Market Committee, in answer to his letter of August 17, 1949, requesting comments upon a staff memorandum entitled "Framework for System Credit Operations under Peacetime Conditions".

Yours faithfully,

Allan Sproul,
Vice Chairman,
Federal Open Market Committee.

Enclosure.

September 6, 1949

Mr. Chester Morrill, Secretary,
Federal Open Market Committee,
Board of Governors of the Federal Reserve System,
Washington 25, D. C.

Dear Chester:

Your letter of August 17th transmitted, and in some ways explained, a memorandum on "Framework for System Credit Operations Under Peacetime Conditions", prepared by members of the staff, and stated that comments concerning the memorandum would be helpful, in anticipation of discussion of its contents at the next meeting of the Federal Open Market Committee.

I said, orally, at the last meeting of the full committee, that some of the broad generalizations contained in the memorandum were admirable. Recognition of the lack of likelihood that the System will soon be given new powers to deal with credit problems, and the consequent need of making the best use of existing powers, seems to me to be a realistic appraisal of our present position. Seeking maximum flexibility in the application of our available powers certainly is a worthwhile objective and is, I think, the policy adopted by the System at the meeting of the Federal Open Market Committee on June 28, 1949. Recognition that you can't force an unwanted volume of excess reserves on the member banks under present conditions and, at the same time, retain any control of interest rates, has now had the confirmation of our July experience, prior to which some contrary views were held and pressed upon the Committee. The view that changes in reserve requirements should be reserved for extraordinary circumstances or "strategic" use seems to me to be a partial recognition of the place of this weapon in our wars with economic disorder.*

Well ?

* It sounds to me, however, as if there was some semantics in the treatment of reserve requirements policy in the memorandum. I can't tell exactly what is meant by "exceptional" means and "reserved for strategic occasions". That might cover a lot of "jiggling". I would be more downright, and say that increases and decreases in reserve requirements should ordinarily be used only to offset fundamental changes in the banking and credit situation, such as an enormous inflow of gold creating an unwanted volume of excess reserves, or a decision on our part (backed by Congressional authority) to make a structural change in the fractional reserve system by altering the ratios which determine the deposit expansion potential of a given reserve base. If you want to meet and correct a situation such as we had last year, something more than the present, or the then requested, authority to increase reserve requirements will be needed.

Finally, I would agree that System policy should permit ready interpretation by the market, in the absence of official announcements, but with this agreement goes my distrust of official announcements explaining System action in most cases. As Dr. Goldenweiser says in his recent book, the actions taken by the System should be so simple and so clear as not to need official explanation, if they are going to be effective. If official explanation is attempted, it is either the explanation of single individuals who can't possibly present, fully, the reasoning of the seven or twelve men who took the action, or it is a statement made up and approved by the seven or twelve, which is a series of compromises, more likely to confuse than to clarify.

It is with objectives that are not set forth or clearly explained in the memorandum that I would argue, and it is the "implications for System's Current Credit Policy Program" and the means of making them explicit that I would largely reject.

There is almost general agreement, I assume, with our present effort to "operate more largely with reference to general credit and economic conditions and less specifically with reference to maintaining particular prices and yields on Government securities". We don't want to get back into the straitjacket of the "pattern of rates". But that is very different from discarding action upon interest rates, in favor of changes in reserves or availability of credit, as our principal method of credit control and central bank administration. These are all inextricable parts of the same whole, and we have to work with all of them. The attempt to abandon any part of the interest rate structure wholly to its own devices, is an abandonment of a necessary central bank power and, in my opinion, impossible of attainment, under present conditions, to boot. In terms of the memorandum, this idea doesn't "take adequate account of basic structural changes in banking and financial organization since the Twenties".

I have dealt with the mainspring of this new idea in another memorandum, "A Proposed Free Market in Bills", dated September 2, 1949, copies of which have been sent to the members of the Federal Open Market Committee. I will only make one or two further points here. First, the staff memorandum I am discussing in this letter does not indicate clearly why a second means of access to Federal Reserve credit at the initiative of the market (the Treasury bill proposal) is necessary or desirable. At the same time it still seems to look askance at the discount window, despite the statement in your letter that it is the intention "only to recognize the well established traditions against borrowing". That tradition you correctly state in your letter - "a tradition against borrowing for extended periods, particularly in times of undue credit expansion". The writers of the memorandum seem to have had something more in mind, which would be quite consistent with their idea of having the Treasury bill window largely supersede the discount window. They say member banks generally would not be expected to make extensive use of the rediscount window, excepting to meet emergencies and "last resort" instances. Unless "extensive" means continuous, or long continued, there is no such tradition among our banks. The practice of borrowing to meet temporary needs for reserves is well established and I see no reason to discourage it. Nor do I see any pressing need for an alternative and easier means of access to Federal Reserve credit, which would be of benefit chiefly to the large member banks in the principal cities. Whether the big city banks would be encouraged, by this proposed bill market technique, to carry a larger amount of excess reserves than has been their habit in present circumstances (as the memorandum suggests), I very much doubt. I think they would continue to invest their funds as fully as possible and then, individually, meet temporary needs for reserves by selling securities, or borrowing.

Having rejected what is seemingly the heart of this memorandum on "System Credit Operations Under Peacetime Conditions", it should not be surprising that I find myself wholly at variance with its implications for current policy.

(1) I see no basis nor reason for a series of reductions in reserve requirements which would release excess reserves by an amount that would permit the System's holdings of Treasury bills to be reduced to a relatively low working level. I think we had better leave reserve requirements alone.

(2) Most of number two falls if one is rejected. To put all System bidding for bills, in the weekly Treasury auction, on a "back-stop" basis would foul up the money market to no purpose. We have just had some experience with this during August.

(3) An Open Market Committee can't or shouldn't try to conduct hour-to-hour open market operations. It had better define clearly its policy and fix its authorized range of buying and selling rates for Treasury bills pretty wide, if it wants flexibility and effectiveness in operations. Acceptances are not presently an important factor in the market.

(4) Reserve bank rediscount rates could appropriately be reduced, to conform to, and to confirm, actions already taken with respect to reserve requirements, and in the open market, which have resulted in lower short term rates. The public, in general, still looks on the discount rate as an important sign and symbol. To leave the discount rate unchanged now could be disruptive of the money market, and would lose a chance to emphasize our major policy of credit ease at a critical moment. It would only seem to make sense if there is a desire to press abandonment of rediscounting in favor of the bill window as imagined in the "free bill market" proposal.

(5) Authority should be granted for the conduct of open market operations in bills as well as in certificates, notes, and short bonds. (Some transactions in long bonds may be desirable from time to time in the management of the account.) If the System is to achieve flexibility in the use of its open market powers, it should not tie its hands by any preconceived plan of operation with respect to any particular type of security.

(6) The above idea carries over into the memorandum's views with respect to the long term end of the interest rate structure. We may have more than orderly market views concerning long term rates at some future time. In fact, one of the next great policy decisions the System may have to make, might be whether we are going to maintain a two and a half per cent rate for really long term debt (as distinguished from outstanding debt which, as it approaches maturity, is becoming less than long term). The decision should be taken under the circumstances which exist at the time.

I hope that the members of the Federal Open Market Committee and the writers of the memorandum may find these comments useful. I cannot help but feel that a better "Framework for System Credit Operations Under Peacetime Conditions" could be written for the guidance of the Committee, if the writers did not seem so intent upon promoting the use of one particular aid to the achievement of our broad objectives.

Yours faithfully,

ALLAN SPROUL

Allan Sproul,
Vice Chairman, Federal Open Market Committee.

P.S. In order that the members of the Federal Open Market Committee may have a chance to consider these comments before the next meeting of the Committee, I am sending copies of this letter to the individual members.

A.S.