

INVESTMENTS IV - MAJOR

Mr. Bopp

FEDERAL RESERVE SYSTEM AND INVESTMENT MANAGEMENT

I. MECHANICS OF THE FEDERAL RESERVE SYSTEM

A. Direct and immediate importance of Federal Reserve actions to investment managers

1. General purpose of the System: To promote credit conditions appropriate to stable economic growth
2. General method of operation: Through influencing supply, availability, and cost of credit
3. Specific illustrations
4. Extent of authority of System to deal in Government securities
5. Relation of System operations to -
  - (a) Security prices and yields
  - (b) Member bank reserves

B. Primary role of bank reserves in our money system

C. How the amount of reserves changes

1. Federal Reserve Bank accounting
2. Major accounts affecting reserves

II. DEVELOPMENT OF FEDERAL RESERVE POLICY AND IMPLICATIONS FOR INVESTMENT MANAGERS

A. The heritage of war financing

1. Size and ownership of the public debt
2. The structure of interest rates
  - (a) Origin of the "pattern of rates"
  - (b) Implication of the pattern
  - (c) Search for alternative methods of influencing credit conditions

- B. The "Accord" of March 3, 1951
  - 1. Background
  - 2. Terms
  - 3. Operations under the Accord
    - (a) "Maintaining orderly conditions"
    - (b) "Preventing disorderly markets"
    - (c) "Correcting disorderly conditions"

### III. OBJECTIVES OF POLICY AND RELATED PROGRAMS

- A. Alternative objectives
  - 1. Convertibility
  - 2. Productive credit
  - 3. Stable prices
  - 4. Full employment
  - 5. Maintaining fixed rate of interest
- B. Need for choice or combination

### IV. GUIDES TO CURRENT OPERATIONS AND MEASURES OF INFLUENCE

- A. From the point of view of the central banker.
- B. From the point of view of the investment manager
  - 1. Volume of money and reserves
  - 2. Availability of credit
  - 3. Cost of credit
  - 4. Policy statements

V. INSTRUMENTS OF POLICY

A. General

1. Reserve requirements
2. Open market operations
3. Advances and discounts
4. Repurchase agreements

B. Selective

C. Coordinated use of instruments

VI. HOW DECISIONS ARE MADE

## LECTURE NOTES

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I am a part of the Federal Reserve System - But this is not  
an indoctrination course.

I hope the System will not consider me disloyal if I present  
more than one side of issues on which it has taken official position.

I hope you won't consider me naive if I come out on side of  
System at times on general ground that - Alles verstehen heisst alles  
verzeihen.

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### I. THE MECHANICS OF THE FEDERAL RESERVE SYSTEM

#### A. Why go into mere mechanics

1. Because what the System does has direct and immediate effects on your portfolios  
e.g., when the System withdrew the peg in 1951  
present ease in money market (esp. short term!)  
because System is providing reserves exclusively through bills
2. The only way you can understand what the System is doing is to learn the mechanics
3. To emphasize relationships - that each act has consequences (degrees of freedom)
  - a. Our latent hope for isolated action
    - (1) Cas on higher coupons but no capital loss on outstandings
    - (2) Why not a tax without economic consequences?
  - b. The inevitability of relationships
    - (1) If the F.R.S. buys securities, then other Reserve Bank accounts must change so that the books remain in balance
    - (2) If the Treasury sells long bonds, somebody must buy them - and he cannot use that money to buy something else - the liquidity of the economy is reduced.
    - (3) This is so simple - we take it for granted - but we also act as though it were not true!

c. Elements of judgment - as related to F.R.S.

- (1) Which other accounts will change in fact (The "uncontrollable" accounts)
- (a) Not every purchase is inflationary - e.g. to offset currency to offset changes in other non-reserve accounts
- Need to look at major accounts - not simply Governments
- (b) The importance of the Reserve accounts
- (c) The role of excess reserves
- (d) Free reserves - availability of credit
- (e) Ease and pressure - changes in the rate
- (f) Impossibility of predicting day-to-day changes
- Transit delays  
Treasury account  
Use average figures

B. Why have a Federal Reserve System?

1. Glib talk about letting money manage itself
2. Kemmerer's study for the N.M.C.
  - a. Average call money rates 1890-1908 (19 years)  
1st week in June 2.28%  
Last week in Dec. 7.38%
  - b. 1907  
Average call rate for June 1-3/4%  
On Thursday, Oct. 24 125%
3. One reason for creating System was to provide an elastic currency
4. But that is monetary management

C. The power of the System

1. To withdraw money ( M=\$30  
\$25 billion of earning assets (Member bank reserves  
( <\$20 bill.
2. To add money
  - a. Free gold to buy \$38 billion
  - b. Reserve requirements of members above legal minimum \$ 8 billion
3. To what purpose should these powers be used, since the System doesn't operate for profit?  
To promote stable economic progress - but that is pretty vague. -  
By influencing the supply, availability and cost of credit

II. DEVELOPMENT OF FEDERAL RESERVE POLICY AND  
IMPLICATIONS FOR INVESTMENT MANAGERS

- A. The heritage of war financing (I hope you won't conclude:  
These are the conclusions  
on which I base my facts)
1. Size and ownership of the public debt
  2. The structure of interest rates
    - a. Origin of the pattern of rates
    - b. Implications of the pattern
    - c. Search for alternative methods of influencing credit conditions
      - (1) Reserve requirements
      - (2) Selective credit controls
      - (3) Direct controls over economic activity
- B. The "Accord" of March 3, 1951
1. Background
    - a. The Douglas inquiry of 1949  
Report 1/23/50
    - b. Korean invasion
    - c. August 18, 1950  
Treasury-Fed dispute in the open
      - (1) Treasury announces 1 1/4% - 13 month note
      - (2) Fed increase discount rate from 1 1/2 to 1 3/4
    - d. Snyder Bond Club speech 1/18/51
  2. Terms of the Accord (Should have been warning)
    - a. Exchange offer 2 3/4 - 29 year convertible  
into 5 year 1 1/2% note
    - b. Purchase 2 1/2s on scale down  
Review daily
    - c. Fed reduce or stop purchase of shorts  
Get banks to rely on discounting  
Discount rate remains at 1 3/4 to end of year
    - d. Conferences of Fed and Treasury
  3. Operations under the Accord
    - a. Maintaining orderly conditions  
- including facilitating Treasury financing
    - b. Preventing disorderly markets
    - c. Correcting disorderly conditions

Joint announcement of full accord - 3/3/51 (New York Times - 3/4/51)

The Treasury and the Federal Reserve system have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize the monetization of the public debt.

C. A review of the past 18 months

1. The story in general - a favorable review

a. The economic development

- (1) G.N.P. rose to peak of \$371 billion in 2nd quarter of 1953
- (2) Since then has slid off slowly, without acceleration, to \$359 in first quar. of 1954

b. Financial policies

(1) Fiscal policy

- (a) Initial desire to balance budget
  - (i) Cut expenditures
  - (ii) Maintain most taxes
- (b) As weakness developed
  - (i) More tax relief including excise cuts

(2) Debt management

- (a) Lengthen the debt  
- April 8th announcement of the 3 1/4's
- (b) Now don't want to absorb long-term funds from local Governments or private borrowers

(3) Monetary policy

- (a) Requirement to report on actions taken
- (b) Successive directions of F.O.M.C. to Executive Committee:

"Transactions for the System open market account should be with a view ....

- (i) March 4-5  
"to exercising restraint upon inflationary developments."
- (ii) June 11  
"to avoiding deflationary tendencies without encouraging a renewal of inflationary developments (which in the near future will require aggressive supplying of reserves to the market)."

(iii) September 24  
"to avoiding deflationary tendencies."

(iv) December 15  
"to promoting growth and stability in the economy by actively maintaining a condition of ease in the money market."

2. It doesn't work out so smoothly in detail - the 3 1/4 story

a. Background

(1) March 1953 - ascertaining the market  
- underwriting ?

(2) April 8 - Preliminary announcement  
\$1 billion + F + G

(3) April 9 - Treasury announces it will  
need \$2 billion through June 30

(4) April 11 - reactions

Porter letter of April 11, 1953:

"We believe this first issue of 30-25 year  
3 1/4% bonds will move to a substantial  
premium in the open market."

Goldsmith letter of April 11, 1953:

"New 3 1/4's expected to be heavily oversub-  
scribed and to go to substantial premium."

(5) April 13 - Circulars of terms  
Martin Detroit speech

(6) April 14 - issue closed - open one day  
"Announcement of allotments will probably  
be made Friday, April 17 "

Subscriptions	\$6 billion
Padding	<u>3/4</u> "
Accepted	\$5 1/4 "

Selective vs. across the board allotment

(Prime rate up?)

(7) April 15 - F.N.M.A. halts buying of VA and FHA  
mortgages presaging higher rates - national  
finance companies increase rates offered on  
their paper.

(8) April 22 - 20% allotment

b. How fast can things change and why?

(1) April 23

Treasury said receipts had not held up. It would  
need more than it had expected on April 9 - no  
estimate of amount. Would meet market terms.



- (2) Possible supply: The allotments by classes
  - (a) Individuals, partnerships, and corporations 254.6
  - (b) Dealers, brokers, investment houses 158.2  
400
  - (c) F and G 400
- (3) Possible demand for - or lack of it
  - (a) Government investment account fully invested had bought 118
  - (b) Real investors annoyed with allocations
  - (c) Fed ? No. Martin Detroit speech
- (4) Prime rate raised from 3 to 3 1/4% (April)
- (5) May 6 - Martin Boston speech
- (6) A. S. conversations  
Anticipatory borrowing - fearing still higher rates and perhaps rationing
- (7) Fed begins buying bills 2nd week in May
- (8) May 25 - Treasury announces \$800 million TAB's - a complete surprise
- (9) You have seen the worst on June 1
- (10) Reduction in reserve requirement July
- (11) Overdo ease to correct misimpression

D. A difference of opinion as to method (See p. 99 of 1953 Annual Report, Bd. of Gov. of Federal Reserve System)

### III. A. Objectives and Related Programs

Objective	Conditions calling for or permitting an easing of credit	Conditions calling for or permitting a tightening of credit
1. Convertibility	High and/or rising primary reserves	Low and/or declining primary reserves
2. Productive credit	Increase in monetary volume of output	Decrease in monetary volume of output
3. Stable price level	Declining prices	Rising prices
4. Full employment	Less than full employment	Jobs in excess of workers
5. A fixed rate of interest	When savings are inadequate	When savings are excessive

B. We have an excellent current illustration of problem of choice among objectives

	June 9, 1954	June 10, 1953	Differ.	Dec.31, 1952	Differ.
1. Monetary gold stock	21,924	22,537	- 613	23,187	- 1,263
		TIGHTEN CREDIT?			

	Latest	In last year		1947-1949 = 100	
		Max.	Min.		
2. Prices					
a. Consumer	Apr. 114.6	115.4	113.7	Apr. 1953	113.7
b. Wholesale	June 1 110.8	111.0	109.3	June 2, 1953	109.7
	LEAVE ALONE - over whole year?				

	May 1954	April 1954	May 1953
3. Unemployment:			
Total labor force	67,780	67,438	66,497
Civilian labor force	64,424	64,063	62,964
Employed - total	61,119	60,598	61,658
Non-agricultural	54,300	54,522	55,068
Agricultural	6,800	6,076	6,590
Unemployed - total	3,305	3,465	1,306
% of civilian labor force	5.1	5.4	2.1

EASE ?

#### IV. INSTRUMENTS OF POLICY

##### A. The means of accomplishing objectives

1. You want to keep our markets for consumption and investment in balance with production at high levels
2. By influencing credit conditions or the TONE of the money and capital markets
  - a. Supply of money and credit
  - b. Availability - mortgage money last May and June !
  - c. Demand for credit
  - d. Price of credit or interest rates

##### B. Types

1. General - or "quantitative"  
affect supply, availability and cost - and demand
2. Selective - or "qualitative"  
relate to particular types  
Limit demand by requiring prospective borrower to meet specified conditions

##### C. Analysis of general controls

1. Discount rate and administration
  - a. Appropriate and inappropriate uses.  
Difference of opinion on relative weight to cost and rules  
Martin's Boston speech
  - b. Limits to effectiveness of rate
    - (1) To control expansion: when no one is borrowing high rate can't reduce
    - (2) To induce expansion when no attractive loan and investment opportunities are available
2. Open market operations
  - a. Developed to overcome defects of the rate
    - (1) To control expansion  
- "making rate effective" by forcing market into central bank
    - (2) To induce expansion  
- make funds freely available,  
supply more liquidity than the market wants

- b. Limits to effectiveness of open market operations  
(1) To control expansion

Portfolio of Government securities

e.g.	Excess reserves	Portfolio
Dec. 1935	\$3.3 bil.	\$2.4 bil.
Nov. 1940	6.9 "	2.2 "

- (2) To induce expansion  
eligible assets in market  
authority to buy - now \$38 billion

Can't push on a string - severe depression

(This led to idea of compensatory fiscal policy -  
but that is another topic that I shall not discuss.)

3. Changes in Reserve Requirements - first suggested in 1917

a. Affects all members directly rather than  
through money market

b. Limits

on authority to change

on effectiveness

- contingent on willingness to see  
"tone" of market change

- pushing on string

4. Interrelations of instruments

Sale of securities may force banks to borrow

Their attempts to repay will be reflected in reduced  
availability of credit and higher rates

Change in reserve requirements not very effective  
unless allowed to affect tone and terms in credit  
market. (We still have much to learn about this.)

But 1% = \$1 billion - may offset part to prevent  
sudden spasm of tightness or sloppiness

D. Analysis of selective controls

1. Margin requirements
2. Consumer credit regulation
3. Real estate credit regulation
4. Other?

- E. A basic issue of monetary policy - relative importance of general and selective
  - 1. Extreme for general - Chicago
  - 2. Extreme for selective - Keyserling, Clark - risk too great to use general
  - 3. In between

Council of Economic Advisers' view on cheap credit  
(Hearings - January 1950 Economic Report - 1/17-20/50, p. 68)

The value of cheap credit. - The difference in our position from that of the subcommittee arises in part from a somewhat different view of the desirability of low interest rates. In the report of the subcommittee it is said, and repeated, that low interest rates are generally beneficial, but it is proposed to yield that principle in periods of inflation and to use central bank operations to induce an increase in the cost of money.

Our view is that low interest rates are always desirable. In periods of inflation they have the undesirable collateral consequence of contributing to inflationary forces, but even then they have the economic advantage of facilitating the expansion of productive capacity which is the best road to stability. Where we differ with the subcommittee is that we would not abandon the advantages of cheap money and use central bank operations to cause an anti-inflationary increase in interest rates. We would retain the advantages of cheap money and adopt other measures to curb the inflationary forces. In extreme cases as in 1947-48, we would tighten the availability of credit by pressure upon bank reserves under the plan proposed by the Federal Reserve Board at that time, but would hold the resulting trend to higher interest rates within narrow limits.

V. ORGANIZATION OF SYSTEM

- A. Relation to Government: Treasury
- B. Centralization vs. decentralization
- C. On differences of opinion within the System
- D. On errors in judgment
  - 1. Looking back
  - 2. Looking forward

(Do not expect perfection in a human institution.)

## CONCLUSION

### A. Suggestions

1. Follow the statistics
2. Follow official statements
3. Follow reports

### B. Principles of War, General von Clausewitz

"The conduct of war resembles the workings of an intricate machine with tremendous friction, so that combinations which are easily planned on paper can be executed only with great effort."

"The results on which we count are never as precise as is imagined by someone who has not carefully observed a money market and become used to it."

### C. Qualities every student tries to achieve

Technical competence

- to recognize and always take into account -  
become part of our thinking: THE NECESSITIES

Improved judgment with experience

Courage and enthusiasm

Humility