NOTE: Packet of papers on Admin problems and communications w/ Fed & Burns

A review for administration purposes of general Federal Reserve practices & how they can be changed to come in line w/ admin goals

Paul McCracken May 1, 1969

L. C. Andersen

Federal Reserve Actions and the Stabilization Program

I pointed out in my memorandum of April 25 that there is a very strong probability that Federal Reserve actions will result in an accelerated rate of monetary expansion. Such a development should be vigorously challenged, because it would threaten the success of the present program of restraint.

This memorandum sets forth some recent monetary developments. It also discusses Federal Reserve operational philosophy regarding monetary management. The Federal Reserve's operating concepts threaten our stabilization program just as they did in every postwar recession and inflation.

Recent Monetary Developments

We have urged the Federal Reserve to take actions to reduce the rate of monetary expansion from the excessive rate of last year. Also, our policy forecast for the next several quarters is based on slower monetary growth. It appeared that progress was made during the first quarter when money (narrowly defined) grew at a 2.3 percent rate. However, money jumped up at a 15 percent rate from March to April and it is anticipated that money will rise substantially throughout the month of May. The Board estimates that at best money in May will average the same as April. If this happens, the rate of expansion in money will be about 4 to 5 percent during the first 5 months of 1969, about the same as during the last half of 1968.

The big jump in money during early April has been attributed to an unusual event -- a marked decrease in cash items in process of collection which increases net demand deposits. However, this factor was self-reversing in one week, but money was about $2 billion higher than before the jump.

Despite claims to the contrary, the case is very strong that the Federal Reserve more than offset the impact of the reserve requirement increase effective for the week of April 23. I estimate that this increase was equivalent to a decrease in total reserves of $660 million. During that week, total reserves (seasonally adjusted) increased $900 million, and when adjusted for the reserve requirement change (the Board's effective reserve concept) they rose $300 million. This rise in reserves is directly the result of Federal open-market purchases of $300 million, an increase in member bank borrowings from Reserve banks of about $400 million, and a rise in float not offset by System operations of $650 million.

Federal Reserve Concept of Monetary Management

Two concepts play a key role in Federal Reserve open-market strategy -- money market conditions and the accommodation principle. Use of these concepts has frequently led to procyclical movements in the money stock and threatens such a movement in the near future.

Money market conditions have been dominant in the Federal Reserve's approach to monetary actions since the early 1950's, despite many studies which have pointed out the perverse effects for stabilization policy of such an approach. This approach holds that measures of money market conditions (currently the Federal funds rate and net borrowed reserves) are the best guide for monetary management. By manipulating these variables through open-market transactions, changes in the discount rate, and changes in reserve requirements the System influences economic activity.

Accepting this approach, significant monetary restraint has been achieved -- Federal funds are trading at the unprecedented rate of 8 percent -- borrowings from reserve banks and net borrowed reserves are both about $1 billion. In fact, it has been argued that, in view of this significant degree of restraint, the System should move no further.

The accommodation principle views the role of the Federal Reserve as essentially accommodating the demand for money or the demand for credit. Despite many studies pointing out its defects, the real bills doctrine still holds forth at the Federal Reserve. This principle along with the money market conditions view threatens to undermine our stabilization efforts. With money market conditions held unchanged, as mentioned above, the System will "accommodate" the demands for money and funds flowing from our overheated economy. Growth of monetary aggregates will accelerate and growth in total demand will not be curbed.

Recommendations

If we are to be successful in our efforts to curb inflation, the Federal Reserve must change its approach to monetary management. We have been living with a mistaken view that it is willing to pay attention to the money stock or any other monetary aggregate. When the chips are down the Federal Reserve reverts to its old "tried and true" procedures, but these procedures have been the main source of stabilization problems over the past.

It is imperative that the Administration convey this concern to the Federal Reserve in no uncertain terms. To have a maximum effect, this expression of concern should probably come from the highest level.

cc: HS, HH, CW, DL