

July 29, 1966

CONFIDENTIAL

Dear Allan:

Your letter of July 18 is the more impressive as being a seashore product. Your comments are very much to the point and certainly seem to me to get at the heart of some basic problems facing monetary policy at the present.

In my view, whatever may have been wrong in past decisions respecting the structure and control of banking, the root of our present problem is the failure of fiscal policy to carry its share of the load in restraining inflationary pressures. With economic activity moving ahead at a rapid pace, any reasonable monetary policy would, I fear, even under the best of circumstances, be up against a serious problem in attempting to provide the necessary degree of restraint while at the same time avoiding severe monetary dislocation.

Your comments on the undesirability of imposing artificial restraints on interest rates are, of course, well taken. I share your view that the financial system works most effectively in the long run if prices are set by market forces, and I believe that it is most unfortunate that we have been unable to work more effectively in achieving the long-run goal of a flexible competitive financial system.

The goal of free financial markets might well have to be temporarily set aside under emergency conditions, however. Whatever the reasons for the predicament of the savings and loan associations, many of them do find themselves in a potentially vulnerable position even though fears concerning them have so far proved exaggerated. One can, of course, question the extent to which the Federal Reserve should feel itself responsible for these associations, which, through usage and advertising, have encouraged people to believe that they are holding deposits

subject to immediate withdrawal. In any case, I must reluctantly agree that there are situations imaginable in which temporary interest rate limitations might prove the best of a number of poor alternatives -- such as the unwanted easing of monetary policy, for example. At the same time, I hardly need tell you that legislation forcing the Federal Reserve to impose unreasonably low interest rate ceilings (in contrast to the power to impose limitations of its own choosing at its own discretion) would, in my judgment, be a most unfortunate development. As you have seen, the Treasury has had second thoughts on this latter issue.

I have been concerned, as you have, that the certificate of deposit, which has given commercial banks a needed competitive instrument, has also allowed banks to slip away from Federal Reserve tightening, at least in the short run. To be sure, I believe that even with lower reserve requirements on certificates of deposit and other time deposits than on demand deposits, the System still has control over the volume of reserves and, therefore, the basic degree of ease or tightness of the banking system. But there is no doubt in my mind that the use of C/D's has magnified the problem in the short run and that banks are able to mitigate temporarily the tightening impact of monetary policy. The suggested solution of requiring uniform reserve requirements seems overly drastic to me, and not really essential. Since, as you say, it is unlikely that we will be able to impose reserve requirements on nonbank savings institutions in the foreseeable future, imposing reserve requirements on commercial banks' time deposits at a rate equal to those on demand deposits would, I feel, simply put the commercial banks at a substantial competitive disadvantage. As you point out, there may, however, be a case for shifting the present dividing line between high and low reserve requirements so as to include negotiable C/D's along with demand deposits in the high reserve requirement classification.

The problems faced by the System are difficult, and everyone in the Federal Reserve, both at the Board and the Banks, recognizes that some of the things we are doing currently represent no more than an attempt to provide temporary solutions to perplexing immediate problems.

As for the present role of the Treasury in these monetary matters, there undoubtedly is some residue of resentment over what the Administration considered

"lack of coordination" last December. However, as indicated above, the Treasury fortunately seems to have backed away from the concept of a mandatory rate ceiling for certain time certificates. In the fiscal area, my feeling of frustration over the absence of a tax increase is as acute as ever.

You touched briefly on the sterling situation. As you can imagine, this has been keeping Charlie and me pretty busy over recent weeks and the performance of the exchange market has given us some worrisome moments. On the other hand, it seems to me that Mr. Wilson's program is really very drastic; and if he can put it through, as now seems probable, we may be on the verge of a considerable turn in market sentiment. But I must confess that this particular "cliff hanger" has been lasting a lot longer than I would choose.

With best wishes,

Yours sincerely,

Alfred Hayes

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AIR MAIL