

OFFICE CORRESPONDENCE

DATE October 26, 1954TO Mr. Sprout

SUBJECT: _____

FROM Robert V. Roosa

Copies to Dr. Williams, Mr. Pouse and Mr. Roelse

The attached comes to you two months after your request reached me. In defense, I can only say that I have used this as an excuse to think through again -- perhaps I could even say to make an "agonizing re-appraisal of" -- my own views on central banking. What I've put down here represents, too, despite appearances to the contrary, an effort to state my conclusions briefly. As you know, for me, that is a time consuming effort.

This memorandum skips little things, even Prof. Wood's interpretation of the historical record. He lumps all Federal Reserve officials together too often; gives you personally much less than full justice for your independent views throughout the postwar period, and may well have carried sin so far as to have ignored our Annual Reports of the past few years and to have skipped my own masterpiece in the Williams volume. I could detail some of these, if you want to mention details in your letter to him, but my hope would be that you might prefer to deal with some aspects of the issues discussed in the attached.

Would you want me to circulate this to anyone not mentioned above? I have taken the liberty of routing copies to them because much of what I have tried to say here has relevance to other matters that we have been discussing among ourselves.

RVR:emd

OFFICE CORRESPONDENCE

October 26, 1954

To Mr. Sproul

Subject: Professor Wood's Revised

From Robert V. Roosa

Paper: "Recent Monetary Policies"

Copies to Dr. Williams, Mr. Pouse and Mr. Roelse

On reading this revised, and much more nearly ample, version of Professor Wood's views, I am frankly disappointed. His critical perception is so keen, and his exposure of the limitations and inconsistencies of the present "norms" is so telling, that one is led to expect an incisive, logical formulation of what the System ought to do. He provides that, to be sure. But I am afraid he also illustrates the nakedness of pristine logic in our complicated world.

His view is that Federal Reserve policy should be defined and carried out solely in terms of the maturity structure of interest rates -- particularly the rate structure for Government securities. Faced with an "either, or" choice, I suspect I would take the Wood formula over that of the Ad Hoc Committee. But I think his formula, too, is an oversimplification. It leads him to several extreme judgments concerning aims and techniques: that there is no need for the discount mechanism; that there is no place for fortuitous changes in rates; and that there is no significance to the concept of uncertainty in carrying out credit control.

I do not see why he has to go so far, and be so dogmatic, in trimming all System effort down to the determination of a rate curve. But before turning to my own reasons for this doubt, I should, first, outline what seem to me to be the important zones of agreement between Professor Wood and the views of most of us here on the underlying principles of monetary policy and action:

Monetary and credit control must be flexible.
The flexibility should be used purposefully, not left to nature's course.

This means:

Policy concern with the "degrees of pressure" in all maturity segments of the market for debt instruments, and

Policy action to reach those maturity segments where a change of pressures clearly furthers the current aim of policy (restraint, neutrality, or ease).

Conversely, for the System to shrink into one segment of the market, exclusively, means not merely that monetary control does less than it could, but even more seriously, that as practised it may at times make things worse -- like helping nature spread a plague.

The differences begin to arise when Professor Wood formalizes his logic. Apparently he reasons that all the thinking which goes into policy determination can be reduced to the selection of a rate curve. That is, there must be one rate curve which most nearly embodies all the conflicting considerations and aims that have to be reconciled in setting the single policy appropriate for any particular set of conditions. If the rate curve, and changes or shifts in it, represent the end results of all policy, and if open market operations by themselves are capable of bringing about any particular rate curve that the System might want to choose, then why bother with other instruments like the discount mechanism? Moreover, why leave things fuzzy, or why stop short of a clear and complete definition of aims, by leaving any zone for fortuitous changes in rates? And why, or how, can there be any place for, or usefulness in, "uncertainty" when there must be one rate curve which best epitomizes the aims of policy at any one time?

This kind of position is difficult to meet on paper, or in debate. Its logic is appealingly simple. By contrast, the basis for my disagreement is an unsatisfying generalization -- that the aims of policy can never be so clearly specified in advance, nor so fully achieved through changes in interest rates alone, that we can rely either on a single measure or on a single tool.

My role in disagreement is not made any easier when I must go further to admit that interest rates are probably more important than any other sets of measures (or guides) for the execution of credit policy, and that open market operations are likely to be the most important among the System's tools most of the time. Perhaps this does suggest, however, that fundamentally my differences with Professor Wood are differences of degree, and that they may prove to be the kind of differences that help to invigorate an alliance, rather than the kind of differences that drive men into opposing camps.

Discount Mechanism

Professor Wood apparently believes that the discount mechanism, in the fabric of financial institutions in the United States, is virtually useless. Without trying to spell out a full rationale for the discount mechanism -- a task that Mr. Rouse and I are now tackling together, with a hope of completing something before the end of the year -- it does seem to me that bank borrowing and the discount rate are, to say the least, necessarily a part of the full use of open market operations. Instead of developing a clear-cut, unequivocal view on what the interest rate curve for Government securities ought to be, at any particular time, it seems to me the System's task instead should be the determination of a discount rate appropriate to the circumstances, with open market operations used, to a large extent, for the purpose of making the discount rate effective.

Though I would not go along with Wood in drawing a whole curve to describe the appropriate aims of policy, at any particular time, I do think it is necessary to select one critical point -- a point that, as it is moved, tends to imply shifts up or down in the level of the rate curve. The curve may bend;

one end or the other may lag, or lead. I would not see how the "right" curve could be fully described in advance, and would not see a need to try. Given the point — the discount rate — and the synthesizing of views that has had to go into determination of it, I would not then see any need for open market operations to mark out a whole series of related points along a curve. Instead, it should be the job of open market operations to bring about the general degree of pressure that will, in the different conditions of each week or month, be consistent with the policy views that have been embodied in the selection of the discount rate.

In line with the discount rate decision and its policy connotations, open market operations should help to bring about a roughly corresponding degree of ease, or of tightness, in all maturity segments of the debt (or credit) structure. But there is a wide zone in which borrowing, and the whole discount mechanism, can do much of the job in developing the ease or tightness intended by general policy. Some of the time, changes in line with the policy objectives may come about, perhaps not precisely, but adequately, in most maturity segments without any open market operations. Even more frequently, limited open market action in one segment, ordinarily the shortest term, may be enough. There is certainly no need to be meddlesome for the sake of meddling, nor for the sake of pinpointing some pre-determined rate curve.

I would argue that there are, indeed, other guides, in addition to the actual rates of interest on Government securities, which are worth watching. No doubt all of us in the System would agree that there should be some concern with the volume of bank reserves. And along with that should go concern over the money supply. There should also be concern with various other market rates of interest, and with the degree of ease or tightening implied by the level of,

and by changes in the interrelations among, these rates.

What would the approach that I am suggesting mean for periods of ease, or of restraint? Very broadly, I would think that in periods of ease the discount rate should be just on the outer fringes of contact with the more sensitive of the money market rates (Federal funds, dealer loans, and Treasury bills) -- and money market rates should be kept within that range mainly through open market operations. Borrowing should occur only irregularly, and in relatively small volume, as a safety valve which opens in response to individual bank situations rather than serving widespread banking needs for funds. Open market operations might at times, in my "ideal" central banking world, exert influences directly upon the intermediate or long term market, if more decided ease, or a prompt turn toward ease, seemed to be called for by current economic or credit conditions. But action would probably take place within the short area most of the time. Open market operations should generally provide funds ahead of, or closely in step with, any general banking need to borrow. And without producing sloppy or disorganized short term markets and rates, open market operations should keep money market rates generally below, and in an "easing" relationship to, the discount rate. In turn, the discount rate should be the benchmark of the central bank's policy toward the money market.

In a period of a policy of restraint (and with variations in degree depending upon the intensity of the need for restraint) the discount rate should be somewhere close to, perhaps below, the important money market rates -- that is, possibly below the rates on dealer loans and Treasury bills, though probably not Federal funds. Again serving as a marker, indicating the center of emphasis in the central bank's current policy toward the money market, the discount rate should be kept effective through the aid of open market operations. This time,

the result should be that banks tend to find themselves in need of marginal reliance upon borrowing fairly frequently, in relatively large amounts, and that a significant magnitude of aggregate borrowings should be expected to remain outstanding much of the time. There are differences of substance, I believe, related to the kinds of reserves made available to the banks -- and to the strings that may or may not be attached to them -- which influence the smooth functioning of the financial mechanism, and the general availability of bank credit. Reserves are not all homogeneous dollars. Nor should they be. In taking advantage of differences that are qualitative, not purely quantitative, the System may exercise a finer, more sensitive, degree of influence than could be possible solely through the pluses and minuses brought about through open market operations. (There can also, of course, be qualitative differences in the uses made of reserves provided, or taken away, through open market operations -- depending mainly upon the trading methods used -- and I would not wish to forswear any of these possibilities, either.)

Fortuitous changes in rates

What then about fortuitous changes in rates? Professor Wood recoils from the kind of mysticism, or perhaps it is romanticism, that would leave all interest rates to "natural forces". He sees the humbug in any pretense that there can be a genuinely "free" money market, so long as a central bank exists for the purpose of influencing the general availability of money and credit. But he lets this wholesome skepticism carry him to another extreme -- that there is no purpose in "continual minor changes in rates which are purely fortuitous and serve no purpose whatever from the standpoint of credit regulation" (p. 10, underlining mine). He says further, "A change of rates should be a signal of the intentions of the authorities" (also p. 10). He indicates that Federal

Reserve officials defend these fortuitous changes on two grounds, first, that they generate an uncertainty concerning future rates that may be helpful in gaining System policy objectives, and second, that they reflect the natural conditions of supply and demand in the market. The role of uncertainty is discussed further below. What about the second? Is there no tillable ground between the "natural forces" point of view, and Professor Wood's scur observation that when "changes occur in a fortuitous way it merely means that the authorities have taken their hands off the controls" (pp. 11 and 12)?

It seems to me that instead of being haphazard, occurring only because of a System failure to carry out policy with exactness, rate changes "in the market" serve a fundamental purpose. They serve to guide the distribution of funds -- to some extent among maturity sectors, but even more among kinds of uses within each sector. Within a boundary set by the policy implications of the discount rate itself, there may be a great number of combinations in the inter-relationships among rates. In the short-term market, for example, whether the Treasury bill rate is 1 per cent or 1 1/4 per cent, in relation to a discount rate of 1 1/2 per cent, may be of less significance in describing the prevailing degree of pressure than whether dealer loan rates are above or below the Treasury bill rate, or the Federal funds rate is above or below, or whether "buy-back" funds are available outside New York at rates above or below the Treasury bill rate. And there are many possible combinations and differences of degree among these, and other, variables in the short-term market -- capable of producing, with rough similarity, the differing degrees of general ease or pressure that may be sought by credit policy.

This constellation of short-term market rates and techniques might possibly adapt itself, and work reasonably well, if the Treasury bill rate were

to become a movable peg, such as Wood contemplates for all rates on Government securities. But that would at best be a gamble. Why put on the System a responsibility to pick out, in advance, the bill rate consistent with the judgments embodied in selection of the discount rate? Why not instead let the market help to find the Treasury bill rate that gives the desired degree of ease or tightness when taken in combination with other freely moving market rates, in the circumstances of any given period?

This is not to say that the System should be unconcerned with the Treasury bill rate, or with rates on any other maturities of Government debt. It is to say, though, that concern need not be identical with certainty as to where those rates ought to be. And that the System should watch rates, and rate movements, not as ends in themselves but as symptoms of the prevailing availability of credit, and as guides to whether more funds, or perhaps less funds, are needed to fulfill the general intentions of policy for increasing or reducing the availability of credit.

To some extent, it seems to me that fortuitous changes among rates may take the place of deliberate System action. Where that is not the case, they can at least provide useful guides to help direct that action. Even if, in given conditions, a rising Treasury bill rate should actually mean that an unwarranted degree of tightness was building up in the short-term market, and that System buying should be undertaken to provide additional reserves and relieve the pressure, there need be no presumption that the System ought just to go on purchasing until the bill rate returned to some specified point. Quite the contrary. Having helped to signal the need for relief, the Treasury bill rate may, once System buying begins, become merely a relatively fixed point around which other rates begin to realign themselves. To force the Treasury bill

rate itself back down might, then, be to overdo System intentions. It would be important to watch the Treasury bill rate, and appraise the significance for general policy of changes in the constellation of rates and credits surrounding it. But the "fortuitousness" of market forces should be relied upon to indicate whether or not it was sufficient merely to lean against developments by releasing a few reserves, or whether sustained buying would be needed to restore a desired degree of ease. The observation of rates is an essential part of that decision making process; but this does not mean that rates are necessarily, however, the common denominator in which all parts of that process can be expressed, unequivocally and unambiguously, and determined in advance, on the basis of independent criteria.

Professor Wood has good reason to doubt that fortuitous changes in rates should be the end-all of policy in "free" money markets. He need not swing all the way from that criticism, however, to the opposite view that no useful zone exists for any freedom of rate action outside the purposeful efforts of the central bank itself.

Uncertainty as a recognizable influence upon credit availability

Professor Wood does not feel that "uncertainty" has any legitimate place among the influences used, or exerted, by monetary control. He recognizes that "uncertainty of future rates" may "reduce(s) the moneyness of debt instruments" (p.11). But he then observes that any such influence can be had through an actual and direct change in the yield itself. Therefore, he implies, why bother with "uncertainty"?

Here is one place where, I think, a little use, even loosely, of the mathematician's language might help, even though it appears to be an academic

digression. For I think Professor Wood might agree, as a logician, that, within reasonable limits, a change which widens the range of variance around an expected value, may take the place of a change in the expected value itself -- in achieving a given effect. Translating, this means that comparisons between, say, the present rate on 10 year Government bonds, and the rate expected on such bonds a year from now, can have vastly different meanings, depending on the degree of certainty attached to the guess concerning the rate next year. Barring other considerations, an investor might be quite ready to buy a $2\frac{1}{2}$ per cent 10-year bond in the market today, for example, if he expects the yield on a comparable maturity a year ahead to be $2\frac{1}{4}$ per cent. But the whole decision turns (still leaving other considerations aside) on how confident this investor, or the consensus of the market, may be concerning next year's yield. If the best estimate -- $2\frac{1}{4}$ per cent -- has a relatively small variance, that is, for example, if investors think it quite unlikely that the rate will deviate by more than $\frac{1}{8}$ either side of $2\frac{1}{4}$ per cent, then buying of $2\frac{1}{2}$'s now should be heavy. But if there is felt to be a good chance that next year's rate may be anywhere from 1 per cent above to 1, or possibly $\frac{1}{2}$, per cent below the "mean expected value" ($2\frac{1}{4}$ per cent), then there may well be fewer investors ready to plunge into the $2\frac{1}{2}$'s today.

Without trying to build this oversimplified example into a real, flesh-and-blood illustration, perhaps I can leap on to the implications. So long as there can be differences in the "band of uncertainty" surrounding any expectations of future rates, even tomorrow's rates, not just those for next year, then any given interest rate curve, as projected ahead, can have a wide range of different possible meanings. It may be as important to influence the

uncertainty band, by narrowing or widening it, as to influence the rate itself. And if for any reason, of a good and practical nature, it proves impracticable or impolitic at times to exert influences that will lead to sizeable changes in the rates themselves, then by working on the uncertainty band instead the central bank may be able to maintain something like the desired degree of pressure upon the availability of credit.

In logic, and no doubt in practice, Professor Wood is right in saying that for every change in uncertainty (i.e., every increase or decrease in the variance -- and possibly every alteration in the symmetry -- of the probability distribution that surrounds each expected mean value) there is a specific change in the rate itself which could achieve the same effect. But why insist on always doing it one way? At times the hazards of life may simply make large actual rate changes unacceptable. Why not then at least make room for uncertainty as a substitute for actual rate change? At other times, and probably much more often, changes in the state of uncertainty may just come about, perhaps without any specific inducement from central bank action. If those changes should be in the direction of reinforcing current policy, the central bank would be ungracious indeed (or perhaps even stubbornly doctrinaire) to insist that the effect must be achieved another way -- through engineering actual further changes in the rates themselves.

Professor Wood's rejection of uncertainty, like his insistence on the definition of all aims at any given time in terms of a clearly drawn rate curve, implies some lack of feeling for what seems to me to be the "art" involved in effective central banking. Yet his references to the need for gauging policy in terms of degrees of pressure (e.g. p. 7) suggest that he could, without changing much that is fundamental in his paper, convert himself

into an exponent of many of the positive views on the nature and aims of monetary controls that have been advanced here.

RVR:emd