AS letter to FOMC and
copy to Pres. not on FOMC
12/ /53

Mr. Robertson - ans. 12/8

Mr. Martin

Mr. Mills — 1/19
Mr. Evans

Mr. Szymczak

Mr. Vardaman

Mr. Erickson
Mr. Fulton
Mr. Johns
Mr. Powell
Mr. Williams
Mr. Bryan
Mr. Leach
Mr. Leedy
Mr. Gentry )first VP)
Mr. Earhart
Mr. Young

Bills. Owl

12/4/53

~~2/12/53~~

FEDERAL RESERVE BANK OF NEW YORK

Sent to all members of FOMC and Presidents
not on Committee.

December 4, 1953

Hon. Wm. McC. Martin, Jr., Chairman,
Federal Open Market Committee,
Board of Governors of the
Federal Reserve System,
Washington 25, D. C.

Dear Chairman Martin:

At the meeting of the Federal Open Market Committee on September 24, 1953 we continued our discussion of System open market operations, in the light of the report of the Ad Hoc Subcommittee first submitted to us in March 1953, and discussed then and at our next meeting in June. In September most of our discussion was on procedural aspects of our operations - the respective roles of the Open Market Committee, its Executive Committee, the Federal Reserve Bank of New York and the Manager of the System Open Market Account. The merits of the two general kinds of operations which were at issue were implicit in this discussion but were not explicitly discussed. I think it is important that they now be discussed, particularly in view of the decision of the full Committee that these are matters on which it should act directly, and if necessary frequently, and on which each of its individual members should, therefore, be fully informed.

In focusing attention upon the merits of different kinds of operations, I do not wish to suggest that we embalm the matter of procedure. Having regard for the way in which human machinery functions, I think we shall want to reexamine the role of the Executive Committee of the Open Market Committee from time to time. For the present, however, I would only express my concern that the kind of action taken by the full Committee in September may lead us into trying to discharge our responsibilities by means of simple formulas, instead of by confronting complex situations with acute analysis, and determining policy in the light of foreseeable circumstance each time we meet.

At our September meeting stress was laid on the fact that each individual member of the Federal Open Market Committee is responsible for our open market operations. And I know that there has been concern, in the light of our past procedure, as to how each individual member of the Committee might defend his discharge of that responsibility if called upon to do so by the Congress. We shall not satisfy our consciences nor the Congress, however, merely by adopting resolutions such as the one adopted in September. What is required on the part of each member of the Federal Open Market Committee, I

would say, is a continuing and absorbing interest in and attention to national credit policy in general and open market operations in particular. There is plenty of work for each individual member of the full Committee to do, and plenty of responsibility to be assumed (whether or not the Executive Committee has discretion in certain matters), if each member is to be prepared constantly to diagnose a dynamic and complex business and credit situation, and competent to prescribe the kind of monetary policy appropriate to it. This demands constructive, affirmative, imaginative development of individual opinions which can be presented to, and discussed with, and debated with a group of equals.

Out of such deliberation general policy should emerge. Out of it also would come that indication of "climate of opinion" which would condition the exercise of whatever discretion may be granted to the Executive Committee, and to the Manager of the System Open Market Account. We need not then debate sterile and misleading questions, such as whether the Executive Committee or the Manager of the System Open Market Account should have "blanket discretion" to operate in other than short term Government securities, or to purchase certain kinds of securities at the time of Treasury financings, or to do anything else. They should not have blanket discretion. They should have discretion only within the limits of policies which the full Committee has determined and which it has continuously under review.

I should like to consider on the merits, therefore, the kinds of operations which led to our discussion of Committee procedure at our September meeting. There were two kinds of operations involved, as set forth in the motion offered by Governor Mills and subsequently adopted by the Committee. One part of the motion required that operations for the System Account be confined to short term Government securities (except in the case of correction of disorderly markets), and the second part required that during a period of Treasury financing there be no purchases of (1) maturing issues for which an exchange is being offered, (2) when issued securities, or (3) outstanding issues of comparable maturity to those being offered for exchange.

I assume that the most recent intellectual underpinnings for this resolution are to be found in the letter and enclosures which the Chairman addressed to members of the Federal Open Market Committee under date of September 15, 1953. When the motion was discussed at our meeting on September 24, I said that I would not attempt to answer the Chairman's analysis of open market techniques during the preceding months, but that I would merely say I disagreed both with his analysis and his conclusions. If we are to continue to consider these matters, I should say something about why I disagreed, particularly as the Chairman's statement took vigorous exception to views which I had expressed in an earlier letter (dated July 16, 1953).

Much of the Chairman's letter was devoted to the performance of the Government security market during the second quarter of this year. I had held that the market had shown a serious lack of breadth, depth, and resiliency, despite the fact that it had been weaned from the "fear" of System intervention in the intermediate or long term market and that this disposed of, or disputed, the Ad Hoc Committee's contention that the threat of our intervention was a major cause of the market's previous lack of breadth, depth, and resiliency.

I still hold that opinion. I believe that judicious intervention in the long term market for Government securities during the second quarter of this year might well have prevented a distorted interpretation of credit policy by the financial community, resultant incipient disorder in the Government security market, and an unintended degree of credit restriction. The Chairman's letter laid great stress on the speculative subscriptions to the Treasury's 3 1/4 per cent bond issue, and to the weight of this "weakly held" issue overhanging the market. He seemed to take the position that the only alternative to confining our operations to Treasury bills would have been to purchase, at arbitrarily determined prices, all of the new 3 1/4 per cent bonds offered for sale, particularly by speculators who subscribed for the bonds only to turn a quick profit. I do not agree. There was actual and latent demand for the new long term bond. (It never fell to a discount of more than a point and a half, whereas prices of the 2 1/2 per cent bonds of 1967-72 fell more than three points after they had adjusted to the preliminary announcement of the offering of 3 1/4 per cent bonds.) The major influence in the market at that time, in my opinion, was not the weight of speculative holdings of 3 1/4 per cent bonds overhanging the market, but the development for a variety of reasons of an expectation of stringency in the money market and a further rise of interest rates of unpredictable proportions. I believe that judicious purchases of long term bonds during this period, certainly no greater in amount than our aggregate bill purchases, would have been more effective in bringing about an improvement in market psychology than were our purchases of bills, and that this would have contributed to both better credit policy and better debt management.

Anticipating this view, the Chairman's letter of September 15 used the experience we had in the purchases of bonds for Treasury investment accounts to refute the idea that bond purchases for the System Account would have been helpful. In fact, he suggested that the purchases we made for Treasury accounts may even have been a perverse influence, accentuating weakness in the market. In support of this contention he cited as evidence the greater decline in bond prices on the days in which Treasury purchases were made than on other days of the period. The simple reason why the greater part of the decline in prices occurred on days when there was buying for Treasury investment accounts was that these purchases were made only on days when the market was especially weak and after that weakness had expressed itself in quotations. They were "reluctant" purchases. It is perhaps significant that the turning point in the market came on the day (June 2) when Treasury purchases were "aggressively" made and when it was incorrectly rumored that the Federal Reserve Banks had bought bonds for System Account. This suggests the possibility that if our public bank statements during May had shown purchases of Government bonds we would never have had the near "crisis" of late May and early June. I am not here advocating - and I never have in this discussion - that we try to substitute our judgment for that of the market in terms of fixed yields and prices. But I do think that action taken by the System has great weight in influencing market psychology and could be used, at times, to give the underlying situation a chance to reassert itself when it has been submerged by unwarranted fears of future credit developments. If under some circumstances the Open Market Account is able to nip scattered pressures as they arise, or to make swaps which facilitate the functioning of the market, it may well be able to prevent unnecessary shocks to the market and to reinforce credit policy.

I do not need to spend much time on the memoranda on "Experience During Treasury Refundings" which accompanied the Chairman's letter of September 15. They were a good illustration of what we all know - that statistics can be used to support or illustrate a variety of opinions, including the Chairman's and mine. The figures used in these memoranda need to be looked at in the light of the circumstances prevailing during the period covered, in order to see what they really mean. As a general statement it may be said that in the earlier period covered by the data, when attrition was high, the reserve position of the banks was being kept under pressure while in much of the later period, when attrition was low, the System was moving to ease its pressure on the banks. Actual or prospective tightness of the reserve position of the banks, and of the money market, makes for relatively high attrition and actual or prospective ease makes for a successful refunding. That is the simple interpretation of the figures in these memoranda. They leave me still believing that at times aid can properly and appropriately be extended to Treasury refunding operations by transactions in "rights", "when issued" securities, and securities of comparable maturity; that it can be extended, at times, more effectively in this way than by confining our operations to Treasury bills; and that it can be done, at times, with no more and perhaps less net release of reserve funds than if we seek to help solely through the bill market.

The question may be raised as to the need for raking over this "ancient" history, but it must be in the light of our experience rather than in revelations from on high, of policy "norms", that we adopt and adapt our open market policy. In introducing the motion which was adopted at the last meeting of the Federal Open Market Committee, Governor Mills said (according to the minutes) he believed that the action of the market and the operations of the Account had given a very convincing performance that the motion proposed was a proper policy for the System to adopt. The final clause of the resolution recognized the fact that policy could be changed by the Federal Open Market Committee, but there was an inference, I thought, that the policy then being adopted is the only "right" policy and that deviations from it should be considered only in extraordinary circumstances. The implication of timelessness in such an interpretation bothers me; I do not think we can afford to allow ourselves to drift into the soothing sleep of a "permanent" policy of this sort.

From the beginning of these discussions I have taken the position that it is possible that, in most circumstances, the System will be able to attain its policy objectives by operating only in the market for Treasury bills and other short term Government securities. (Except for swaps involving existing holdings which I see no compelling reason permanently to proscribe.) But I have also contended that on some occasions the System might be better able to makes its policies effective by operating in other sectors of the Government security market and that, consequently, the Federal Open Market Committee should avoid standing commitments which would confine open market operations to "short term securities, preferably bills". It has seemed to me that we could not afford to become frozen in our ideas, and that bearing in mind the uncertainties of the future we had better keep our minds, as well as our hands, free to conduct System open market operations in the light of conditions as they exist from time to time. The attitude of the Committee in the recent past, with its undercurrent of pronouncing permanent doctrine, strikes me as an extreme reaction to the extremes of market

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intervention which took place during and after the war, and which inhibited the exercise of our powers of credit administration. The desire for unchangeable "rules of the game" and a "free" market could similarly inhibit the exercise of our powers. We need flexibility in operations and we want flexibility in markets, but so long as our central banking system exists and performs its necessary functions in a dynamic growing economy, we shall have to adjust our operations to changing circumstances and we shall not be able to avoid "intervention" in the Government security market. That market, and the expectations of the whole market is conditioned by Federal Reserve policy and the amount and type of our open market operations.

There has been little occasion to raise these questions, as a matter of practical operation of the System Open Market Account, since our meeting in September. It may be that restricting open market operations to Treasury bills has caused some distortion in the structure of interest rates, and that the impetus given to a rapid decline in short term rates, by our operations, has created some misconceptions as to our methods and objectives. If so, the evidence of harm is not clear when stacked against the evidence which our actions have provided of alertness to changing business conditions. It is not in periods such as the past two months, however, that current policies are severely tested. Once it is made clear that bank reserves will be readily available, and once a downward trend of interest rates has been established, and is part of market expectations, changes in longer term rates may well follow changes in short term rates quite promptly, and Treasury financing becomes relatively easy. The test of current policy will probably come in other circumstances. Barring conditions of deep depression, which fortunately we have not been forced to consider in recent years, it is when monetary policy should be restrictive, or at critical turning points in economic activity and credit policy, that we may most need to be ready to operate over a wider range of Government securities and to assist Treasury financing by operations other than in Treasury bills (so long as this is consistent with credit policy). In this way we may be able to cut down the lag between our action and market reaction, in discharging our primary responsibility, and we may be able to facilitate appropriate policies of debt management, in discharging a secondary responsibility which we cannot escape and which, in fact, we have accepted.

It is of some significance, perhaps, that among those who at present most strongly advocate confining our open market operations to Treasury bills, are some of those who in 1949 (under admittedly different conditions) would have had us get out of the bill market entirely so that there could be free and independent determination of bill rates by the market. The thread that runs from this earlier proposal to the present policy is that, no matter how you do it, credit policy rests on System control of the volume of Federal Reserve credit outstanding and that it need not - and indeed should not - be directly concerned with the level or structure of interest rates. This represents an abrupt departure from the traditional lines of development in modern central banking, a development which had its origins in reliance upon the discount rate. Whether we have regard for tradition and experience or not (it is interesting that the two foreign central banks - the Bank of England and the Bank of Canada - which operate in a social and economic climate most nearly akin to ours, definitely do not confine their open market operations to Treasury bills, and do assist Treasury financing by other means than trading in bills), it should be clear that rate policy and determination of the volume of bank reserves have been and are opposite sides of

the same coin. We cannot formulate and understand credit policy unless we are aware of its rate implications. While forces originating in the market set the precise decimal points of rates each day, the System by its general credit policy inevitably determines the significant characteristics of the rate structure. In that sense you cannot have a "free" market for Government securities so long as purposeful monetary control exists. Flexibility is what we want and what we should aim to have; and flexibility is not synonymous with "freedom".

It is really because of these underlying considerations that I am disturbed by the action of the Committee at its September meeting. Certainly it is a matter of importance that the locus of responsibility for policy decisions be defined, so that there can be no implication that the full Committee has abdicated its responsibilities. And it is important that the Executive Committee find guides to its decisions in the consensus resulting from informed and informative discussion at the meetings of the full Committee. But more important still is the definition of the area in which the Federal Reserve System has responsibility for public policy. The report of the Ad Hoc Subcommittee reflected a theory of central banking that would define the appropriate area of central bank interest and responsibility in too narrow terms. By implication, I thought the action of the Committee in September endorsed this definition of the role of the central bank. It is my contrary belief that the monetary and credit authorities are, and should be, directly concerned with any and all developments that bear upon the cost as well as the availability of all types of credit, to the extent that such concern can serve to promote economic stability.

These are not matters involving the position or prestige of individuals in the Federal Reserve System; we are all equals on the Federal Open Market Committee. They are not matters involving the relative weight of Washington and New York in our councils; we are all seeking to develop credit policy to its highest effectiveness in promoting economic progress. They are not matters to be decided on the basis of what Brother Patman may charge against the Federal Reserve System at the next session of Congress. Once we stray from the straight and narrow path of trying to meet our statutory and moral responsibilities for credit administration, into the murky morass of individual prerogatives, spheres of influence, and the reactions of particular members of Congress, we shall risk our existence as a "System".

Yours faithfully,

Allan Sproul, Vice Chairman,
Federal Open Market Committee.