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FEDERAL RESERVE BANK OF NEW YORK

NEW YORK 45, NEW YORK

November 5, 1954

Professor Elmer Wood,
University of Missouri,
Columbia, Missouri.

COPY

Dear Professor Wood:

For some time I have been intending to write to you about your paper on "Recent Monetary Policies" which came to me about two months ago.

I am delighted, of course, that you are enough interested in the recent views and actions of the Federal Reserve System to study and write about them, and pleased that your general ideas about a "free" money market appear to be similar to mine. ✓

If I raise one or two questions about your paper, therefore, it is within the frame of my delight and my pleasure that you wrote it at all. First, I think your interpretation of the historical record suffers from compression, and from lumping together all officials of the Federal Reserve System. This thought of mine is affected, I know, by personal considerations, but I believe a reading of the annual reports of the Federal Reserve Bank of New York and of Mr. Roosa's and my papers in the John Williams' essays, would give you a somewhat different picture from the one you have sketched. One specific point I would mention here is that I have not blamed the inflation which occurred after the war on "continued heavy Government spending", but I have blamed it on the swollen money supply created during the war which I did not think we could shrink without grave risk of deflating the economy at the wrong time. ("Monetary contraction is such a terribly lethal weapon, it should be used with great moderation.") Another point which you do not mention, is the fact that our support operations during the postwar 40's not only gave the commercial banks automatic or semi-automatic access to reserve funds, but also gave others such as insurance companies and savings banks the same sort of access, which did present a danger outside of the ordinary operations of central banks.

These and similar smaller points are not why I am writing you, however. I am writing because I think, that after exposing the limitations and inconsistencies of present majority thinking in the Federal Reserve, you have proposed an over-simplified alternative. I do not believe we can enjoy the luxury of a fixed formula of monetary management in our complicated money economy.

It seems to me to be neither possible nor desirable to try to reduce all of the conflicting considerations which have to be reconciled in formulating monetary policy to the selection of a single rate curve. I agree, of course, that interest rates are a most important guide to policy and its execution, and that open market operations are likely to be the most effective tool of the Federal Reserve System, most of the time, in relation to rates. But I also think that there are guides to policy other than interest rates, and that the discount rate and bank borrowing have their uses as well as open market operations. Most often the discount rate and open market operations can be used together; the discount rate to symbolize the policy adopted, and open market operations to keep market rates and member bank borrowing in appropriate relation to the discount rate. At times of credit ease, this would mean sensitive money market rates below the discount rate and infrequent and minor borrowing in response to temporary needs of individual banks. At times of credit restraint, it would mean sensitive money market rates (except Federal funds) at or maybe above the discount rate, with member banks having to borrow fairly frequently and in relatively large amounts so that, in the aggregate, they would be in debt more or less continuously. There are different kinds of reserve dollars and differences in the response of the banking system to their availability. We should take advantage of these differences.

Similarly, I think you go too far when, after demolishing the idea of leaving interest rates to "natural forces" you condemn unnecessarily "fortuitous changes" in rates - the "continual minor changes in rates which serve no purpose whatever from the standpoint of credit regulation." Here, too, I see a middle ground. Rate changes in the market can serve a useful purpose, as a guide to distribution and uses of funds within each sector of the market as well as between sectors of the market. It makes a difference, for example, whether the Treasury bill rate is 1/4 or 1/2 of 1 per cent below the discount rate, and whether dealer loan rates are above or below the Treasury bill rate, or whether the Federal funds rate is above or below the bill rate, and where the time deposit rate is in relation to other short term rates. We need to watch rates and rate movements, and the varying interrelations among different rates, as indications of the prevailing response to general policy, and as guides to whether more or less reserves are needed to carry out the intentions of credit policy, but we do not need to try to pick out a single set of rates for each phase of credit policy.

Finally, I think you dismiss "uncertainty" too readily as a legitimate influence. You may be right in saying that for every "change in uncertainty" there is a specific change in rate which would achieve the same effect, but must our effects always be achieved in the same way? Is there not room for uncertainty as a substitute for actual rate change? If there is - if uncertainty at times reinforces current policy - need we reject it? Perhaps I am too much imbued with the idea of central banking as an art, but when you refer to the need for gauging policy in terms of degrees of pressure, are you not also writing of an art which cannot always express itself in one way and which could take advantage, at times, of a little uncertainty?

With appreciation of your paper and its stimulating presentation of your views concerning recent monetary policy,

Yours faithfully,

ALLAN SPROUL

Allan Sproul,
President.

P.S. I am looking forward to seeing you at Princeton on November 21 when the Committee on the History of the Federal Reserve System will be meeting with you and Bopp and Chandler.

A.S.