FEDERAL RESERVE BANK OF
ST. LOUIS

The Federal Reserve Bank of St. Louis
Theodore H. Roberts
President

Post Office Box 442
St. Louis, Missouri 63166
314 444 8301

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

1984 NOV 13 PM 2:04

RECEIVED
OFFICE OF THE CHAIRMAN

THE FEDERAL RESERVE BANK of ST. LOUIS

November 9, 1984

Dear Paul:

Thank you for inviting our board to hold a meeting in Washington which would include a special session with the Board of Governors.

We discussed this at our board meeting yesterday, and the concept was very favorably received. In due course, we will be back in touch with your staff regarding a potential meeting date and subjects of special interest to our directors.

Cordially,

Ted

The Honorable Paul A. Volcker
Chairman
Board of Governors of the
Federal Reserve System
Washington, D. C. 20551

Theodore H. Roberts
Executive Vice President,
Secretary, and Treasurer

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Forward to sec
Chrm

HARRIS BANKCORP

1982 DEC 13 AM 9:53

RECEIVED
OFFICE OF THE CHAIRMAN

December 9, 1982

Dear Paul:

I have been remiss in not writing sooner to thank you for the confidence you and your fellow board members have placed in me by approving my election to the presidency of the Federal Reserve Bank of St. Louis. The reason for my delay has been an overwhelming and favorable response from throughout the country. Never have I experienced such warmth and encouraging comments. Everyone makes it plain that the Fed of St. Louis is held in the highest esteem and most everyone has remarked on the difficult decisions facing the Federal Reserve Board.

I just wanted you to know that I am enthusiastically looking forward to becoming a part of the Federal Reserve System and working with you and your associates in the future. It's an exciting time and I anticipate the challenge and prospects for making a personal contribution at this critical period.

Sincerely yours,

Ted

Mr. Paul A. Volcker
Chairman
Board of Governors
Federal Reserve System
Washington, D.C. 20551

January 4, 1983

Mr. W. L. Hadley Griffin
Chairman and President
Brown Groups, Inc.,
Post Office Box 29
St. Louis, Missouri 63166

Dear Hadley:

Larry Roos tells me that there will be a ceremony in honor of Armand Stalnaker toward the end of January. I am sorry that I cannot attend. Here is a letter, however, that I hope will be suitable for the occasion.

Armand's well-deserved retirement tribute should not drown out our welcoming you aboard. This is a challenging time for the Federal Reserve System. With a new president, there will be inevitably extra challenges and opportunities at St. Louis, and in those circumstances we are glad to have you with us.

Sincerely,

PAUL

Enclosure

JMcAfee:ldf

January 4, 1983

Mr. Armand C. Stalnaker
Chairman and Federal Reserve Agent
Federal Reserve Bank of St. Louis
411 Locust Street
St. Louis, Missouri 63166

Dear Armand:

On the occasion of your retirement as Chairman of the Board of Directors of the Federal Reserve Bank of St. Louis, I want to make sure your are aware of my sincere appreciation of your service and the gratitude of the Board of Governors.

Your seasoned, reliable financial judgment and business experience have been a great help to the Reserve Bank. Your active sponsorship of civic progress in St. Louis and your awareness of local needs have helped keep the Reserve Bank sensitive to its district and its community. For these positive contributions we have been particularly grateful.

On behalf of my colleagues on the Board and myself, let me extend thanks for a job excellently done and best wishes for the future.

Sincerely,

PAUL

JMcAfee:ldf

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

August 27, 1982

Mr. Larence K. Roos
President
Federal Reserve Bank of
St. Louis
St. Louis, Missouri 63166

Dear Larry:

Your letter of July 14 raises a knotty issue about use and publication of internal material for research purposes. Clearly the data needed for evaluation of our operating procedures should not be kept from analysts within the System even to the degree the data are confidential (if the analysts are or can be cleared for FOMC material) or from outside analysts to the extent the data are not confidential. Use of confidential material by researchers within the System would not preclude publication of the results, provided the confidential material was in a summary form, as was done, for example, in our large staff study of operating procedures a year and a half ago.

I understand your problem, perhaps frustration, in seeing a partial set of statistics in the Manager's published version of his annual report to the Committee and in wishing to publish a week-by-week series of the same statistic derived from his unpublished weekly reports. It seems to me, though, that we would be well advised to stay with the Committee's earlier decision on publication of internal documents. The Manager's weekly reports and reports covering a whole inter-meeting period (as well as the green and blue books and certain other documents) have been available with a 5-year lag tied in with release of the old memorandum of discussion. We no longer prepare the memorandum of discussion, of course, and do release our policy record with a short lag. Still, I would not now favor a lag significantly shorter than five years for such sensitive internal documents as the weekly report and the others. In short, I would hope that your staff article can be published based on data available to the public under present procedures with suitable summaries of other data to the extent needed.

On the subject of research, I ought to mention the material published in your June 24 issue of "Monetary Trends." Using such simple comparisons and statistical measures as is done there to assert a causative relationship between the variability of money growth and the variability of both real GNP and interest rates strikes me as tendentious at best and not in keeping with the straight reporting of data which is and should be the hallmark of statistical releases from the Federal Reserve. Economists certainly can, and will, disagree on the interpretation of economic events, but this is normally based on extended analyses undertaken in full knowledge of alternative hypotheses and using sophisticated statistical techniques and lines of economic reasoning in an effort to evaluate degrees and directions of influence. Among other things, analyses of variability would certainly need to take account of the 1980 credit control program--an exceptional, if not unprecendented, event that itself contributed to the increased volatility in money, GNP, and interest rates since 1979.

Sincerely,

PAUL

SHA:dmg-b
#2394

cc: Mr. Axilrod
Mr. Coyne
Mrs. Mallarid (2)

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

DATE: 7/27/82

OK

TO: Chairman Volcker

FROM: STEPHEN H. AXILROD

The attached draft response to Roos' July 14 letter also includes at the end a possible paragraph criticizing some statistics in a St. Louis Bank publication of June 24. You had earlier suggested that you might like to do so. I can provide you with background on the Roos letter.

Mr. Volcker 8/24
Mr Roos asked about this today. Catherine

Darlene —

Please type

Thanks

C.

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

DATE:

TO: Steve

FROM: DAVID E. LINDSEY

We hardly need to do any more research on the volitility issue with sophisticated work like this being done by St. Louis

MONETARY TRENDS
PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS

MONTH ENDING: May 31, 1982 RELEASED: June 24, 1982

A great deal of discussion has occurred about the effects of money growth on the economy since October 1979. While it generally is recognized that a reduction in trend money growth is necessary to reduce the trend of inflation, it is important to recognize that the variability of money growth also affects economic activity.

The table below breaks the past five years into equal calendar periods before and after October 1979. The data below reveal that the average growth rate of money has declined since late 1979. For example, the adjusted base increased at an average rate of slightly less than 7 percent since III/1979 compared with an average rate over 8-1/2 percent during the preceding period. Likewise, the average growth rate for M1 declined during the past couple of years, dropping from about an 8 percent rate to about a 6-1/2 percent rate. In conjunction with the decline in the average rate of money growth, the inflation rate has abated somewhat. For example, during the past four quarters, the inflation rate has averaged about 7 percent, down from about 10 percent during the previous four quarters.

While it is important to curb the trend rate of monetary growth to fight inflation, it is equally important to recognize that sharp fluctuations in short-run money growth may adversely affect the economy. For example, since late 1979, the variability in the average growth of the adjusted base has increased threefold. Similarly, M1 growth variability has increased more than three times its pre-October 1979 levels. This dramatic increase in money growth variability is revealed in the marked increases in the variability of both real GNP growth and interest rates (see table below).

Money Growth, Output Growth and Interest Rates 1/

Period	Adjusted monetary base 2/	M1 2/	Real GNP 2/	4-month commercial paper	Corporate Aaa bonds
I/1977-III/1979	8.8%	8.1%	4.1%	8.02%	8.69%
	(0.94)	(1.50)	(2.87)	(1.96)	(0.55)
III/1979-I/1982	6.9	6.4	-0.2	13.79	12.98
	(2.78)	(5.37)	(5.22)	(2.15)	(1.59)

1/ Figures in parentheses are standard deviations, which measure the variability of the quarterly growth rates about the average rate shown.

2/ Averages of quarterly growth rates.

Orig to Mr. Axilrod
cc Mr. Volcker
Mr. Coyne

FEDERAL RESERVE BANK OF ST. LOUIS

P. O. BOX 442
ST. LOUIS, MISSOURI 63166

July 14, 1982

#2394

LAWRENCE K. ROOS
PRESIDENT

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
1982 JUL 16 AM 11:52
RECEIVED
OFFICE OF THE CHAIRMAN

Mr. Paul Volcker
Chairman
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Dear Paul,

One of our economists, R. Alton Gilbert, has written an article entitled "The Conduct of Monetary Policy Under the Nonborrowed Reserves Operating Procedure," which we would like to publish in our Review. This article uses two specific sets of numbers for 1980 and 1981: the difference between total reserves as projected by the staff and the total reserve path, and the difference between actual total reserves and the final total reserve path level for each intermeeting period. These numbers are derived from the confidential Weekly Reports of Open Market Operations and Money Market Conditions as published by the Federal Reserve Bank of New York.

Gilbert proceeded with this project after he was assured by the Board staff that he could use these numbers in the form described above. The only restriction that he was given was that he could not publish his article prior to the publication of the Federal Reserve Bank of New York annual "Monetary Policy and Open Market Operations" for 1981, which uses some of these same numbers.

Recently, however, he was informed by others on the Board staff that he may use only the actual numbers published by New York; the rest are to remain confidential until they are declassified by the FOMC.

To "break" this research "bottleneck," I respectfully request that the Weekly Reports of Open Market Operations and Money Market Conditions for previous years be declassified so that Alton Gilbert and others may use these for policy analysis. I realize why current data might be classified confidential; however, it is difficult to understand how past projections, paths and actual reserve numbers could benefit market participants or provide any "inside" information. It is also difficult to justify the publication of some of this data by one reserve bank while maintaining that the data must remain "confidential" for other institutions or analysts. We cannot hope to benefit from research and advice that may improve our operations if we insist on classifying such past data as confidential when there seems to be no real purpose for so doing.

I am convinced that authorizing use of this data for past years is essential for properly explaining and assessing our current operating procedures.

I am sorry to burden you with this problem, but because it involves FOMC material I believe it should be clarified at the highest level.

With warm regards,

Sincerely,

Larry

Lawrence K. Roos

CC: Mr. Axilrod

FEDERAL RESERVE BANK OF ST. LOUIS
P. O. BOX 442
ST. LOUIS, MISSOURI 63166

1981 MAR 18 AM 8:59

March 16, 1981

LAWRENCE K. ROOS
PRESIDENT

#849

Mr. Paul A. Volcker
Chairman
Board of Governors of the Federal Reserve System
Washington, D. C. 20551

Dear Paul:

In our conversation last Friday evening in Fredericksburg, you raised a question as to why, if we are primarily concerned with inflation, I indicated concern at FOMC that money was growing at less than our targeted rate. My response was that empirical evidence demonstrates that whenever the two-quarter moving average of M1B growth is 2% or more below the long-term trend rate of money growth, a recession is precipitated. You seemed to question that premise, and I said that I would try to dig up some specific evidence to support my thesis.

Attached are several graphs reflecting the effect of trends in money growth on prices, output, and unemployment. I would invite your attention to the graph at the top of the sheet entitled "Money stock (M1B)." That graph reflects the relationship of two-quarter rates of change in M1B to the twenty-quarter trend rate of change of M1B. It also shows certain shaded areas which represent periods of business recession since 1957. You will note that each recession was associated with two quarters when the moving average of money supply growth fell significantly below the long trend rate of money growth. In 1967, which appears on the graph as an unshaded year, we experienced a "mini-recession." We have not shown the recession of 1980, because its duration has not as yet been officially described.

My concern about the recessionary consequences of abrupt and sustained reductions in money growth does not reflect any lack of concern about inflation. My concern is rather that if, as a consequence of abruptly reducing money growth we precipitate a recession, it is almost inevitable that political sentiment would surface for spending our way out of the recession. That, in turn, would lead to worse inflation than what we are presently experiencing.

I hope that this reasoning makes sense and that it will reinforce the point of view

I was trying to express during our conversation.

With warm personal regards.

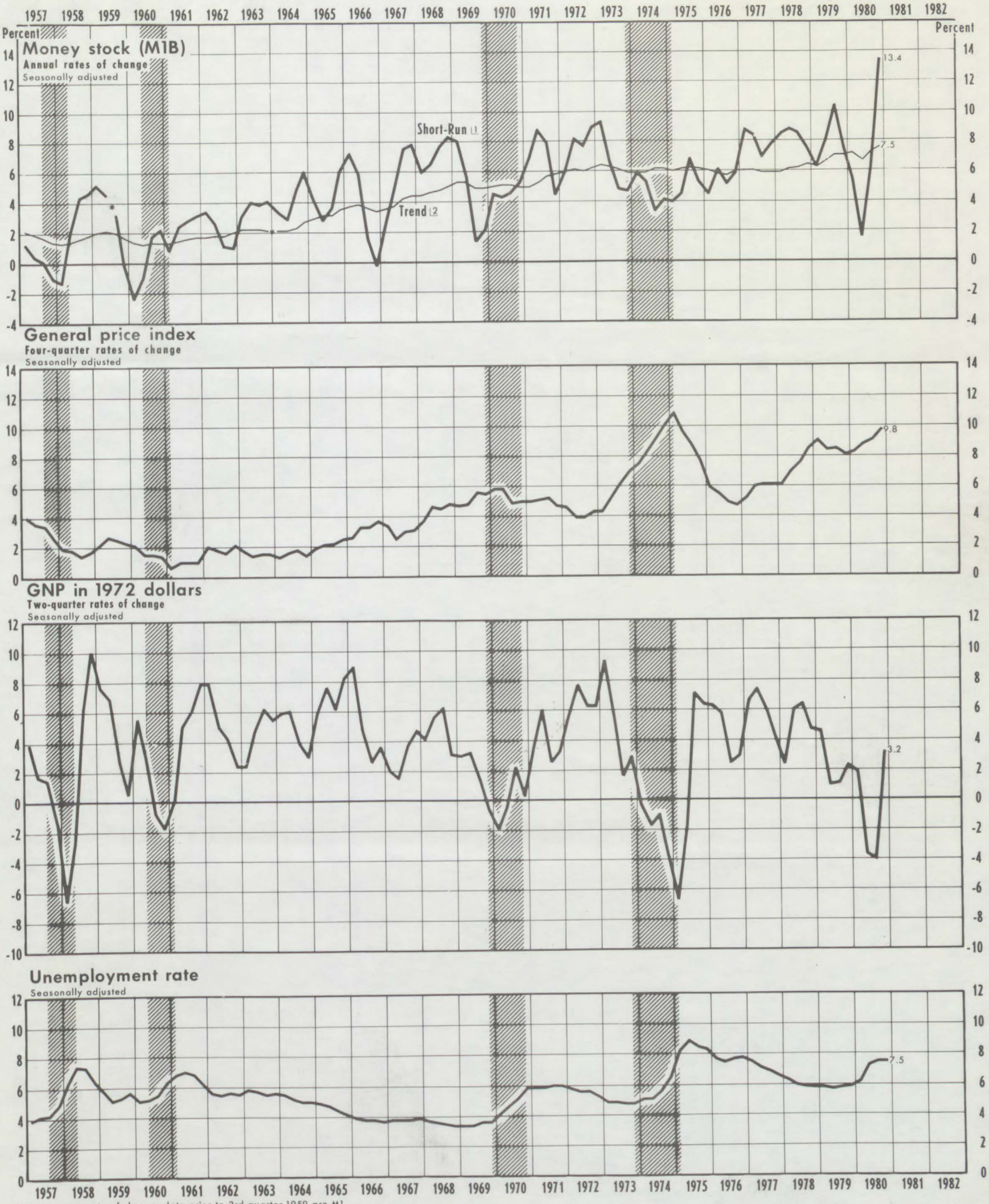
Sincerely,

Larry

Lawrence K. Roos

Attachment.

Trends and Fluctuations of Money, Prices, Output and Unemployment



1 Two-quarter rate of change; data prior to 3rd quarter 1959 are M1.
2 Twenty-quarter rate of change; data prior to 1st quarter 1964 are M1.
Shaded areas represent periods of business recessions.
Latest data plotted: 4th quarter

Prepared by Federal Reserve Bank of St. Louis

Larry Roos

Pardon to analysts with analysts points that are mighty wrong

Inventions

It is a pleasure, once again, to have the opportunity to address this distinguished assemblage. Meetings of the New York Society of Securities Analysts have a well-deserved reputation as a forum for the discussion of vital economic issues, and I consider it an honor and privilege to have been invited to a repeat performance before you.

When I previously appeared here on February 5, 1979, I gave a talk entitled "Monetary Policy . . . A Better Way." In that speech I was sharply critical of the manner in which monetary policy was then being conducted, and I made specific reference to how interest rate stabilization stood as a major obstacle in the way of reducing inflation. I suggested that consistent monetary restraint offered a much better means of dealing with inflation than continued efforts to fine-tune interest rates.

As you may recall, on October 6, 1979, some ten months after I spoke to you, the Federal Reserve announced a significant change in the manner in which it intended to conduct monetary policy. It announced that henceforth it would focus greater emphasis on controlling the monetary aggregates and less on constraining movements in interest rates.

I remind you of this in no way to imply that the Fed's change of heart was a direct consequence of the irresistible logic of my 1979 speech. Nor do I infer that my colleagues at the Fed suddenly "saw the light" and, in a moment of blinding inspiration, rushed to embrace the monetarist precepts of Milton Friedman. Rather, the Federal Reserve found itself compelled to change its procedures simply because it was increasingly apparent that the old methods of policymaking had proved ineffective in combating inflation, and that something better was needed if financial disaster was to be averted.

In order to appreciate the seriousness of the situation leading up to the October pronouncement, I would ask you to think back for a moment to that particular period of time. By the end of September 1979, interest rates were rapidly rising and the foreign exchange value of the dollar was plummeting. In both 1977 and 1978, money growth had exceeded the Federal Reserve's intended targets, and, in the six months immediately preceding October 1979, money had grown at an annual rate in excess of 10%. It had become obvious that, unless some significant actions were taken, monetary growth in 1979 would exceed the Federal Reserve's target ranges for the third year in a row. Against this backdrop there was widespread concern over the Fed's seeming inability to control the situation, and financial markets were reflecting a need for a change in the methods by which monetary policy was being conducted. Chairman Volcker's pronouncement on October 6, 1979, that henceforth the Federal Reserve would emphasize control of money and credit, offered such a change.

Initially the new thrust of policy showed real promise. Growth of M1B (the money stock measure consisting of currency and transactions balances) slowed abruptly in the fourth quarter of 1979 to an annual rate of 3.2% and, for the first time in three years, the Federal Reserve found itself able to report that money growth had remained within its announced annual target ranges. As we entered 1980, hopes were high that the Fed's new procedures were working.

Then something went wrong. Instead of more stable monetary growth, fluctuations in M1B became more pronounced than at any other time in the past two decades. Interest rate movements became equally erratic. Financial markets were dazed by interest rates that rocketed to all-time highs by the end of March, plunged precipitously in the second quarter of the year, and by year-end shot up again to record high levels.

The general pattern of money growth and interest rate movements throughout 1980, although perhaps somewhat more exaggerated in its ups and downs, was not unlike what typically had occurred in the past. As the economy slowed, interest rates and money growth declined; when the economy accelerated, interest rates and money growth increased. It is no wonder that, by year-end, "Fed watchers" were beginning to question whether anything had really changed.

This afternoon, I should like to examine how such wildly erratic growth in money could have been the product of a policy, the primary purpose of which was to concentrate on controlling money growth.

I believe that we would all agree that the fundamental mission of monetary policy must be to reduce inflation in a manner that does not have a destabilizing effect on the economy. It is important to consider just how well the Federal Reserve's new program met this test. Did it indeed contribute to a reduction in inflation? Did it promote greater economic and financial stability?

First, consider its impact on inflation. To have any meaningful effect on reducing inflation, money growth must be reduced and held below its long-run trend rate of growth. This did not occur in 1980. The trend rate of growth of M1B in the five-year period from the end of 1974 to the end of 1979 was 7%. From the fourth quarter of 1979 to the fourth quarter of 1980 . . . the first year of the Fed's new procedures . . . M1B grew 7.3%. This was above the growth rate of money over the past five years and certainly does not reflect the reduction necessary to achieve significant progress against inflation.

No mention of NOW accounts

Furthermore, although M1B growth was targeted to grow at between 4% and 6-1/2% in 1980, its growth last year actually exceeded the announced target range by nearly one percentage point. And that overshoot would have been considerably greater had money growth in December not dropped to a –8% annual rate. Based on that record, it is difficult to conclude that monetary policy in 1980 contributed in any meaningful way to the reduction of inflation.

Numerous headaches Reserve question NOW ATS adjustment

In judging the new policy against the objective of achieving stability in financial markets, we again see something less than satisfactory performance. The incredibly erratic gyrations in the growth of money last year reflect anything but stability. Money growth staggered and stumbled like a drunk on Saturday night, falling at –13% in April, spurting to +24% in August, and then dropping at –8% in December. These excessive gyrations, and the associated erratic behavior of interest rates, led to increased uncertainty as to the intended course of monetary policy and resulted in severe instability in financial markets.

Thus, from the standpoint both of reducing inflation as well as achieving financial stability, the first year of the Fed's new program was disappointing.

There are two critical questions that must be answered: "What went wrong?" and, "What can be done to avoid similar problems in the future?" First of all, I want to make clear that I am in no way suggesting any lack of good intent on the part of policymakers. The problem was one of procedure, not purpose. And it was not a matter of having set incorrect annual targets for money growth. The experience of 1980 provides a perfect example of what happens when policy changes are not accompanied by technical and procedural changes necessary to make them work. It is the same as if a football team, in the middle of a losing season, changes its offensive strategy, but neglects to replace its old playbook. Changing monetary policy from stabilizing interest rates to focusing more directly on controlling the aggregates called for certain changes in practices and procedures. The Fed's reluctance to change its operating techniques to a sufficient extent was, in my opinion, the primary cause of the poor results of 1980.

Completely unsupported by study

To avoid a repetition of the problems experienced in 1980, and to enhance the Fed's ability to achieve its 1981 monetary growth targets, I propose the following changes in the conduct of monetary policy.

1. The Federal Reserve should use either total reserves or the adjusted monetary base, instead of nonborrowed reserves, to control money growth. The most direct and effective means of controlling money growth would be to control the growth of reserves that constrain monetary expansion. The Fed's present procedure of choosing a nonborrowed reserve growth path, and assuming a certain level of future commercial bank borrowing from the Fed's discount window, unnecessarily complicates its ability to hit its targets. This is because of the difficulty inherent in accurately predicting the future level of bank borrowing. Not only is the practice of targeting on nonborrowed reserves cumbersome, it is also based on the erroneous assumption that banks somehow respond differently to changes in borrowed reserves than to changes in nonborrowed reserves. This assumption is clearly

No evidence whatsoever

affects total reserves

Nonsense

incorrect; it is the quantity of total reserves, regardless of their source, that determines money growth. Consequently, a total reserve or monetary base target would be distinctly preferable to the present targeting procedure.

2. The Federal Reserve should revert to contemporaneous reserve accounting. The Federal Reserve currently uses lagged reserve accounting to determine the required reserves that financial institutions must hold against their deposit liabilities. Any current week's required reserves are based on deposits held two weeks previously. As a result, banks tend to create new loans and deposits without knowing what reserves will be available to them at settlement time two weeks hence. Under the present practice of lagged reserve accounting, the monetary authorities have tended to accommodate these loans and deposits by subsequently providing necessary required reserves. Effective monetary control requires that reserves serve as a constraint on future money growth, rather than an accommodation of lending actions already taken by banks. A return to contemporaneous reserve accounting would strengthen the impact of monetary policy.

3. The Federal Reserve should "float" the discount rate so that it will conform more closely to movements in market interest rates. This change is especially important under a nonborrowed reserve targeting procedure. The extent to which financial institutions choose to borrow from the Federal Reserve to meet reserve requirements is directly related to the relationship between the discount rate and interest rates in financial markets. Failure to move the discount rate often enough and by large enough amounts increases the difficulty for policymakers to accurately estimate and thereby control the extent of commercial bank use of the discount window.

wrong

One objection to floating the discount rate has been a belief that the Federal Reserve would lose the "announcement effect" on financial markets that discount rate changes are alleged to have generated in the past. This objection is irrelevant. Experience has shown that financial markets respond primarily to published money numbers and the extent of their deviations from announced targets, rather than the so-called "announcement effect" of changes in the discount rate.

4. The Federal Reserve should target on a single monetary aggregate, preferably on M1B. Currently the Federal Reserve announces target ranges for a variety of aggregates: M1A, M1B, M2, M3, and commercial bank credit. This multiplicity of targets is confusing to policymakers and the public alike. This is especially true when some aggregates are within, while others are outside of their announced target ranges. It is simply not true that all of the aggregates are "equal" with respect to their impact on the economy. Research conducted at the Federal Reserve Bank of St. Louis shows that M1B, when compared to the other monetary aggregates, is more closely controllable by the Federal Reserve and is more closely related to aggregate demand and inflation than other aggregates.

5. The Federal Open Market Committee's short-term money growth targets must be consistently related to its long-term target. At each meeting of the FOMC, short-run targets for money growth over subsequent months are chosen. Too often in the past, these short-term growth targets have not been consistent with the Federal Reserve's announced long-term target ranges. Consequently, as was the case last year, money growth from month to month may be within the short-term growth ranges, but at variance with the long-term targets. For example, the short-term target established at the May meeting of the FOMC sought an M1B level of $393.6 billion in June, while the midpoint of the long-term range called for $396.5 billion. Similarly, at the October meeting, the short-term goal was $414.7 billion for December, and the level consistent with long-term ranges would have been $406.7 billion. Such deviations from long-term path necessitate

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severe adjustments late in the year, as actually occurred in 1979 and 1980. By explicitly linking the short-term money growth targets to the long-term ones, the FOMC would eliminate unnecessarily drastic swings in money growth and would assure more stable financial market conditions during the year.

6. The Federal Reserve should eliminate all constraints on the federal funds rate. This change is, perhaps, the most crucial of all. Although the present federal funds rate ranges are considerably broader than the ones that were used prior to October 1979, they still, on occasion, frustrate the achievement of money growth targets. This is especially true whenever the federal funds rate approaches the upper or lower bounds of its targeted range.

when

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Unfortunately, a reluctance to totally eliminate federal funds rate constraint stems, in large part, from a widespread belief that the Federal Reserve can, and therefore should, control interest rates. This belief is totally false and, as far as I know, unsupported by any serious evidence whatsoever. Federal Reserve actions affecting the growth of the money stock do influence interest rate movements, but usually in the exact opposite direction to that espoused by common mythology.

The market interest rate is the price of credit and is determined by supply and demand for credit. Federal Reserve actions influence both the supply and demand sides of the credit markets. "Looser" monetary policy may temporarily increase the supply of credit. However, at the same time it permanently increases the demand for credit as the inflationary consequences of the Federal Reserve's expansionary actions are quickly recognized by the public, particularly under present conditions when inflationary expectations are so important. "Loose" or "easy" monetary policy increases money growth, enhances inflationary expectations, and thereby raises interest rates. "Tight" policy reduces money growth, reduces inflationary expectations, and reduces interest rates. This association between money supply changes and interest rates is well documented. In 1980, even over periods as short as one week, published changes in money stock figures were directly correlated with changes in interest rates. Yet, the public is still inundated with the economic and political nonsense that the Fed's tight policies are responsible for high interest rates and that only monetary ease will bring rates down.

There is another widely-held argument put forth by the advocates of interest rate stabilization. It is based on a belief that stability in money growth necessarily means instability in interest rates. This questionable reasoning supports sentiment for the Federal Reserve to revert to smoothing the movement of interest rates, even if this means that money growth would be destabilized. I find this argument to be without merit. Last year's erratic interest rate behavior was a reflection of the erratic pattern of money growth and the market's increasing uncertainty as to the direction of policy. More stable growth of money and the achievement of the Fed's publicly-announced monetary growth targets would stabilize rather than destabilize interest rates and would remove much of the uncertainty affecting financial market conditions.

I believe that U. S. monetary policymakers have learned a considerable amount in the past two years. In 1979, we learned that a fundamental change in implementing monetary policy was called for. The rising rate of inflation and the rising level of interest rates over the past fifteen years demonstrated the fallacy inherent in conducting monetary policy through the control of interest rates.

In 1980, we learned that good intentions alone will not suffice and that basic changes in Federal Reserve operating procedures are necessary to achieve monetary stability.

As we gather here today, we have an unprecedented opportunity for economic progress. We have a foundation of support for economic reform such as has not existed for some time. The American public has presented policymakers with a mandate to overhaul the Nation's economic machinery from top to bottom. We have a national Administration that is dedicated to urgently-needed fiscal and regulatory reforms. The Federal Reserve System through its Chairman has expressed its intention to supplement fiscal reforms with a monetary policy directed toward reducing inflation in a stable and orderly manner.

The necessary elements are in place for effecting major changes in the course of economic events which, if successful, can have a profound beneficial effect for many years to come. But the task will not be a simple one. To succeed, all economic systems, fiscal and monetary alike, must be set on "Go." A failure in any single aspect of the effort can doom the prospect for success of the entire mission.

Monetary policy is but one part . . . albeit an important one . . . of the process of restoring stability and growth to our economy. The ability of monetary policy to achieve its objectives, especially in the critical year 1981, is of special importance, not only for the achievement of our Nation's economic revitalization, but also for the maintenance of the Federal Reserve's credibility.

Today, I have suggested certain changes in the way the Federal Reserve conducts monetary policy. Those changes are essential for the success of the Fed's effort to control monetary growth. Fortunately, they would be relatively simple to implement.

Whether they are put into effect will require the support of many diverse groups. Participants in financial markets must be prepared to accept short-term movements in interest rates. Economists must be willing to test new techniques of monetary policy-making. And the Federal Reserve must be innovative and ingenious in choosing those operating techniques most likely to assure the attainment of the System's monetary targets.

I hope that you will agree that the climate for economic progress has never been better. Let us make certain that we do not let this important opportunity slip through our fingers.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

1. You can not avoid fact of being a Federal Reserve spokesman

2. You are talking abroad ~~etc~~ to an audience that can't possibly be conscious of your role as you see it.

3. You are talking in a country that missed its monetary target by 100%

4. All countries in Europe have more instability than we do

6 You are directly contradicting my own public testimony

7. You are, at least inferentially, saying the study we made is poppycock.

5. You are entering into a vicious public debate in Britain that will embarrass the Bo

Roos
4/3/81

cc My Apfel
My Altmann

#22

FEDERAL RESERVE BANK OF ST. LOUIS
P. O. Box 442
ST. LOUIS, MISSOURI 63166

January 9, 1981

LAWRENCE K. ROOS
PRESIDENT

Mr. Paul A. Volcker
Chairman
Board of Governors of the
Federal Reserve System
Washington, D. C.

Dear Paul:

It is my understanding that the monetary policy targeting project is nearing completion and that a report containing recommendations for consideration by the FOMC will be distributed to members of the FOMC approximately one week before the scheduled February meeting of the Committee.

That project, especially its recommendations relating to monetary control, will be of critical importance to our ability to meet whatever targets we set for growth of the monetary aggregates. In my opinion, whatever problems we might have encountered in the past year resulted more from operating procedures in seeking our targets than errors of judgment in the setting of those targets.

It is my further understanding that present plans contemplate a two or three hour preliminary meeting on the afternoon of Monday, February 2 to consider the project report. In view of the critical significance of this report, I believe that provision should be made for as full a discussion as possible.

For this purpose, I would urge that consideration be given to setting aside at least one full day for discussion of the report so that the Committee is accorded ample time for deliberation. This could be done either by a meeting on Monday, February 2 commencing in the morning and continuing through the afternoon or, if that is not convenient, at a special meeting during the last week in January.

With warm regards,

Sincerely,

Larry

Lawrence K. Roos

n/r
Had two day meeting

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

September 29, 1980

Mr. Lawrence K. Roos
President
Federal Reserve Bank of St. Louis
St. Louis, Missouri 63166

Dear Larry:

As you know, for some time the Board has been concerned about certain transactions designed solely to reduce reserve requirements by generating "cash item" and "due from" assets for the purpose of artifically lowering net demand deposits. Such practices create inequitable advantages for the institutions involved and also, by overstating deductions from gross demand deposits, have the potential for distorting measures of the monetary aggregates. This latter problem may become more acute if and as the intermediary role of U.S. agencies and branches of foreign banks changes once they become subject to reserve requirements and, as a result, our current method for avoiding distortions in money supply measures become less effective.

In early June, the Board proposed for public comment that reserve requirements be calculated on a business-days basis. The intent of this proposal was to eliminate the profitability of "weekend Eurodollar arbitrage" transactions. Comments on the proposal pointed out reserve avoidance transactions that would not be halted by its adoption. In particular, it was learned that some institutions engage in, and others are aware of, the practice of borrowing for very short periods in clearinghouse funds and repaying in federal funds. At the same time, the Board became concerned about the burden of requiring all reporting institutions to change reporting methods solely in order to discourage reserve avoidance practices currently employed by only a few banks. Consequently, the Board decided not to implement the business-days proposal, but to include in its announcement of the new Regulation D reference to Board expectations that depository institutions will not engage in these reserve avoidance practices in the future. It was further announced that individual institutions would be monitored with regard to such practices. Meanwhile, study of regulatory means of discouraging reserve avoidance is continuing.

I would like you to join me in a Systemwide effort to end these kinds of reserve avoidance activities. What I have in mind is for you to contact each of the large member banks in your district, reminding them of the Board's position and requesting their full cooperation. Later this year it may be desirable to contact some of the large nonmember institutions that will become subject to reserve requirements in order to point out this policy to them. A draft letter for possible use is enclosed.

I attach considerable importance to monitoring the response of banking institutions to this call for a cooperative effort to end reserve avoidance activities. The Board staff, in cooperation with Reserve Banks, will monitor Eurodollar activities of individual institutions on a monthly basis and provide the Board and you with their analysis. Based on the monitoring technique described in the enclosure, Board staff have prepared the enclosed list of institutions in seven districts that appear to have engaged in weekend Eurodollar reserve avoidance practices in the past. I ask that you appoint a member of your staff to assist in this effort. The name of your bank's staff contact, as well as amendments to the list of banks and any questions your staff may have concerning the technical aspects of this program, should be directed to either Allen Frankel, Division of International Finance, extension 3577, or Frederick Jensen, Division of Research and Statistics, extension 3361.

I am hopeful that we shall receive the full cooperation of the banks in this important matter. If you conclude, however, from a month or two of monitoring bank activity that reserve avoidance remains a problem in individual cases, I assume that you will bring the matter directly to the attention of that bank's senior management. I invite you to keep me informed as this effort goes forward.

Sincerely,

Paul

Paul A. Volcker

Enclosures.

IDENTICAL LETTER SENT TO ALL FEDERAL RESERVE BANK PRESIDENTS

DRAFT LETTER TO CHIEF EXECUTIVE OFFICER OF ALL MEMBER BANKS WITH DEPOSITS IN EXCESS OF $500 MILLION FROM PRESIDENTS OF FEDERAL RESERVE BANKS

Dear ______________________:

The Federal Reserve System has become increasingly concerned about the growth of transactions which appear to have no economic rationale other than lowering the reserves an individual institution must maintain with the Federal Reserve. Such reserve avoidance practices not only pose problems of equity among institutions, they also distort measurement of the monetary aggregates, which play a key role in monetary policy. These complications take on a higher level of significance as we move toward the more equitable reserve relationships brought about by the Monetary Control Act of 1980.

As you may recall, the Board of Governors, in its original proposal for implementing the reserve requirement changes mandated by the Monetary Control Act, solicited public comment on a proposal that reserve requirements be calculated on a business-day basis rather than the traditional calendar-day basis. The shift to a business-day calculation of required reserves was proposed as a way to remove the economic incentives for engaging in "weekend Eurodollar arbitrage" and other reserve avoidance transactions. Mindful of the burden a shift to business-day calculation would place on all reporting institutions, the Board of Governors decided not to make the shift at the time. In announcing that decision, the Board expressed its expectation that depository institutions would not engage in reserve avoidance practices under which reserve requirements are lowered by transactions that artifically increase "cash items in process of collection" and "balances due from banks". The Board also indicated that to insure compliance "the Federal Reserve will monitor individual institutions and will consider the need for implementation of additional measures ...."

The other Reserve Bank presidents and I are asking large banks throughout the country to join with the Federal Reserve in a cooperative effort to eliminate reserve avoidance practices--such as "weekend Eurodollar arbitrage" transactions, borrowing arrangements involving receipt of uncollected funds and repayment in collected (or federal) funds, and similar activities that are designed to artificially lower reservable deposits. I also ask that you designate one of your senior officers as a point of contact to assist us if questions arise in the course of our efforts. Any questions you or your officers may have about this matter should be directed to

______________________________.

Chairman Volcker and I are confident that the Federal Reserve can count on your cooperation in the effort to end these practices without the need for burdensome reporting or regulatory changes.

Sincerely,

RESERVE AVOIDANCE MONITORING
FOR WEEKEND EURODOLLAR ARBITRAGE

The Board staff is using a combination of two monitoring techniques at present. These are the methods from which the enclosed list of banks was derived.[1/] This list will be updated monthly.

The first method is a direct measure of the benefits derived from weekend game transactions. The percent reduction of net demand deposits on Friday is calculated relative to the five week-day average. If the reduction averages 10 percent or more over a four week period, this is viewed as evidence of reserve avoidance activity.

The second method is an approximate measure of the volume of weekend Eurodollar game activity. Cash item or due from deductions can be generated over the weekend by either borrowing Eurodollars on Friday or by receiving repayment on Friday of overnight Eurodollar loans initiated on Thursday. The Friday minus Thursday difference of net liabilities to the bank's own foreign branches is an approximation of the total of both activities, since Eurodollar borrowings on Friday typically increase net liabilities to own foreign branches while overnight Eurodollar loans made on Thursday typically decrease net liabilities to own foreign branches.[2/] If this difference averages \$100 million or more over a four week period, the bank is viewed as an active weekend game player.

1/ The list includes only banks with \$100 million or more in deposits.
2/ This is only an approximation since these activities need not be channeled through a bank's own foreign branches.

Attachment.

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Citations: Institutions Aggressively Using Weekend Eurodollar Arbitrage Techniques as of September 1, 1980 [list].

November 29, 1979

Mr. Lawrence K. Roos
President
Federal Reserve Bank of St. Louis
St. Louis, Missouri 63166

Dear Larry:

Your letter of October 26 raises a number of fundamental issues about control of the aggregates through a reserve target. The Committee will no doubt be continuously reviewing its procedures over time as experience is gained and as economic and financial circumstances change. I hope that the seminar held prior to the November FOMC meeting was helpful in that respect, and I would anticipate that such discussions would continue in the future as the need arises.

With regard to lagged reserve accounting and the discount window, the Board has instructed the staff to evaluate options in light of the new FOMC operating procedures.

Your views and interest in all these matters are greatly appreciated.

Sincerely,

#2547
SHA/pjd

Mr Volcker
Mr Axilrod

FEDERAL RESERVE BANK OF ST. LOUIS
P. O. BOX 442
ST. LOUIS, MISSOURI 63166

October 25, 1979

LAWRENCE K. ROOS
PRESIDENT

#2547

1979 OCT 29 PM 2:28

Honorable Paul A. Volcker
Chairman
Board of Governors of the Federal
Reserve System
Washington, D. C. 20551

Axilrod should respond

Dear Paul:

First of all, I would like to express my deep admiration for, and total support of, the new monetary policy direction you enunciated on October 6. It took real courage to "bite the bullet" and most knowledgeable people in the Eighth District wholeheartedly applaud what you have initiated.

Although I know you are receiving input from many sources, I would like, in a constructive manner, to suggest a few procedural changes which we feel would facilitate the success of our new operating practices. In each instance, I am offering specific recommendations along with the rationale in support of them.

Recommendation I

OUR OPERATING TARGET SHOULD BE EITHER ADJUSTED MONETARY BASE OR ADJUSTED TOTAL RESERVES RATHER THAN NON-BORROWED RESERVES.

The ability of banks to create deposits depends on availability of reserves, irrespective of where they come from. It makes no difference whether such reserves occur from open market operations, discount window operations, changes in float, Treasury deposits at the Fed, or other items in the Federal balance sheet. It is the net sum of these transactions that determines bank ability to create deposits. While some of these transactions are not directly controllable by the Fed, the net sum of these transactions can be precisely controlled by offsetting changes in the Federal Reserve portfolio. The data for these transactions is readily obtainable from the Federal Reserve balance sheet on a daily basis. Targeting on non-borrowed reserves or any particular portion of reserves does not control the total and therefore, does not control banks' ability to create deposits.

Recommendation II

DAILY DESK OPERATIONS SHOULD BE DIRECTED TOWARD SUPPLYING A DESIRED AMOUNT OF RESERVES, RATHER THAN ACCOMMODATING AN ESTIMATED "NEED" FOR REQUIRED RESERVES.

Given an FOMC target on the growth of M 1 for a specific period ahead and given an estimate of the base multiplier, it becomes a matter of simple arithmetic to compute a daily, weekly, or monthly average of reserves to be supplied. Experience indicates that such method of providing reserves would achieve desired money targets within an error of one-half of one percent over a period of one year. Estimation of various classes of deposits and therefore "need" for reserves on a daily basis makes reserve growth endogenous and makes monetary control vastly more complicated, if not impossible. In other words, we should cause the banking system to adjust to our policies rather than adjusting desk operations to lending policies of the banking system.

Recommendation III

WE SHOULD PUBLICLY ANNOUNCE OUR SPECIFIC GOALS FOR GROWTH OF MONETARY AGGREGATES, THE DOLLAR AMOUNT OF BASE TO BE SUPPLIED AND THE DETAILED METHOD OF DESK OPERATIONS DESIGNED TO ACHIEVE OUR GOALS.

As events of the past two weeks have clearly indicated, a lack of public knowledge of the "rules of the game" has led to confusion in financial and equity markets and probably has contributed to the sharp decline of security and equity prices. Unless this confusion is dispelled, we may continue to face unnecessarily disorderly fluctuations in financial markets. While there may have been a valid reason for withholding information when our operating target consisted of the Federal Funds rate, market knowledge of proposed growth rates of the base cannot differentially help or hinder market decision-makers. On the other hand, the ability to compare past and announced growth rates of the base would enable bankers to anticipate what money market conditions they might expect. For the past thirty years bankers have operated on the assumption that reserves would always be available ... their risk was limited to small changes in the price of such reserves. Under the current method of desk operations, bankers must consider the availability of reserves as well as possible large fluctuations in the price of purchased funds. Decision-making by banks can be made easier if the total supply of expected reserves is known.

The above recommendations are for changes of a procedural nature which could be effected quite easily. In addition, there are a few institutional changes which I believe merit consideration as possible ways to help facilitate the achievement of our new objectives. These include:

(1) Changing from lagged to contemporaneous reserve accounting;

(2) Tying the discount rate more closely to the Federal Funds rate;

(3) Establishing more uniform reserve requirements in order to decrease the variability of the base multiplier and thus increase the predictability of monetary aggregate growth.

I realize that these subjects have been considered in the past and that they involve institutional changes which are perhaps more complicated than the procedural changes I have suggested earlier.

I assure you that these suggestions are offered in a constructive vein. Policy changes such as you have announced cannot be achieved without a certain amount of trial and error, and I would hope that these and other suggestions might prove helpful as we move ahead.

With warm regards,

Sincerely,

Larry

Lawrence K. Roos

cc: Members, Board of Governors of the Federal Reserve System
Presidents, Federal Reserve Banks