C O N F I D E N T I A L -- (F.R.)

To Members of the Federal Open Market Committee

April 15, 1957

From Alfred Hayes, Vice Chairman

The attached memorandum was prepared at the New York Bank on the problem of improving communications between the Committee and the Manager. All in all, the conclusions are in general agreement with those reached by Governor Balderston in his recent memorandum to the Committee, although Mr. Gaines would de-emphasize the use of absolute figures in the instructions.

I am sending the memorandum to the Committee in the hope of encouraging further discussion and development of ideas on this matter. Both Governor Balderston's memorandum and Mr. Gaines' paper are provocative efforts to find methods of improving the instructions, and I recommend both to the careful consideration of the Committee.

Att.

C O N F I D E N T I A L -- (F.R.)

OFFICE CORRESPONDENCE

DATE April 10, 1957

TO Mr. Hayes

FROM T. C. Gaines, for the Securities Department

SUBJECT: Improving the Instructions to the Manager of the System Account

Governor Balderston's memorandum (dated April 3, 1957) points up clearly both the need for more precise instructions from the Federal Open Market Committee to the Manager of the System Account and the difficulty of using exact targets in terms of net borrowed reserves or Treasury bill rates. We share Governor Balderston's concern in this matter and would welcome careful consideration by the Committee of procedures that might promise improvement. The problem, essentially, is to develop a procedure for communicating the Committee's policy intentions in a form sufficiently precise to eliminate any possibility of misunderstanding, either by the Manager or by any member of the Committee, while avoiding precise statistical targets that would involve the Committee in time-consuming operational details and would handicap the Manager in carrying out the Committee's basic intentions.

In his memorandum, Governor Balderston concludes that net borrowed or free reserve targets, with their admitted deficiencies, offer the best hope for quantifying the Committee's policy intentions. However, he suggests that reserve targets be set more carefully than they have in the past, and only after careful consideration by the Committee of the influences during the period covered by the instructions that might affect the significance of any particular level of bank borrowing or net borrowed or free reserves. Also, he suggests that the reserve target be viewed as the level around which the reserve statistics would be expected to fluctuate over a period of several weeks or months rather than as a precise objective to be achieved each week.

We are in substantial agreement with Governor Balderston's conclusion that the net borrowed and free reserve statistics are probably the most appropriate single measure for regulating open market operations. However, we would be inclined to give more weight than does Governor Balderston to the difficulty of setting up targets--either short run or long run--based on a forecast that a particular level of net borrowed or free reserves over a specified period will have a predictable relationship to underlying conditions of money and credit availability. It can be expected that credit conditions will generally respond to some extent and with some lag to changing conditions of reserve supply, and over the longer term it is possible to look back and observe that a particular degree of ease or restraint in the credit markets was successfully maintained by holding the reserve statistics in a range about some mean level. But our experience has been that it is almost impossible to predict in advance the kind of reserve statistics that will yield desired results.

Some illustrations might help to show how difficult it is to make the kind of forecasts that are implied when reserve targets are employed. As the members of the Committee have remarked, and as the reports from the Account Management have pointed out, the credit markets have been easier in February and March of this year than they were in October and November of last year, despite the higher net borrowed reserves in the more recent period. As Governor Balderston notes in his memorandum, the degree of pressure on credit availability is the result of both supply and demand conditions, and the demand for bank credit has been much less aggressive in the last few months than it was in the closing months of 1956. The apparent conclusion is that the same degree of credit restraint can be achieved with lower net borrowed reserves in a period of seasonally large credit demands than are called for when credit demand is seasonally reduced. Yet, under quite similar economic circumstances in 1952-53, pressures on the credit markets became cumulatively greater in the spring months although net borrowed reserves at that time were lower than the levels that had been maintained without serious disturbance to the market in the last quarter of 1952. If the Committee had attempted to forecast appropriate net borrowed reserve figures earlier this year, would it have relied on the 1952-53 experience? If not, what seasonal pattern would have been used?

Taking another illustration, the instructions from the Committee in October and November of last year emphasized the "feel of the market", and operations were in fact guided almost exclusively by the feel of the market rather than by reserve targets. The result was lower average net borrowed reserves than anyone on the Committee or the Manager's staff would have forecast in advance--and the degree of restraint at that time is now generally considered to have been about right. More recently, at the March 26 meeting, the Committee made it clear that the $200-$300 million net borrowed reserve figures that had run through Committee discussions in previous meetings were not to be considered as a satisfactory target, and the Account has been managed since that meeting with principal emphasis on achieving somewhat tighter conditions in the market. As a result, the effective degree of restraint in the money and credit markets probably has been brought much closer to Committee intentions, but this has been done only by creating net borrowed reserves in the neighborhood of $700 million. It is unlikely that anyone on the Committee or on the Manager's staff at the time of the last meeting could have forecast that reserve statistics of this magnitude would be necessary to bring about the tightening the Committee intended.

Inability to forecast the significance of particular reserve figures does not imply that net borrowed or free reserve measurements cannot be used effectively in giving precise instructions from the Open Market Committee to the Manager of the Account. Reserve objectives might be phrased in the ordinal sense of "more" or "less"--symbolizing the Committee's conclusion that more or less restraint or ease is called for--rather than attempting to attach figures to the instructions. If the consensus of the Committee at a particular meeting is that credit conditions are presently too easy, the instructions to the Manager of the Account would be to tighten the credit markets and to shoot for a higher level of net borrowed reserves than had been maintained recently, forcing banks to rely more heavily on discounting. In executing the Committee's instructions, the Account Management might, for a period of time, find that a combination of circumstances in the market was independently generating an appropriate increase in pressure without an actual increase in the net borrowed reserve statistics. On the other hand, the Management might find that a very substantial increase was called for to get the desired effect. Over a period of weeks and months, the result very probably would be higher net borrowed reserves, regardless of the results within any one, two, or three week period. In the meantime, the Committee would have an apportunity every three weeks to assess, on the basis of observable results in the central markets and in the various Districts, whether operations had gone far enough or too far, and to renew or amend the instructions as indicated. The Committee, through its frequent review, would be exercising close control, and at the same time the Manager would be in a position to carry out Committee intentions more effectively since he would not be bound to some absolute target or target range that might, in fact, prove to be inappropriate to the Committee's intentions.

It is suggested, then, that greater precision can be achieved in conveying Committee intentions if the instructions with respect to reserves are in terms of "more" or "less", than can be achieved by setting statistical targets--which may give the appearance of more precision. (An incidental advantage of allowing somewhat more play in the reserve statistics is that some of the importance the market attaches to these figures as policy signals might, in time, be broken down.) While reserve instructions in this form would help to clarify Committee intentions, it would be helpful if these instructions were accompanied at each meeting by more detailed instructions on other points, devised to be appropriate in dealing with the particular problems that are likely to arise in the three or four weeks to be covered by the instructions. A few illustrations follow.

While we would agree with Governor Balderston that Treasury bill rates may be an even more imperfect measure of basic money and credit conditions than are the reserve statistics, we believe that the instructions might, from time to time, very usefully include references to Treasury bill rates. For example, the Committee might instruct the Manager that it considers the level of bill rates to be too low and that the Manager should include this fact in considering day-to-day operations. Commercial banks at present hold few bills, and changes in bill rates reflect principally corporate tax accruals and other conditions not immediately relating to the underlying bank credit situation. The Committee might, nonetheless, instruct the Manager to avoid, if possible, operations that would further distort the rate structure by driving the bill rate lower. In our judgment, operations should not be regulated exclusively by reference to this particular market rate--or any other market rate of interest--but the relationship of the bill rate to the discount rate might, for example, be given special mention by the Committee as a factor to consider in making marginal operating decisions.

Another instruction that the Account Management has found useful in the past is the expression of the Committee's intentions that doubts be resolved on the side of ease or restraint. This instruction is an important qualification of the Committee's statement of intentions and is very useful to the Account Management in deciding from day to day whether particular actions should be taken. More precise Committee instructions might also be given to the Manager to deal with special situations that arise from time to time.

1. At times of Treasury financing, the Committee might spell out in its instructions what it has in mind when it refers to "maintaining an even keel". Specifically, should the Account Management at such times sell Treasury bills if the bank reserve data and the feel of the market suggest some slight easing (or the reverse)? How much emphasis should the Manager place on the possible psychological reaction to

System Account selling or buying during a financing? If bank reserves appear to be in adequate supply but a log jam is developing in the money market because dealers have loaded up with "rights" and are less able or less willing to make markets generally, should this circumstance be a reason for repurchase agreements or System Account purchases of Treasury bills in order to help in assuring a fluid money market?

2. Another important area on which the instructions to the Manager might be made more precise is the general area of psychology and expectations. To cite an illustration, the leveling off in business conditions in recent months led professionals and investors to conclude that interest rates were more likely to decline in the months ahead than to advance and therefore that it was a good time to buy. The resulting easier tone in the capital markets has persisted, even though the specialists in the market have been fully aware that credit policy is still restrictive. Should the System Account have resisted this psychological development by pursuing restrictive actions more aggressively? Or should the stronger capital markets be welcomed as a development tending to attract savings and to reduce the demand for bank credit?

3. Another type of instruction that would be useful would deal with the assistance to be given the banking system at any particular time in carrying new Treasury deposits resulting from underwriting a Treasury cash offering. In a given financing, the Committee might instruct the Manager as to whether the funds to meet the increase in required reserves

should initially be provided in full, so as to avoid additional pressure on the market, with subsequent absorption of reserves gradually to encourage bank liquidation of the new securities and avoid a sustained increase in the money supply; or whether only some proportion of the initial reserve needs might be met in the initial cushioning of the impact of a large operation; or whether there should preferably be no buying at all, with full dependence to be left to the discount window.

Another part of the instructions usually given to the Manager of the Account is to adjust operations to "the feel of the market". Logically, it should always be assumed that the Manager will adjust operations in a manner that is most appropriately attuned to the particular circumstances at the time, as he evaluates the circumstances, and this is all that is implied by this instruction. The "feel of the market" is no more than the informed judgment of the Account Management as to the degree of pressure being exerted upon the credit mechanism. This judgment is based upon statistical data and factual reports available at the Desk, and has relatively little of the "seat of the pants" type of judgment that the term, unfortunately, implies.

During the course of each day and each week a vast array of information passes through the hands of the officers of the Securities Department at the New York Bank. Included are daily data on reserve positions of New York banks, Federal funds rates and activity, lending rates to dealers in New York City and outside, dealers' positions by maturity, dealer financing needs and the hour-by-hour progress in meeting these needs, reports on the volume of security liquidation or demand, spot reports on the impact of major developments in the corporate and municipal markets as well as the Government securities markets, and many other types of information. Also, of course, there is the constant stream of reports on market attitudes and expectations. Evaluation of all this information at any particular time will give a reasonably clear picture of the nature and intensity of the pressures on the central money market and the Government securities market. The significance of this evaluation rests upon the assumption that the state of money and credit availability throughout the credit structure is directly related to the relative ease or difficulty with which liquid funds may be secured in the central money market or with which short-term assets may be converted to cash. If there is a good nonbank demand for short-term securities, dealer positions are relatively low, financing for dealers is readily available, and New York banks are in a comfortable position, the money market is easy and the banking system is relatively liquid regardless of what the reserve statistics for the banking system as a whole might show.

In such a situation, if the objective of credit policy is restraint, additional reserve pressures might be allowed to build up until the liquidity of the money market has been reduced to a point where restraint is being imposed as a result of the reduced access to cash through the money market. On the other hand, restraint probably should never be pushed to the point where the fluidity and viability of the money market are seriously hampered. Therefore, if dealer positions are large, securities are being pressed upon them aggressively, and unfavorable rate expectations prevail, the Account Management probably should be expected to keep on the alert to guard against a breakdown in the money market apparatus--sometimes referred to as a "knot"--even though it is necessary to allow the reserve statistics to move away from what would otherwise be considered the appropriate level for the credit policy then being followed.

Over the longer run, of course, the reserve statistics, the "feel of the market", Treasury bill rates, and yields on other securities will ordinarily move in a consistent relationship. But experience shows that deviations from this relationship can persist for a considerable period, and real damage can be done to credit policy execution unless open market operations are flexible and able to adjust to the immediate short-run situation. The only satisfactory guide that can be followed under such circumstances--and they can arise at any time--is the Account Management's "feel of the market". Open Market operations can be adjusted flexibly and effectively to establish the effective degree of credit availability that the Committee intends only if the Account Management is, in fact, free to probe without necessarily holding closely to any single measure such as reserve statistics, Treasury bill rates, etc.

The importance of clarifying the instructions from the Open Market Committee to the Manager of the System Account has been dramatized by recent events. At the meetings of the Open Market Committee on February 18 and March 5, the instructions were to maintain about the same degree of restraint. During the discussions at the meetings, most Committee members mentioned net borrowed reserve figures generally in a $200-$300 million range. It was understood, of course, that the Account Management would adjust its operations to the feel of the market, but the Management's understanding, based on the discussion, was that although the figures mentioned were not absolute targets, they did reflect the degree of restraint intended by the Committee, and that substantial deviation from the range mentioned by the Committee members would require justification in terms of special circumstances prevailing at the moment. It was our understanding that the Committee was aware of the possibility that this level of net borrowed reserves might not achieve a degree of restraint equivalent to that obtained last fall, even though some members occasionally mentioned a desire to return to this previous degree of restraint. (The reports from the Management to the Committee made the point on several occasions that the actual degree of pressure on the market resulting from these reserve statistics was not what might ordinarily have been expected; that is, that the money market was not under severe pressure in spite of the reserve statistics.)

In passing, it might be mentioned that the measures of money market conditions other than the "feel of the market" suggested considerable restraint throughout

February and March. Net borrowed reserves averaged higher than they had last fall. Three-month bill rates averaged 3.08 per cent in March and 3.11 per cent in February, against averages of 2.99 per cent and 2.90 per cent in November and October, respectively (market rates on Treasury bills dropped somewhat in the week ended March 20, during which week the Treasury abandoned its program of adding $200 million to each weekly issue, but this was the expected result of the Treasury's action). Average issue rates in every auction during February and March were above the discount rate, whereas they fell below the discount rate most of the time in October and November. Federal funds rates held almost constantly at the discount rate. Effective market yields of U. S. Government certificates, notes and bonds, while lower than levels reached in December and early January, were equal to or higher than the levels prevailing in October and November (and prices and yields of Government securities were generally steady in February and March, suggesting a steadily maintained degree of restraint in the market). All in all, on the Management's understanding of the Committee's intentions, market conditions throughout this period, including the period in which the Treasury was financing, were held closely in line with the Committee's instructions. However, the comments of some of the members at the March 26 meeting would suggest that a more intense degree of restraint had been intended. With that point clarified, and with the implication that no reserve target need be kept in view, the Account Management has moved in the past two weeks to re-establish a degree of tension in the money and capital markets more like that which prevailed last fall (when seasonal loan pressures were contributing to the tension), recognizing that achievement of this degree of tension would mean that the statistical measures of money market conditions would have to be moved to levels that suggested substantially more restraint.

If there was a breakdown of communication between the Committee and the Manager during this recent period, it apparently was complicated by a breakdown also of communication in the other direction, between the Manager and the Committee. As noted above, the Account Management interpreted developments during February and March as reflecting an essentially steady degree of restraint (with the exception of some temporary easing toward the end of the March 27 statement week as the bulk of all the pressure in the money market shifted to Chicago, where the banks were not reluctant borrowers), and the reports to the Committee reflected this interpretation of a well-maintained degree of restraint. However, some of the members of the Committee, on their independent analyses, concluded that System Account operations around the middle of March contributed to an easing in the money market at and after that time. No doubt owing to some failure by the Account Management to communicate accurately its own analysis of market conditions, the Committee members were apparently not aware, at the time, that action was being taken which differed from their understanding of Committee instructions. No member of the Committee contacted the Manager at the time to question the interpretation of instructions and developments which the Manager was presenting through the daily telephone reports or through the written reports.

At the March 26 meeting, the Manager of the Account requested the members of the Committee to review our reports and to suggest any changes in content or coverage that would help to make them more useful Committee documents. In our opinion, these reports should be detailed and objective descriptions of developments in the money and credit markets which can serve as the foundation for Committee appraisal of the present state of credit conditions and from which conclusions as to the need for changes in these conditions can be derived. Every effort is made by the Manager and his associates to make the reports as factual and objective as possible, and the Account Management would welcome any suggestion for change that would make them more useful as basic working documents for the Committee. Moreover, the Account Management needs the continuous review of its actions and judgments by the members of the Committee which these reports are intended to encourage.

It is our judgment that no matter how much further progress can be made in giving specificity to the instructions from the Committee to the Manager, the need for considerable reliance upon judgment "at the desk" will remain. The way to minimize the possibilities for such judgment to deviate from the Committee's general intentions, in the face of changing conditions that could not all be foreseen at the latest meeting of the Committee, is to rely most heavily upon a full flow of communications--daily and even hourly. The Account Management wishes to do everything possible to provide, through those communications, a full picture of what is happening and how action is being adapted to fit policy aims into the emerging market situation. In turn, we should hope that there would be no hesitancy on the part of any member of the Committee, at any time, in contacting the Manager (and other members of the Committee) if he perceives any deviation from what the member considers to be the essence of the Committee's intentions and instructions. That kind of check, superimposed upon the best possible combination of specific Committee instructions, should promise the fullest measure of adherence to the Committee's wishes, within a pattern of market developments that is inevitably always changing.