

REC'D IN RECORDS SECTION
NOV 28 1961



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

November 27, 1961.

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Young

There is enclosed a copy of a letter from Mr. Bryan dated November 24, 1961, containing comments on the operating procedures and directive of the Federal Open Market Committee, prepared pursuant to the suggestion made by Chairman Martin at the meeting on September 12. Also enclosed is a copy of a letter from Mr. Deming dated November 24 on the same subject.

Ralph A. Young
Ralph A. Young, Secretary,
Federal Open Market Committee.

Enclosure

REC'D RECORDS-SECTION

NOV 28 1961

FEDERAL RESERVE BANK
OF ATLANTA

OFFICE OF
PRESIDENT

November 24, 1961

Dear Mr. Young:

I have carefully studied your communication of September 6 regarding the Federal Open Market Committee's operating procedures and directives. I have also read with attention the comments made by Mr. Broida and Mr. Knipe and by several of the Presidents.

I find myself largely in agreement with the letter of Mr. Irons. The suggestions that Mr. Irons has made for changes in the draft proposal of standing rules all strike me as excellent, with one exception. That exception is the inclusion of the phrase "although such operations may tend to influence rates of interest" in Rule 3 of Attachment I. I believe this modification is unnecessary, and I note that Mr. Irons himself expresses no strong feeling about the suggestion he makes. I also believe, though this is a minor matter, that in the preamble to the standing rules the reference to "stability of the price level" is preferable to the plural (i. e., price levels) suggested by Mr. Irons.

Absent from Mr. Irons' letter are several suggestions that I regard as objectionable. He does not:

- (1) Eliminate from the statement on standing rules the reference to bank reserves as an objective of open market operations;
- (2) Eliminate the reference to the maturities in which operations of U. S. Government securities are to be conducted;
- (3) Weaken in any way the present prohibition against dealings in issues involved in a Treasury financing operation; or
- (4) Remove the present 15-month maturity limitation on U. S. Government securities held under repurchase agreements.

I like two of Mr. Irons' suggestions: these are his support in Rule 2 of a statement that would define in terms of some precisely-stated number of months just what "short-term issues" are, and his insertion

FEDERAL RESERVE BANK OF ATLANTA

Mr. Ralph A. Young

- 2 -

November 24, 1961

in Rule 5 a statement that would permit swaps only upon the authorization of the Committee.

Turning to the current economic directive, I again find myself in complete agreement with Mr. Irons' view that an attempt should be made to spell out such a directive in more detail. Of the four alternative formulations found in Attachment III, I like best of all alternative "D." It is the only formulation, among the four illustrations, containing quantitative instructions.

As I see it, the need for stating instructions in quantitative terms, within a range of latitude suitable to the practical administration of the Account, is now, and has been for a long time, one of the most important problems confronting the Committee. I regard the successful solution of this problem as imperative; I believe that, unless the problem is successfully resolved, the survival of the Committee in its present form, and with its present power, is gravely and needlessly endangered.

It is clear that the relationship of the Agent Bank and of the Manager to the Committee is a fiduciary relationship, and it is subject to the general canons governing a fiduciary and his principal. Among the responsibilities of a principal in such a situation is not only that of making his instructions to his agent reasonably clear, but also that of giving instructions within the limit of the means available to the agent. If the instructions are not clear, or if they lie beyond the means at the agent's disposal, then the agent has an adequate defense against misadventure, all to the discomfiture of the principal. The agent, quite aside from the requirement that he faithfully discharge his fiduciary responsibilities, has an even greater responsibility: the responsibility of being able to demonstrate that he has done so, and this responsibility is the more demanding in a public trust than in a private trust. Implicit in this is the responsibility, discharged every day in private fiduciary relationships, of refusing instructions that are excessively vague, meaningless, or beyond the means at the disposal of the fiduciary.

I thus believe that the Committee, as principal, owes it to itself and to its Agent Bank and Manager to make its instructions not only clear but also within the means disposed by the Bank and the Manager. I also believe the Agent Bank and the Manager have the responsibility--inadequately realized, I think--to accept no instructions that are unnecessarily vague, meaningless, or beyond the means disposed by the

FEDERAL RESERVE BANK OF ATLANTA

Mr. Ralph A. Young

- 3 -

November 24, 1961

Bank and the Manager.

The Committee, I strongly feel, has tended to avoid clear, quantitative instructions because it has failed to draw a distinction between means and ends. Although most of the things that we wish ultimately to influence, our ultimate purposes or ends, can be stated in quantitative terms, many of them cannot be so stated. Even when they can be stated in quantitative terms, the combinations and permutations of such items as price levels, employment, interest rates, and so on through a long list, are so many as to make an instruction, weighing all items, impossible. More than that, many of our purposes or ends are qualitative, not quantitative: ease, tightness, and so on through a long list, which I spare you. These things, despite an element of reality, defy adequate and meaningful definition, and they are unreasonably vague, sometimes meaningless, and not always proportionately responsive to the means governed by the Committee and at the disposal of the Agent Bank and Manager.

What the Committee has failed to remember is that the Committee has control over but one means, whatever its ultimate purposes; that is, it controls bank reserves. Unless it gives its instructions in terms of a quantitative reserve concept, from time to time modifying the instructions in accordance with its view of the attainment or non-attainment of the final purposes or ends it has in mind, then in my judgment the Committee cannot decently hold the Agent Bank and the Manager responsible for the fulfillment or non-fulfillment of the Committee's instructions. What is equally important, the Agent Bank and the Manager, while they may have an adequate defense in the ineptitude of the instructions given by the Committee, are deprived of the positive proof to the Committee and the Congress, when such instructions are given in vague and qualitative terms, that they have followed the Committee's intent. This will ultimately be a disaster, I feel sure.

I lay the chief responsibility for this situation on the Committee, where the authority and power vests, but I believe some responsibility lies with the Agent Bank and, to a much lesser extent, with the Manager. They should have the keenest awareness of the canons of fiduciary responsibility; they should give the Committee the greatest aid and assistance in developing a basis for clear, quantitative instructions within the means that are disposed by the open market operation; they should cease their eternal yowling for greater discretion.

FEDERAL RESERVE BANK OF ATLANTA

Mr. Ralph A. Young

- 4 -

November 24, 1961

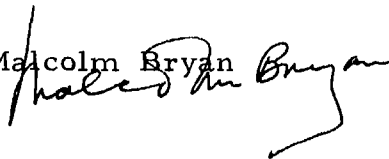
As I have said, I regard this matter of quantitative instructions, and a clear distinction between means and purposes or ends, as imperative. Unless we solve it, we shall one day be confronted with an explanation to the Congress of what we intended, all without being able to say what we did in fact intend; the Agent Bank and the Manager, after our retreat into vague generality, will one day be confronted with the task of explaining whether it fulfilled as the fiduciary the wishes of the Committee, without being able to explain.

Let me make two other comments:

One is to indicate general agreement with Mr. Irons' suggestion that the directive be written after each meeting by the Secretary of the Committee and the Manager of the Account, and after approval or amendment by the Chairman, forwarded to the members of the Committee. I believe there is nothing more futile than nineteen men trying to edit a directive around a table at a meeting. Incidentally, if we ever attain clear, quantitative directions to the Desk, the present hairsplitting shifts of linguistic emphasis in the directive will be reduced to a lesser and more proper importance, and we shall have a better guide to when a change of language is called for.

Finally, I wish to express the hope that we do not strive for complete unanimity in the document we are struggling over. There are evident great differences of philosophy in the Committee, and great differences in evaluating what is important and what is unimportant. If we struggle for unanimity, we shall produce an amorphous and witless document, satisfying to no one and resolutely defensible by no one.

Sincerely,

Malcolm Bryan


Mr. Ralph A. Young, Secretary
Federal Open Market Committee
Board of Governors of the
Federal Reserve System
Washington 25, D. C.

FEDERAL RESERVE BANK OF MINNEAPOLIS

NOV 28 1961

MINNEAPOLIS 2, MINNESOTA

November 24, 1961

Mr. Ralph A. Young, Secretary
Federal Open Market Committee
Board of Governors of the
Federal Reserve System
Washington 25, D. C.

Dear Mr. Young:

At the Federal Open Market Committee meeting of September 12, 1961, Chairman Martin suggested that comments on your memorandum of September 6 (Discussion of Changes in the Committee's Procedures) and its attachments might be sent directly to you. This letter contains such comments and is written after review of Attachments I, II, and III, the memoranda of Messrs. Knipe and Broida, and the comments of Presidents Ellis, Hayes, Fulton, Wayne, Allen, Clay, Irons, and Swan.

I

After studying all of the suggestions concerning the standing rules and trying my own hand editorially, I come, somewhat reluctantly, to the same conclusion reached earlier by Messrs. Allen and Ellis that the rules should be eliminated. My reluctance has little to do with the substance of the question; in general, I concur in the position taken by Messrs. Allen and Ellis that the rules are unnecessary and can prove to be administratively embarrassing at times. Rather it reflects my feeling that we cannot take this action gracefully. I have become convinced, however, that neither maintenance of the rules, as is, nor rephrasing to make them more broad can be accomplished with any more grace.

Along with others, I have tried to explain the background of the rules, have noted that the language itself makes plain that they can be changed or deviated from at any time the Committee chooses to do so, and have stressed the demonstrable fact that they have not been rigid in application. I have noted that they are mainly technical operating matters, that there are technical operating reasons for them and that short-term securities are the best instruments for most central banking open market operations. Progress toward outside understanding and acceptance of the rules seems to me to have been zero at best, and I am not at all sure that it has not been negative. Therefore, I believe that it is hopeless to try to live with the rules without change.

It seems to me that there are two major disadvantages to amending the rules. First, unless they are written in very broad language they are subject to the same kind of attack as the present rules and, in fact, they may be limiting at times and thus force hard-to-explain deviations; if they are written so broadly as to escape these difficulties,

Mr. Ralph A. Young, Secretary

- 2 -

November 24, 1961

they become almost meaningless as "rules". Second, the difficulties involved in explaining the substance of amended rules and the reasoning behind the changes would be at least as great, and perhaps more so, than just eliminating the rules completely.

Therefore, I believe that we should abandon the rules and, at the proper time, say so publicly. I believe the action should be taken before the end of this year so that it can be covered in the Annual Report for 1961.

My own preference as to form of announcement would be a tightly written article which would trace the background, rationale and record of the present operating rules, discuss the role of short-term securities in central banking open market operations, note that they have stirred up so much misunderstanding and controversy that they no longer serve any particularly useful purpose, and that the Committee, with its frequent meetings, no longer sees the need for such a body of rules. The article should be quite frank in approach but not apologetic. I see no reason why it should not appear, perhaps in somewhat longer form, in the Bulletin as well as in the Annual Report.

In effect, the above comments apply to the first five "rules" in Attachment I. If repurchases are covered in II, there should be no need for Point 6 in any set of "rules" anyway. Point 7, designation of the New York Bank, can be covered, as now, by action at the organization meeting, and Point 8 should be left where it now is in the "Rules on Organization".

II

I am in agreement with those who believe that the present directive should be split into two parts and have no significant comments on the language used in Attachment II. I think repurchases should be covered in II.

III

My comments with respect to the form of the current economic directive should be taken against the background of the following points:

(a) I agree with Mr. Broida that the problem is not one of communicating instructions to the Desk, but of communicating to the public, and that the form and content of the directive and the policy record should be aimed at this end.

(b) I do not agree that the language or the form of the (b) clause, as used at present, is as meaningless or as absurd as some critics contend. I have given apparently well received and understood talks on Federal Reserve policy using the (b) clauses as a framework on which to hang discussion of policy. It is true, of

Mr. Ralph A. Young, Secretary

- 3 -

November 24, 1961

course, that the clauses were given more meaning by being explained against the background of economic and financial developments and credit policy actions than if they had been presented standing alone, but the significant point to me has been that no one has raised questions about language. Until the recent comments on the Open Market policy record appeared I had heard no adverse comment on (b) clause wording outside the Committee (or the System) itself.

(c) The above should not be taken to mean that I think the current economic directive is perfect. Of course, I think its language can be improved. I believe, however, that the key to better understanding lies in more full explanation of policy, either in the policy record or in special articles, or both, rather than in the directive.

My feeling then is that the directive should be simple, general, and brief. I rather like the form suggested by Mr. Allen. That form would imply more frequent changes in directive than have occurred in the past, but I see no objection to that. I think it would offer the advantage of presenting a somewhat more definitive policy on which to vote than does the present form.

Should this form be adopted, I would see no objection to having a "general policy position" stated and voted upon also, as outlined by Mr. Hayes. As a matter of fact, the "general policy positions" might be used for the complete policy record in the Annual Report, if a published explanation of policy, as noted below, were to be done.

What I particularly want to avoid is a directive couched in terms of a guide or guides such as free reserves, money supply, total reserves, federal fund or bill rates, or the like. I simply do not believe that any one indicator is going to be good enough to use all of the time and I fear that should we attempt to use one (or more) in the directive itself, we will spend a great deal of time subsequently trying to explain why we did not get quite the precise results that these apparently precise indicators would imply we sought. I also feel that an attempt to write directives in specifics would push us uncomfortably close to mechanistic policy-making.

This does not mean that the policy explanation need avoid using these (and other) indicators. In fact, I think that the policy explanation should use such indicators but should put them in better perspective and should make clear that no one indicator (or several) can serve as an absolute guide to or explanation for policy at all times. The essence of my argument is that a full, authoritative, current and readable policy explanation would go a long way in dispelling the kind of criticisms now being made of the directives and the policy record. Mr. Swan makes this same point in his letter and I agree with him almost completely.

Mr. Ralph A. Young, Secretary


- 4 -

November 24, 1961

If such a policy explanation were done quarterly for Bulletin publication, I see no reason why it should be lagged a quarter. Given the normal delays of writing and publication, it would be lagged 45 to 60 days anyway. I agree with Mr. Swan that such a quarterly article should not be an official Committee statement, but I assume that it would quote the Committee directives and policy actions as a framework on which to hang the discussion. Were this approach to be used, the official policy record in the Annual Report could be confined to a "bare bones" story, perhaps using the "general policy position" form as the only explanation of the policy action.

I do not favor the suggestion that two or three alternative directives be prepared by staff prior to a Committee meeting. I do favor Mr. Irons' suggestion that the secretary and manager be charged with drawing up the formal directive, and, if it is to be used, the "general policy position", after the meeting. I should think this work could be done quickly and probably could be made available on the afternoon of a meeting. In fact, it should not be too difficult to arrange affairs so that the Committee reconvened briefly after lunch to pass formally on the statement or statements at the time. It seems clear that a formal vote should be taken on the directive, and perhaps on the policy position, and I think this could be done more easily and efficiently at a meeting than by mail.

Very truly yours,


Frederick L. Deming
President

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