January 27, 1966

To: Members of the Federal Open Market Committee

From: J. L. Robertson

I believe the Committee will be interested in the attached memorandum (which I have held in deep freeze for some time) analyzing the advantages and limitations of a free reserve operating target and then suggesting how such a target can be adapted to more effective use. The proposal, or something akin to it, is especially relevant to periods when credit demands are changing sharply (like the present and recent past) and when, therefore, a focus on interest rates accompanied by a strong effort to modify interest rate tendencies is liable to produce "pro" rather than "contra" cyclical movements in aggregate reserves, money supply, and bank credit.

Attachment

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A Free Reserve Proposal

In this memorandum I would like to suggest that the Open Market Committee now put most stress on free reserves as an operating target for the guidance of the System Account Management, but that, in doing so, free reserves should nevertheless be permitted to fluctuate over a wider range in response to variations in credit demands. The Federal Open Market Committee's operating directive to the Account Management is currently expressed in terms of money market conditions. Such conditions include free reserves and the 3-month Treasury bill as principal components, along with a variety of other factors, such as dealer financing costs and the Federal funds rate. In the earlier years of this expansion, stress was placed on the Treasury bill rate because of its significance for the balance of payments, but it no longer appears so relevant in that respect. The bill rate should now be a subsidiary element in money market conditions, with the key role played by free reserves (and with member bank borrowings a crucial element of such reserves).

Apart from periods of transition to new interest rate levels in the wake of discount rate changes or in response to changes in other factors that radically alter market expectations, the FOMC has, of course, generally had some net free reserve number in mind in conveying its instructions to the Desk. The principal modification to such a use of free reserves that is proposed here involves the Committee in deliberately setting a wider range of free reserves for guidance of the Account Management, with the expectation that this will actually result in wider week-to-week fluctuations in bill rates than we have seen in recent years (though not perhaps than in recent months). The proposal has three objectives:

First, it would be of obvious benefit if the market were less conditioned to every little twist and turn of free reserves. A lessened fixation on free reserves by government security dealers and others would, among other advantages, increase the freedom of monetary policy around, and particularly after, Treasury financings.

Second, a wider range of fluctuation in free reserves of the kind to be proposed here would introduce even more flexibility into the bill market, and possibly also the bond market. This would develop in part because the System would likely become a less active factor in the market, since it could refrain from some of the operations (including offsetting intra-weekly transactions) that would be necessary to maintain free reserves within a relatively narrow range.

A market with a reasonable degree of day-to-day rate fluctuation is, I persist in believing, the healthiest kind of market, and also the most informative to policy-makers, since interest rates become more reflective of supply and demand rather than of purported official rate objectives and since the associated continuing activity on both sides of the market tends to limit whatever propensities dealers may have for backing off from their prime function of keeping market price movements orderly. It should be clear that I am referring here to very short-run interest rate variations of modest size; strong and especially unexpected cyclical forces can always generate disorderly conditions, even in the healthiest of markets.

Third, a wider range of week-to-week fluctuation in free reserves will - provided the proper basis for fluctuation is achieved - enable the System to exert some restraint on credit demands when they are more than seasonally large and to attempt to encourage such demands when they are falling below seasonal expectations. This third advantage is perhaps most important from an economic point of view and requires further explanation.

One of the chief reasons for adhering to free reserves as an operating goal - apart from the fact that it represents pressure on the banking system - is that it enables the System to provide for seasonal and other temporary reserve needs without having to undertake the very difficult task of predicting them in advance. In accommodating such needs, the System keeps credit markets relatively free of large-scale day-to-day changes in pressures for tightness or ease. In doing so, the System provides whatever nonborrowed reserves are necessary to offset fluctuations in such factors as float, currency in circulation, and required reserves and to keep free reserves at a relatively constant level consistent with the FOMC directive. This is by and large desirable, for it thereby enables decisions in the securities and loan markets to be made on the basis of the longer-run supply-demand outlook, without the possible misjudgments that could develop if day-to-day or week-to-week static were substantial.

But there is still scope for permitting a little more short-run flexibility in credit markets. And there is good reason to do so.

In the context of a free reserve target the reason for doing so is related to the probability that some part of the change in required reserves over a short-run is neither seasonal nor temporary but represents the impact of longer-run or cyclical credit demands. While a free reserve target has the advantage of leading the System to offset fluctuations in technical reserve factors - such as float, currency, and gold - that are mostly unrelated to variations in domestic credit demands or in banks' demand for free reserves, it has the disadvantage of leading the System to accommodate itself to all domestic credit demands, whether small or large, as they impinge on banks, regardless of whether they reflect temporary or longer-run economic forces.

The free reserve proposal presented here would require the Account Management under ordinary conditions to offset all fluctuations in technical reserve factors, excluding required reserves, but would permit it to let some of any larger than usual or expected change in required reserves to be reflected in a wider range of variation in free reserves. This would be done on the grounds that it would automatically introduce a safety valve against the greatest danger of a free reserve target - the danger that the System will not recognize, or will recognize only belatedly, that demand conditions have changed fundamentally and that, therefore, a particular free reserve target has now either a more expansionary (if demands have risen) or more restrictive (if demands have contracted) meaning than it formerly did. Since we cannot know for certain how permanent new demand conditions will be, we are, it must be recognized, introducing an element which increases only the probability that day-to-day operations will be improved. In that sense, the limits on free reserves are still necessary to guard against the likelihood that some of the abnormal change in required reserves is indeed temporary or seasonal and therefore should not be reflected in a wider movement of free reserves.

To give a specific example of the proposal, the Committee might indicate a net borrowed reserve target to be centered around $100 million, with a range from (say) zero to $200 million. The understanding would be that if required reserves were coming in during the week as indicated by past patterns for that period, together with an allowance for growth, the Management would be expected to end the week around $100 million (with the usual range of acceptable error). But if required reserves were falling below expectations, which would be taken to indicate smaller than usual credit demands, net borrowed reserves would be expected to fall back toward zero (with the usual range of error even permitting some small net free reserves). On the other hand, if required reserves were expanding at a faster than anticipated pace, some of the rise in required would be permitted to absorb free reserves, which would then mean that net borrowed could rise as high as $200 million (again with the usual range of error permitting some movement beyond the boundary point). The stronger and more persistent was the rise in required reserves, the greater might be the extent of free reserve tightening permitted by the Manager.

If operations were conducted in this way, those who favored an easier policy than adopted might have to acquiesce in net borrowed reserves sometimes being near $200 million. In compensation for this, however, those who favored a tighter policy would sometimes have to live with a net borrowed reserve figure closer to zero. If the free reserve figure persistently remained near the upper or lower ends of the range, the Committee as a whole would certainly want to determine whether credit demands had become strong enough, or weak enough, to suggest that the free reserve target range should be shifted in one direction or the other, with a coincident shift in the target center.

But the fact that the free reserve figures were persistently near one end or the other of the range would not, of course, in itself be reason for changing the target range. The target range would still depend, as it does now, on our evaluation of the wide range of economic and financial facts presented at each FOMC meeting.

In presenting this proposal, I have not intended to cover every aspect of it or every problem that might be raised with respect to it. For one thing, since required reserves can change for reasons other than credit demand (e.g., because of changes in the deposit mix) the Account Manager will have to take account of whatever other relevant information he may have in reaching his decision as to what extent credit demands are greater or less than expected.

Another related aspect of the problem is raised by time and savings deposits. There might be, for example, a rapid expansion in time deposits at a time of rapidly growing credit demands, with the result that these demands may be satisfied with relatively little rise in required reserves but with a strong expansion of bank credit. Under the proposal presented here, the net borrowed reserve figure then need not rise toward its upper limit since required reserves would probably not be expanding rapidly.

This is far from catastrophic, however. In the first place, it may be that some of the expansion in time deposits represents funds that would otherwise have gone into the credit market directly or through other savings institutions. Thus, these funds are not a substitute for money and do not represent money expansion in another form. Secondly, even if they were, the FOMC will have an opportunity at its next meeting to evaluate the whole situation and come to a judgment about whether it does or does not wish to change the free reserve target.

The latter point also brings up the question of why it is necessary to institute a wider free reserve range when the FOMC anyhow meets about every three weeks (though sometimes in four or two-week intervals).

One reason is that the Committee for good reason is reluctant to undertake any overt change in policy unless the economic situation and need is crystal clear. This new proposal would permit market developments themselves to influence, within limits, the degree of pressure on bank reserves without the System changing the directive.

A second reason is that the wider movement of free reserves between meetings would be another factor forcing the Committee into a continuing evaluation of the relation between credit demands and the bank reserves that are being supplied. We would focus even more than we do now on our provision of nonborrowed reserves - which, under the proposal, would probably be lower than it would be under existing procedures if credit demands became very large and would be higher (or would decrease less) if demands became very weak.

Third, as mentioned earlier, free reserves persisting at one end of the range or the other would be another important, though not necessarily crucial, factor for the Committee to consider in evaluating the target range itself. Such free reserve variations are also likely to reduce the market's own concern with the level of free reserves as such.

Finally, the flexibility of interest rates that would result when a free reserve target fluctuates with required reserves[1/] would in itself be a healthy market development and would also make interest rate movements a more useful source of economic information to the System.

[1/] This is to be contrasted sharply with fluctuations in free reserves that do not depend on changes in required reserves but rather are designed to offset short-term rate movements and thereby to create interest rate stability.