CONFIDENTIAL (FR)

June 6, 1955

Memorandum:

To Members of Federal Open Market Committee Special Committee

Subject: Management of the System Open Market Account

From J. L. Robertson

The Federal Reserve Act empowers the Federal Open Market Committee to "adopt ... regulations relating to the open-market transactions" of the Federal Reserve Banks, and requires the Reserve Banks to participate in open market operations "in accordance with the direction of and regulations adopted by the Committee".

In view of the broad discretion thus conferred, the Committee lawfully could prescribe for the System Open Market Account almost any organizational or "housekeeping" pattern that was not patently unreasonable or capricious. However, our present consideration of practical alternatives seems to have narrowed to three:

1. The Committee could have its policies executed through a separate Open Market Committee managerial staff, having no other functions, located in Washington.

2. The Committee could have its policies executed through a Manager of the System Open Market Account, appointed by and responsible solely to the Open Market Committee, but located in a Federal Reserve Bank designated from time to time by the Committee.

3. The Committee could continue the present arrangement of having the Manager be an officer of the Federal Reserve

Bank of New York, but the annual appointment of the Manager would be handled through a joint committee of members of the FOMC and directors of the Federal Reserve Bank of New York.

As I see it, the first of these alternatives would establish most definitely (short of new legislation) the "independence" of the Committee's operations and their divorcement from the operations of any particular Reserve Bank. The second alternative is that suggested in Mr. Martin's memorandum of May 10, 1955. The third is the possibility mentioned in Mr. Sproul's memorandum of the same date.

1. <u>Separate Open Market Committee staff located in Washington.</u> "If we had a clean sheet of paper to write upon", as President Wilson said, this alternative might have greater appeal. The majority of the Committee have their offices in Washington, and the presence of the Manager (whose position might be merged with that of the Committee's Secretary) and his immediate staff in Washington would encourage those members to have frequent direct contacts with the Manager, thereby enhancing their understanding of day-to-day operations and the staff's understanding of the Committee's policies. It is probable that such close and continuous contact between a majority of the Committee and the Managerial staff would increase the effectiveness of the Committee in its performance of one of the Reserve System's most important functions and would result in the System Account's transactions reflecting more precisely the Committee's current policies and objectives.

It might also be contended that the existence of a separate Open Market Committee staff and the location of that staff in Washington would make for more "detached" Account operations. Washington is not a great money center and the thinking of the staff inevitably would be based more upon objective economic facts and less upon the "feel" of the market, which is bound to exercise greater force when the staff is located in a great money market and is in frequent contact with the people who constitute the market. In other words, by shifting to Washington all Open Market Committee operations except the mechanical performance of market transactions, we could minimize the possible influence of people other than members of the Committee and its staff.

There are cogent arguments against this alternative, however. In the first place, management of the System Account always has been centered in New York City. Against this historical background, a shift of location to Washington might be interpreted as indicating a lack of confidence in the New York Reserve Bank's handling of this work, which is not the case. Such public misunderstanding might be detrimental in more ways than one, and should be avoided unless the counterbalancing benefits are very clear.

An even stronger argument against the Washington-staff proposal is simply a denial of the contention that the Committee's operations necessarily are most effective when based solely on "objective" statistical data. It is plausibly contended by some that, although the making of monetary policy calls for detachment from day-to-day market influences, central-bank operations can achieve maximum effectiveness and minimum disturbance only if they are conducted on the basis of first-hand and up-to-the-minute knowledge of current happenings in the nation's chief money market. Washington is certainly not the best place in which to obtain such last-minute knowledge and "feel"; without doubt the prime location for this purpose today is New York City, which is still our principal money market.

2. Separate Manager of the System Open Market Account located in a designated Reserve Bank. It seems to me that this is the nub of the changes suggested by Mr. Martin. Its objective would be to secure the benefits of an operating Manager concerned solely with execution of FOMC policies, while avoiding the disadvantages, previously mentioned, of a shift of physical location to Washington. If this alternative is adopted, the Committee's decision presumably would be couched in terms of location "in a Federal Reserve Bank to be designated from time to time by the Committee". For the foreseeable future, probably, the designated bank would be the Federal Reserve Bank of New York, but the suggested form of resolution might have psychological value by enhancing the sense of the FOMC staff that it is not a part of a particular Federal Reserve Bank, but is only physically situated there, for convenience, and at the pleasure of the Committee. To some extent, our purpose would be to give to the Manager and members of his staff a relationship comparable to that

of the District Chief National Bank Examiners who maintain their office in Reserve Bank buildings, for reasons of efficiency and convenience, without being considered in any sense a part of the Reserve Banks.

In my view, the chief value of Mr. Martin's proposal is that it will tend to increase the likelihood that, in all circumstances, the management of the System Open Market Account will reflect precisely and exclusively the policies of the Committee. But to take full advantage of such organizational changes, the Committee must be determined - and must carry out its determination - that directives to the Manager will be more definite and absolute than has been the case generally in the past. It might well require more frequent meetings of the Committee, as a result of which relatively narrow ranges of operations would be prescribed. Under this procedure, the Manager's functions might consist of observing the market and economic factors generally, preparing economic information and views for submission to the Committee, and devising mechanics and techniques of orders to the Open Market Desk of the designated Federal Reserve Bank which will effectively carry out the specific directives of the Committee.

As an illustration, let us assume, putting aside other standards and criteria for the moment, that the Committee in September 1955 decides to maintain a free-reserve level of $100 million to $200 million. At that time, free reserves happen to be in the neighborhood of $240 million. In these circumstances, the Manager would act as promptly as possible without undue market disturbance to sell some $50 million of bills (or perhaps $40 million or $60 million); in other words, ordinarily the Manager would take the minimum action necessary to bring the situation within the limits prescribed by the Committee but would keep the Committee informed of changes in economic environment or trends which might warrant a change in the instructions.

Necessarily, the Manager would also act promptly to offset other factors affecting the level of free reserves, such as money in circulation, Treasury deposits, float, and gold movements, but such action would be taken only when one or more of those factors resulted in a level of free reserves which was above or below the prescribed range. For example, in the situation outlined above, no action by the Manager would be called for by a subsequent increase of $70 million in money in circulation (other factors not changing), since the resulting level of free reserves - approximately $120 million - would still be within the range contemplated by the Committee's current directive.

To sum up the foregoing, it seems to me that a decision by the Committee to maintain closer contact with the management of the Open Market Account may be no more than a matter of form unless it is coupled with a regular practice of making that contact effective through directives which are definite and quantitative as well as philosophical and qualitative.

3. Continuation of present arrangements, except that Manager would be appointed through joint action of the Committee and the New York Reserve Bank. This appears to be the essence of Mr. Sproul's suggestion. To the extent that it gives the Committee a more effective voice in the selection and reappointment of the Manager and staff, it is a move in the direction deemed advisable by a majority of the Committee. However, it seems an unnecessarily limited effectuation of the principle that the management of the Open Market Account should be responsible solely to the Committee. To the extent that any Reserve Bank, as such, participates in the selection of the Manager, divided responsibility necessarily results, particularly because the Manager and his staff would be physically located in, and immediately compensated by, the Reserve Bank which had a measure of control over their tenure and perquisites.

In brief, my reaction is that Mr. Sproul's idea does not go far enough in a direction of carrying out the Committee's objective in this respect, which is to have an Open Market managerial staff that looks only to the Committee for control and approval, provided that this objective can be attained without loss of the practical benefits of the present arrangement and without creating any erroneous impression of intra-System conflict or Committee dissatisfaction with the manner in which the Committee policies have been carried out in the past. (In this connection, I should perhaps mention my understanding that the Federal Reserve Bank of New York, through its trading desk, presumably would continue to be the agency through which actual open market transactions would take place. The relationship between the New York Bank's trading desk and the Open Market Account Manager would be comparable to the relationship of the desk and the Treasury Department in connection with Treasury open market transactions.)

Allocation of salaries and expenses. I do not feel any importance should be attached to the immediate source of the compensation of the Manager and his staff. It is difficult to believe that a man of the caliber required for this position would be affected by the circumstance that his salary checks were drawn by a certain Reserve Bank or by the Board of Governors, particularly since he would know that the ultimate source of his compensation would be the Reserve System generally, via proration among the Reserve Banks.

However, in the event the Committee feels this phase of the matter is not negligible, it will be recalled that the Committee's General Counsel is of the opinion that the Board of Governors could employ persons needed for the Committee's staff at salaries specified by the Committee; accordingly, this procedure appears to be available if the Committee concludes that technical "employment" of the Manager by the Board is preferable to his employment by a particular Reserve Bank.

Conclusion. It appears to me that, having due regard to the history and present status of the System's Open Market procedures, changes along the lines submitted by Mr. Martin are best calculated to achieve our objectives in this area, provided the Committee effectively utilizes the new arrangement by providing the Account Manager with more definite (and probably more frequent) directives than has been our practice in the past.