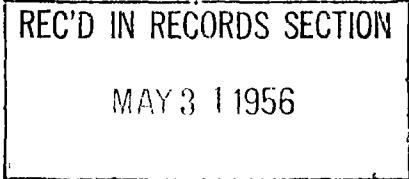


May 3, 1956

Confidential



To Members of the Federal Open Market Committee and
Presidents not currently serving on the Committee

From Vice Chairman Sproul

Chairman Martin's memorandum of April 17 seems to me to illustrate the all or nothing attitudes which have colored so much of our discussion of the "continuing operating policies" of the Federal Open Market Committee. Nudging the market in the direction in which credit policy would suggest or require is translated as rigging the market. Assisting in the underwriting of Treasury financing, when deemed desirable, is equated with injecting into the market hundreds of millions of reserve funds. Operating in all sections of the market, when it will forward the aims of credit policy, is misread as taking over the dealer function and using the System Open Market Account as a massive dealer portfolio. An attempt to measure the depth, breadth, and resiliency of the Government security market before and after the adoption of the "continuing operating policies" is met by assertions of belief and opinion that the market has responded favorably to the adoption of these policies. There is no place any recognition that possibly all is not black or white; that there may be a middle ground which we should at least explore.

Following are the specific points in the memorandum of the Chairman which call for more than the mere assertion of an opposing point of view.

Point 3. The Chairman's disagreement, in his point 2, with my observations concerning the performance of the Government security market during the past three years (which incidentally is something different from the money market, where I noted improvement) is followed in point 3 with the statement that judgments about the depth, breadth, and resiliency of the market cannot be based on statistical comparisons of the volume of transactions in various sectors of the market when the market was pegged with the volume of transactions in these same sectors when the market was free. But is that not the point of a whole section of the Ad Hoc Subcommittee report - that adoption of the policies it recommended would result in improvement in the functioning of the Government security market as compared with what it had been in the previous period of administered markets?

If my statistical methods are questionable, however, I must ask what measures are to be applied in judging market performance; or must we admit that there are no objective measures for testing improvement, and that we must rely on some sixth sense, bolstered perhaps by statements from individuals in the market? In this latter connection, I think there is much more to be learned from a study and analysis of developments in the Government security market as observed at the trading desk, where the whole market can be seen and its interactions observed, than can be learned from anecdotal reports from dealers and other participants in the market, who cannot see the market as a whole and usually have a special interest to develop or promote. So far as the judgments involved in operations are concerned, we have never found it possible to base action on generalizations derived from the statements of one or two dealers. We have always found it necessary to check directly against the reactions of other dealers, and against the actual performance that dealers demonstrate in the face of real transactions.

Point 4. We can all agree that present facilities for financing the operations of Government security dealers leave much to be desired, and that we should be working toward an improvement of this situation - which is what is being done. That is not to say, however, that the establishment of a call money market for Government security dealers is the answer or that giving non-bank dealers limited repurchase facilities over weekends and holidays is a desirable partial answer. There are arguments for and against both of these proposals. In any case, the need for improvements in dealer financing should not be allowed to divert us from further examination of our own performance.

I am somewhat baffled by the Chairman's statement that he cannot understand how the importance of keeping System initiative with respect to releases of reserve funds to dealers, in limited amounts, can be so strongly defended in the same memorandum (mine) that also strongly urges that the System go back to underwriting Treasury offerings. He says that we know from experience that such underwriting frequently involved injections into the market of hundreds of millions of reserve funds. At no point did I suggest that the System Open Market Account go back to passive and unrestrained underwriting of all Treasury offerings, and at no time did I imply that the System should give up the initiative as to the amount of reserve funds to be released if and when underwriting support was given. What I have suggested is that at times of Treasury financings the Federal Open Market Committee should decide whether or not, and in what amounts it wishes to provide underwriting assistance based on the whole situation surrounding the operation. The important consideration is that the Federal Open Market Committee should be free, in any given situation, to make the best choice possible in the light of all the circumstances and not be bound by rigid rules. The best choice should reflect our policy objectives with regard to bank reserves, and our secondary responsibilities to the Treasury which we have observed and must observe in any case. This is a far cry from a rigid policy of underwriting all Treasury financing operations, with complete loss of initiative over the release or absorption of reserves, which is the policy the Chairman seems to think I was advocating. What he must mean is that we cannot help ourselves, and that any step into underwriting will degenerate into a loss of control, whether we plan it that way or not. I have certainly not been blind to that risk, but my memorandum of March 21 attempted to show that the Treasury itself has made the pioneering tests for us, and that on the basis of all experience through 1955 there is no reason to accept the view that such degeneration will be forced upon us. The Chairman has given no answer to that.

Also under point 4 the Chairman misread my position concerning dealing in all sectors of the Government security market when he implied that it might mean that the Federal Open Market Committee would take over the dealer function, either by carrying an active portfolio in all maturity sectors or by making markets in all of these sectors. There is a considerable difference between this sort of thing and what I suggested, which was the occasional use of open market operations in various sectors of the market for specific purposes. Having the System Open Market Account take over the dealer risk function strikes me as a preposterous idea just as it strikes the Chairman. It is a straw man in this instance.

Point 5. We can all agree that constructive analysis of the problem of coordinating debt management and credit policy is needed. I suggested a joint Treasury-System study of the problem at least six months ago and attempted to

make a contribution toward such constructive analysis. What I do not agree with is that constructive analysis cannot consider the possibility of some measure of underwriting of Treasury financing under some conditions (which has nothing to do with "enormous seepages of reserve funds accompanying underwriting activities"). And what I suggest is that it is doubtful if System-Treasury relationships can be left on an all or nothing basis, or on the basis that all adjustments must be made by the Treasury, over the long run. We should be in a position to consider jointly with the Treasury the market impact of Treasury issues and the aspects of market performance or psychology that involve credit policy as well as debt management. And we should then determine our course, in each instance, rather than adopting rigid rules which will sooner or later appear to be doctrinaire to the political authorities.

Point 6. In point 6 the Chairman denies that long term rates were sluggish in responding to an easier credit policy during the late summer and fall of 1953. I had referred to this incident, in passing, as one period during which direct System operations in the longer end of the Government security market might have contributed to the effectiveness of System credit policy. The Chairman is right in stating that the records of the Federal Open Market Committee do not show that the Committee explicitly recognized the need to resist deflationary influences until its September 1953 meeting. But as early as May 1953 the Committee did see the need of avoiding a further tightening of the reserve position of the banks and in June the Board of Governors announced a reduction of reserve requirements. There can be little doubt that policy, in fact, was changed during May and June and that it contemplated a check to further constriction and rising rates in the capital markets. The record shows that the capital markets were sluggish in responding to this change. Until the fall quoted yields on Government securities, municipal and corporate bonds stayed at levels above those prevailing during the period of tight money in the first four months of 1953. Whether or not the intention of the Committee to bring down long term rates is explicit, it is explicit in the doctrine of the Ad Hoc Subcommittee report that reserve changes of the magnitude then effected would, through market arbitrage, bring about this result. The fact that easing the money market by large scale provision of reserve funds did not bring about this adjustment, except after a considerable period of time, is the point I wished to make with respect to our experience in 1953.

If that experience seems cloudy in retrospect, however, we need go back no further than the latter part of 1955 for another example of sluggish arbitrage hindering the effectiveness of credit policy. This was a period during which long term rates moved in the opposite direction from that indicated by System credit policy for some time. Direct action in modest amounts in the longer term sector of the market might then have helped to correct faulty expectations which were causing this perverse rate movement.

Point 7. In summary, the Chairman argues under point 7 that the proper effects upon the cost and availability of funds at all maturities can be achieved through operations in very short term securities which have the effect of changing the supply of reserves. He grants that direct operations in longer maturities will have a more immediate effect upon the cost of funds in the capital markets, but he argues that this effect will not be lasting - will, in fact, constitute a temporary "rigging" of the market - since these relatively small operations do not bring about a change in the supply of investment funds in the amounts required to clear the market at the newly quoted price.

In the first place, I would say that the admission that the rate effect of operations in the longer term sector of the market would be more rapid than the effect of operations in the short sector, constitutes important support of my argument, particularly at times when policy is in the process of change and an immediate reflection of this change in the longer markets would be an important adjunct to the simultaneous change in the conditions of credit availability at commercial banks and in the short term market generally.

In the second place, the Chairman's contention that changes in long term price and yields resulting from direct System participation in longer term security markets would be only temporary, and that yields would have to return to a level consistent with previously existing supply and demand conditions, seems to me to be an oversimplified economic interpretation of the way in which prices are set in the market. Supply and demand are not fixed and unchanging magnitudes that must, in a free market, irresistibly restore a particular equilibrium price. It may be useful to think of these forces as the economists do, in terms of supply and demand schedules. These schedules can change in shape or shift in either direction as circumstances change, with the changing points of intersection of these schedules giving a changing set of "equilibrium" prices. Moreover, among the factors affecting the shifts in these schedules, or changes in their shape, are changing expectations. And whether we like it or not, expectations concerning System policy will inevitably be a part - and often as much a part as the present volume of bank reserves - of the forces that determine the market's prices and yields. The question is whether we can at times, when the market is obviously groping for clues as to our policy, be content with ambiguous signals that are being misinterpreted by the market.

I have never argued that over periods measured in months or years we should try to maintain a rate structure that did not reflect market reactions to supply and demand factors. But I do contend that when reserve action is taken, and the capital markets show no response or even move perversely, the System should be able to give these markets a "nudge" (not rig them), directly. Prompt market arbitrage from the short sector to the long sector is often lacking, although over longer periods it eventually works itself out. We are concerned with what happens in between. And it is in these short periods that the Chairman seems to concede my point.

The relevance of my argument that such direct action, at times, may enable us to economize in the use of reserve funds, is that the direct approach avoids the temptation of flooding the market with reserves, or applying excessive pressure at the short end in order to get the desired effects at the long end.

Finally, and in general, I would stress that I have not at any time suggested that operations in any sector of the market should ignore the reserve effect of these operations; the Chairman's memorandum seems to imply that the operations I suggest might be undertaken without regard to reserve effect. I have simply suggested that our policy objectives cannot be defined wholly in terms of the supply of bank reserves, but must encompass the availability and cost and credit of all maturities, and the influence of expectations concerning System policy upon all maturities. In fact, discussions at Federal Open Market Committee meetings, and elsewhere, by System officials indicate that objectives are phrased in this broader context. I argue, therefore, that in order to execute policy more effectively we should leave ourselves free to engage in

those operations that, from time to time, might give us effects in the long term market that could not be achieved, or could only be achieved with a lapse of time, through operations limited to the short end. It is axiomatic, of course, that our operations in the long term area would have reserve effects, and these reserve effects would at all times have to be integrated with our policy objectives in the bank reserve area - a point which I was quite careful to make in my March 21 memorandum.

What we now need is not a re-statement of articles of faith, but an objective study and analysis of our experience during the past three years and a determination as to whether or not that experience, in theory and in fact, justifies the continuance of our "continuing operating policies".