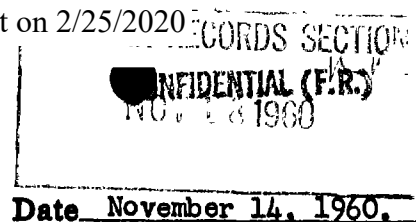


BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

To Chairman MartinSubject: Instructions to the Desk--From James L. KnipeFOMC.CONFIDENTIAL (FR)

Within the System there appear to be three general schools of thought as to how instructions ought to be handed to the Desk. These schools might be called:

- I. The "Total Reserves" or "It is our responsibility and let's do the job" school.
- II. The "Free Reserves" or "Yes, it is our responsibility, but let's be practical" school.
- III. The "Market Tone" or "Let's tell the Desk how we are thinking and they will feel their way to a proper policy" school.

There are many, and ever-changing, combinations of thought within and among these three schools. For example, the "Total Reserves" idea may be replaced from time to time in favor of "Nonborrowed Reserves" as a more useful measure. Or the "Free Reserves" goal may be modified with an interest-rate (market) caveat. Or the "Market Tone" school may occasionally firm up an instruction with reference to some specific range of yields on, say, 91-day bills.

There is, of course, something to be said on behalf of each of these three schools. A few remarks on one characteristic of the schools may aid in highlighting a point which deserves emphasis.

Who is in command?

The most basic difference between School I, on the one hand, and Schools II and III on the other hand, is related to the question of whether

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the Federal Reserve System is essentially an active or a passive agent. If the System is to be the active leader of the financial community, then its thinking must be concerned primarily with the levels of either "Total Reserves" or "Nonborrowed Reserves," or both. It is these levels which must be manipulated, sometimes with little regard to the current level of "Required Reserves," if the System is to lead the banks in the money-creation process toward the amounts it feels are proper for the economy. Granted that it is theoretically possible for the System to lead the banks by manipulating "Total Reserves" through changes in "Free Reserves," the fact remains that there is sometimes a tendency on the part of policy makers who work with "Free Reserves" to lose sight of the fact that they are really aiming at changes in "Total Reserves."

School II accepts as given whatever level of "Required Reserves" will be established by current banking practices during the next three weeks and decides on the desired degree of restraint or encouragement with reference to the distance of the level of "Nonborrowed Reserves" above or below the bank-determined level of "Required Reserves." If continuous, and principal, attention is devoted to "Free Reserves," it is clear that the System thereby tends to yield at least a portion of its leadership to the banks.

School III goes a bit further in the same direction, in that it tends to accept as given for the next three weeks the market structure of security yields as they will appear, together with the "tone and feel" of

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the market which accompany such yields. Policy is formulated only as a continuation of, or change from, such levels of yields and confidence.

What is practical?

The debaters who are most convincing, at least to me, are those who say, "We are all, of course, really in School I, but it is impractical to give a three-week instruction in terms of Total Reserves or Nonborrowed Reserves. One must accept the financial community's actions as given during any three-week period, and plan policy as encouraging or restraining with respect to those financial community actions. Otherwise, financial markets might be thrown into chaos as a result of Total Reserve or Non-borrowed Reserve instructions."

This is a telling argument. If Required Reserves, for example, were to slip off sharply during the three-week period, for some unanticipated reason, an instruction couched in Total Reserve terms might very easily knock bill yields off by a hundred basis points. The opposite sort of thing could also happen, with bill rates jumping upward as a result of an unexpected rise in Required Reserves.

What is wrong with Schools II and III?

There is nothing wrong with Schools II and III, in their less extreme forms, as I see it, provided:

- (1) They continually refer back to the movements of the levels of Total Reserves and Nonborrowed Reserves and adjust their three-week instructions to take these movements into account,

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- (2) They do not abdicate their responsibilities as members of the Federal Open Market Committee in the vagueness of their instructions, and
- (3) They do not create a record which is so fuzzy and inconclusive that it can neither be analyzed nor defended.

If these pitfalls are avoided, it is unfair to criticize a Committee which makes sure that its instructions are practical, workable, and realistic. The Committee cannot, and certainly should not, attempt to call every detailed turn for a Desk which has a long record of competence and integrity. The Committee cannot, however, escape the fact that it is legally entrusted with the responsibility for doing the job, explaining the job, and defending the job.

Some recent instructions.

On the next three pages are extracts from directives and policy entries (draft form) covering the last eight months. They are divided into three groups:

Group I March 1, 1960-May 23, 1960 -- 12 weeks.

Group II May 24, 1960-August 15, 1960 -- 12 weeks.

Group III August 16, 1960-October 24, 1960 -- 10 weeks.

In each case, there was a directive change to start off the period, followed by meetings in which the directive was left unchanged.

Any analyst, or critic, would naturally assume that the wording in the directives and entries would bear some relationship to, or give some

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hint of, the speed of easing which took place within any particular time-span during these eight months of easing. However, different analysts might disagree as to how the easing ought to be measured, whether in Total Reserves, Nonborrowed Reserves, or Free Reserves. Some of them might feel that one ought to go farther afield to measure the speed of easing, perhaps to interest rates, or to money supply, or even to the movement of the more distant objectives, such as production or prices.

Confining ourselves to Total Reserves, Nonborrowed Reserves, and Free Reserves, may I suggest that the reader try to guess which of these Groups called for the speediest easing. The measurements are on the page following Group III.

A TWELVE-WEEK PACKAGE OF INSTRUCTIONS - I
(March 1, 1960 - May 23, 1960)

March 1, 1960 - Directive change -

To: ". . . fostering sustainable growth in economic activity and employment while guarding against excessive credit expansion."

From: ". . . restraining inflationary credit expansion in order to foster sustainable economic growth and expanding employment opportunities."

Comments in policy entry -

". . . it would be appropriate to supply reserves to the banking system somewhat more readily."

". . . a policy of moderately less restraint."

March 22, 1960 - Comments in policy entry -

". . . maintaining about the existing situation, with no tightening and with no further relaxation."

April 12, 1960 - Comments in policy entry -

". . . easing slightly the reserve positions of member banks . . ."

May 3, 1960 - Comments in policy entry -

". . . moving modestly in the direction of increasing the supply of reserves. . ."

A TWELVE-WEEK PACKAGE OF INSTRUCTIONS - II
(May 24, 1960 - August 15, 1960)

May 24, 1960 - Directive change -

To: ". . . fostering sustainable growth in economic activity and employment by providing reserves needed for moderate bank credit expansion."

From: ". . . fostering sustainable growth in economic activity and employment while guarding against excessive credit expansion."

Comments in policy entry -

". . . further moderate supplying of reserves . . . with a view to permitting a moderate expansion of bank credit . . ."

June 14, 1960 - Comments in policy entry -

". . . marking time and watchful waiting . . . with the understanding that any deviation in the conduct of open market operations should be on the side of ease rather than restraint."

July 6, 1960 - Comments in policy entry -

". . . mark time . . ."

July 26, 1960 - Comments in policy entry -

". . . continue to make reserves for bank deposit expansion readily available."

A TEN-WEEK PACKAGE OF INSTRUCTIONS - III
(August 16, 1960 - October 24, 1960)

August 16, 1960 - Directive change -

To: ". . . encouraging monetary expansion for the purpose of fostering sustainable growth in economic activity and employment."

From: ". . . fostering sustainable growth in economic activity and employment by providing reserves needed for moderate bank credit expansion."

Comments in policy entry -

". . . doubts should be resolved on the side of ease . . ."

". . . take into account, to a greater extent than usual, the tone of the market . . ."

September 13, 1960 - Comments in policy entry -

". . . supplying needed reserves readily . . ."

". . . resolving doubts on the side of ease . . ."

". . . more on the basis of the tone of the market than on the basis of statistical yardsticks."

October 4, 1960 - Comments in policy entry -

". . . supplying needed reserves readily . . ."

". . . resolving doubts on the side of ease . . ."

". . . with the feel and tone of the market to be emphasized more than statistical guidelines."

What happened

(Measured in three-weeks' averages, from just before the beginning of each period, to the last three weeks of the period.)

Group I, March 1, 1960 - May 23, 1960 - 12 weeks

| | | |
|----------------------|------|-------------|
| Total Reserves | + \$ | 97 million |
| Nonborrowed Reserves | + \$ | 391 million |
| Free Reserves | + \$ | 304 million |

Group II, May 24, 1960 - August 15, 1960 - 12 weeks

| | | |
|----------------------|------|-------------|
| Total Reserves | + \$ | 324 million |
| Nonborrowed Reserves | + \$ | 485 million |
| Free Reserves | + \$ | 217 million |

Group III, August 16, 1960 - October 24, 1960 - 10 weeks

| | | |
|----------------------|------|-------------|
| Total Reserves | + \$ | 166 million |
| Nonborrowed Reserves | + \$ | 353 million |
| Free Reserves | + \$ | 350 million |

* * * * *

For the entire 34 weeks:

| | | |
|----------------------|------|---------------|
| Total Reserves | + \$ | 587 million |
| Nonborrowed Reserves | + \$ | 1,229 million |
| Free Reserves | + \$ | 871 million |

* * * * *

Using these three methods of measurement, the Groups rank as follows:

| | |
|-----------|--------------------------------|
| Group I | 3rd as to Total Reserves |
| | 2nd as to Nonborrowed Reserves |
| | 2nd as to Free Reserves |
| Group II | 1st as to Total Reserves |
| | 1st as to Nonborrowed Reserves |
| | 3rd as to Free Reserves |
| Group III | 2nd as to Total Reserves |
| | 3rd as to Nonborrowed Reserves |
| | 1st as to Free Reserves |

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Has vagueness gone too far?

Perhaps the reader will not agree, but to this observer no relationship is readily apparent between the wording and the actions taken during these past eight months. The directives are cast as such pious expressions of intent that they convey, in their changes, almost no meaning after the obvious switch of March 1. As to the policy entries, they seem even less satisfactory. One gets very little sense of progress from one meeting to the next, and not much of an account of what has just been accomplished or what the Committee believes ought to be accomplished during the next three weeks.

With all of its problems, would not the restoration of some use of numbers be a good idea? Ought not some reserve levels be mentioned, both in retrospect and in prospect?

The "Policy Analysis Sheet"

My answer to the two questions just posed is, of course, "Yes." To that end, the "Policy Analysis Sheet," with its three accompanying pages of figures, has been prepared as a handy device for encouraging gradual return to the use of numbers in the instructions which are handed to the Desk. It is fully recognized that this use of numbers must be practical, and that it can easily be carried beyond realistic limits. At the moment, though, it would seem as though the instructions have swung much too far away from numbers.