



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

REC'D IN RECORDS SECTION

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April 8, 1960.

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

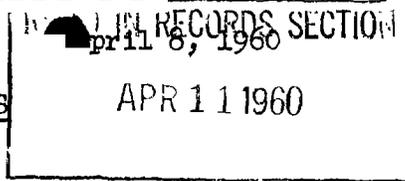
FROM: Mr. Young

Enclosed is a draft of letter that would be sent by Chairman Martin to a group of Senators in response to a letter which they addressed to him under date of March 12, 1960. It is contemplated that at the close of the Open Market meeting to be held on April 12, there will be an opportunity for comments regarding this proposed letter.

A handwritten signature in cursive script that reads "Ralph A. Young".

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

Enclosure



DRAFT OF PROPOSED LETTER TO 21 SENATORS

Dear Senator:

Let me thank you again for the interest in monetary affairs shown by you in the letter of March 12 which you signed with other Senators. It is important to have public understanding of our monetary problems and of the reasoning that underlies decisions in this field. The very fact that there are no easy answers to the problem of maintaining a sound money makes even more important thoughtful study and discussion of the subject.

On the basis of your letter, it would appear that we can readily agree that monetary policy should exert a counter-cyclical force, combating inflation and deflation alike so as to contribute to a healthy, growing economy, aided by stability in the purchasing power of the dollar, that will provide a high level of dependable jobs. That agreement over the methods of attaining these objectives is more difficult to achieve than agreement over the objectives themselves is only natural, since highly technical matters are involved.

The portion of your letter concerning the desirability of preventing harmful speculation and undesirable practices in the Government securities market illustrates the point. The fact that neither the Treasury nor the Federal Reserve has as yet felt ready to recommend legislation directed to that end is not ascribable to a reluctance to make detailed legislative proposals if we were confident that the proposals would be workable and effective. Our study of the problem has shown that some very real, practical difficulties would be faced in drafting such legislation.

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I am sure that we all agree that it is important to maintain a strong and efficiently functioning market for Government securities. To both the Treasury and Federal Reserve, this is a matter of primary importance. By and large, we have such a market today. In this country, indeed, we are accustomed to a broad, resilient market through which: (a) large amounts of funds can be transferred expeditiously and at low cost among financial and nonfinancial institutions; (b) the Treasury can float substantial cash offerings of securities without formal underwriting; and (c) the Federal Reserve can provide or withdraw bank reserves as needed. In striving to correct market imperfections or deficiencies, care is needed to avoid injuring the market's capacity to bring buyers and sellers together in transactions involving both very large and relatively small amounts of investible funds.

When legislation to regulate the securities industry was being formulated in the early 1930's the Congress determined that the interests of the Government and the economy in general called for the exemption of both U. S. Government securities and those of State and local governments, and the Congress excluded them from the legislation as enacted. One of the difficult questions raised by proposals to regulate trading in and margin on U. S. Government securities is whether such regulation could and should also include State and local issues.

If you have had an opportunity to examine the quite voluminous study of the Government securities market by the Treasury and the Federal Reserve System, copies of which were provided to the member of the Joint Economic Committee and to the Chairmen of the Committees on Banking and Currency, Ways and Means, and Finance, in July 1959, I am sure you will

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share the view that this is a very complex subject, with a highly technical background.

As the Congress recognized in the 1930's, the Government securities market differs from the stock market in many important respects. Stock brokers carry margin accounts for their customers, thus extending credit directly to them. The vast bulk of margin transactions in stocks is handled in this way. In contrast, most of the transactions in the Government securities market are handled by dealers who, unlike brokers, take positions in securities, and absorb the market risk growing out of any fluctuations in their value. Borrowing for purchasing or carrying of Government securities by these dealers is arranged through a wide variety of channels, bank and nonbank. The transaction between the dealer and his customer is a cash transaction. For this reason, the regulation of U. S. Government security dealers or their practices would not have any effect on the margins on which securities are carried by their customers, who must arrange the financing from other sources.

An important use of credit in this market is by dealers to finance the holdings of Government securities which constitute their "stock in trade." Dealer borrowing is both protected and limited by their capital as well as by any specific margin lenders may impose on dealers' borrowings. I am sure that we are all mindful that any significant additional limitation on the availability of financing to dealers would necessarily reduce dealer participation in Treasury financings, to the disadvantage of the Government. It should also be mentioned that a large share of dealer financing relates to the carrying by

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dealers of very short-term Treasury bills, where the period to maturity is so short that the risk of loss attributable to market fluctuations is negligible.

As we further assess the problems of preventing undue speculation in Government securities it has seemed to both the Treasury and the Federal Reserve System that substantial progress can be made toward desired objectives under existing authority. One approach that has been receiving close study has been the issuance of a supervisory instruction to Federal bank examiners that prudent and sound bank lending practice calls for appropriate margins in the case of all loans to non-dealer borrowers against Government securities as collateral. It is possible that an approach of this kind would not only influence the lending practices of banks but also, indirectly, those of nonbank corporations that advance funds on a temporary basis to the Government securities market through repurchase agreements and similar arrangements. Leading banks and corporations probably have been made cautious by the unfortunate consequences of under-margined credit such as occurred in the 1958 episode, and the managers of these institutions likely want to avoid any repetition of this experience.

In addition, the Treasury has already announced plans to modify its refinancing procedures to discourage the assumption of speculative positions in maturing issues. When appropriate, it will rely on issues for cash rather than on exchange offerings, thus making it feasible to require sizable downpayments as a bar to excessive speculation. Also, the absence of value on the "rights" of holders of maturing issues would avoid speculation in "rights," and curb speculation

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in the market at the time of refundings. This type of speculative activity was an important source of instability in the Government securities market in mid-1958.

Last year's study of the Government securities market revealed evidence of widespread satisfaction on the part of buyers and sellers with the mechanism of the market and the trading practices which prevail in it. We found little or no feeling that present mechanisms or practices are disadvantageous to the investing public to any significant degree, and we gathered a definite impression that existing transaction arrangements are efficient and economical. There was a commonly expressed need, however, for additional statistical information, available promptly to the public, about the flow of transactions through the market, and about the market's use of credit. The Treasury and the Federal Reserve System have now inaugurated such a program. From the standpoint of public interest, these comprehensive factual materials about the market should be helpful in future evaluations of its performance, and in identifying what needs there may be for regulatory intervention.

It is our belief that this informational program will be an effective supplement to the steps mentioned above, all of which will help to reduce the future dangers of speculative excesses in the market. It is not possible to determine at this stage if such steps will be sufficient to avoid completely future speculative excesses. We will continue, therefore, to study the problem as to whether statutory regulation of the market is desirable, and, if so, what character it should take to be most effective.

The second item in your letter would have the System discontinue the practice of normally limiting its transactions in the United States Government securities market to the short-term sector. By this limitation, which has been inaccurately referred to in some critical commentary as the "bills only" policy, the System limits the effect of its open market operations on the term structure of security yields and prices established by the free interplay of savings--investment processes in the market. From inception of this policy, the System has been aware of exposure to criticism by those who adhere to the viewpoint that the Government should exert more active, direct influence over the levels and structure of market interest rates. To take account of this viewpoint and make sure, in the light of developing experience and critical reappraisal, that its policy was effectively serving the public interest, the System has frequently reviewed this decision. The Open Market Committee is prepared to make, and in fact does make, adaptations in its operating procedure when it believes that economic or market conditions call for such action. For example, the Committee authorized such adaptations in November 1955 and July 1958, when the System acquired some longer term securities, in connection with Treasury financings; and in August 1959 and February 1960, when the System exchanged its maturing issues for other than short-term securities.

That the System has shown its readiness to make adaptations to unusual conditions does not alter the fact that the System needs normally to follow operating procedures which will have as little disturbing influence as possible on the functioning of the Government securities market.

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It follows that, if the System is to abandon its practice of normally conducting its open market operations in short-term securities, the alternative adopted should measure up to this criterion. On the basis of our experience, the Federal Open Market Committee does not believe that an alternative of continuing intervention in the long-term as well as short-term sectors of the market would result in a better functioning market from the standpoint of public interest and does believe that such a policy would make the market more unstable.

For these reasons the Federal Open Market Committee has continued the System's procedure of normally conducting its operations in short-term securities. However, if the suggestion that we abandon our present operating procedure is based on the assumption that our present policy is as rigid and inflexible as is sometimes attributed to us, I want to assure you that we have always been and continue to be prepared to alter these procedures whenever conditions may make it appropriate to do so.

On your third point, we are in substantial agreement. Our principal difference would seem to relate to the way in which changes in the turnover or velocity of money should be taken into account in arriving at a rate of growth in the quantity of bank credit and money that will be consistent with maximum economic growth and reasonable price stability. As I have testified to the Congress on various occasions, it is the Board's position that we should provide for such increases in the money supply as can be absorbed in a growing economy without generating inflationary pressures. Over the long run this may result in a rate of growth in the money supply which, as you suggest, might broadly match the long-term growth in real gross national product.

In your discussion, however, you suggest that the relationship between the money supply and gross national product over a period of a few years will tend to be quite close. Actually, short- and intermediate-term fluctuations in the ratio between these two aggregates, which is sometimes referred to as income velocity, appear to be fairly wide and to have a degree of independence from the pace of economic growth. These trends are related in part to variations in the public's attitudes toward the use of funds in general, and particularly to movements in the volume of other assets in the community which perform a short-term store of value function in competition with currency and demand deposits--often referred to as liquid assets, near monies, or money substitutes.

For this reason, we have found that it is important to consider not only the volume of money, narrowly defined; i.e., demand deposits adjusted and currency outside banks, but also the amount of time deposits at commercial banks and mutual savings banks, of shares in savings and loan associations, and of savings bonds and short-term Government securities in the hands of the public. If one includes the growth in these liquid assets in recent years, money and liquid assets expanded by an average rate of 4.2 per cent per year from 1953 to 1959. In my own judgment, the principal explanation of the slow rate of growth in the money supply over postwar years is that, during the war period, the public's holdings of money and of other liquid assets, especially U. S. Government securities, were built up to an abnormally high level relative to gross national product, and, hence, in postwar years less expansion in money was needed while we returned to a more normal relationship between the money supply and gross national product.

The final point in the letter is an important but technical one. Its acceptance would require the System to determine in the present its choice as to the use of the instruments of monetary policy in future circumstances.

It is my personal view that, in absorbing the large volume of redundant reserves generated during the great depression in the 1930's and then supplemented by war finance, reserve requirements were pushed up to levels higher than are necessary or desirable in the long-run, and higher than Congress intended they should be maintained indefinitely. It would be a mistake, however, to assume that it is our established policy to provide for all future increases in the money supply by reducing reserve requirements from the present average of around 16 per cent to some lower level, say 10 per cent.

I should like to point out that, in reply to a question from the Joint Economic Committee last fall, the Board stated unequivocally that "The Federal Reserve has had no policy specifically directed toward achieving a long-run secular decrease in reserve requirements." It follows from this statement that the Board accepts the use of the open market instrument as one way, and an important one, of providing the bank reserves needed to support long-term growth in the money supply. The System, in fact, has added to its holdings of United States Government securities regularly for this purpose in the decade since the Treasury-Federal Reserve accord. What the Board is not prepared to do is to commit itself and its successors not to use an instrument for monetary regulation that Congress devised and reaffirmed in the last session, when, all things considered, the use of that instrument would be the

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best way of making reserve funds more readily available to the banking system.

I might mention in this connection that legislation passed by the Congress in 1959 authorized certain changes in the structure of reserve requirements, including authority to count vault cash as reserves and the eventual elimination of the central reserve city classification. The equitable implementation of this legislation would appear to require some provision of the reserves needed for monetary growth through adjustments of reserve requirements.

To summarize, the Board's position on this point is that it would be improper for it to enter into any commitment which would limit the discretionary authority specifically granted to it by the Congress. We believe, and have testified, that it is desirable for the System to have authority to vary reserve requirements from time to time in either direction. We have also stated, however, that such authority is not indispensable to the effective day-to-day functioning of the System. If reserve requirements are to be maintained at present levels, or their use circumscribed, we believe that this should be accomplished by legislative action, not by a renunciation of authority by the Board.

In closing, I want to assure you of the Board's desire to cooperate with you at all times in furthering understanding of our policies, our reasons for them, and their relation to the economic condition of the United States.

Sincerely yours,

Wm. McC. Martin, Jr.