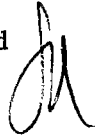


TO: Board Members and  
Reserve Bank Presidents

DATE: May 14, 1980

FROM: S. H. Axilrod



SUBJECT: Additional memorandum  
for discussion of reserve  
proposals.

Attached is a brief memorandum suggesting conclusions about the desirability of reserve proposals analyzed in the lengthy document circulated to Board members and Presidents at the time of the last FOMC meeting. The attachment and the earlier document would be a basis for discussion of the issues on the afternoon of Monday, May 19.

Attachment

CONFIDENTIAL (FR)

TO: Board Members and  
Reserve Bank Presidents

DATE: May 14, 1980

FROM: Messrs. Axilrod, Lindsey,  
and Simpson

SUBJECT: Reserve Proposals

At the time of the previous FOMC meeting, a lengthy document analyzing various reserve proposals was distributed to Board Members and Reserve Bank Presidents. These proposals included contemporaneous reserve accounting, reserve carry forward provisions, staggered reserve accounting, "reverse lag" accounting, and a 100 percent marginal reserve requirement. The proposals have subsequently been considered at a meeting of System economists. The present memorandum suggests conclusions about the desirability of the proposals as a possible basis for discussion at the time of the May FOMC meeting.

It would appear that discussion might most usefully be focused on proposals to change from lagged reserve accounting (LRA) to contemporaneous accounting (CRA) and possibly to alter the reserve carry-over provisions. The disadvantages of the other proposals discussed in the earlier document seem to us rather clearly to outweigh the advantages:

(1) "Reverse lag" accounting tightens the relationship between reserves and money, but bears a high risk of producing substantial money market disturbances as the Federal Reserve, and the banking system, are deprived of their usual means of adjusting to week-to-week variations in money and credit demands.

(2) A 100 percent reserve requirement on changes in deposits has certain monetary control advantages, but such a requirement apparently is not permissible under the new Monetary Control Act and in any event would add to short-run money market disturbances in the face of week-to-week volatility in money demand.

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(3) Staggered reserve accounting might moderate funds rate movements toward the end of reserve statement weeks, but this is a small potential benefit in light of the administrative complexity of the scheme and of the high risk of delaying the impact of monetary policy changes as reserve surpluses or deficits are shifted among banks.

From the viewpoint of improving short-run monetary control, without engendering undue market disturbances, a shift from lagged to contemporaneous reserve accounting merits more serious consideration than the alternatives noted above. Over the years, the advantages and disadvantages of CRA relative to LRA have been debated at great length within the System, and outside. The staff's latest assessment of the issues is contained in the memorandum dated January 21, 1980 that was recirculated at the time of the last Committee meeting and which was the basis for discussion among Board members and Presidents earlier this year.

In our view, the desirability of a shift from LRA to CRA depends essentially on the priority the System wishes to give to money stock control, especially over relatively short periods. A return to CRA would permit closer control of total reserves in the short-run, would re-establish a multiplier relationship between reserves and money that is based more directly on required reserve ratios, and would therefore lead to tighter short-run control of the money stock. Of course, short-run control over reserves and money would still be subject to slippages arising from (a) the uncertain speed with which banks and the public might respond to changes in reserve availability generated by open market

operations, given the buffers provided by the discount window and excess reserves, and (b) any federal funds rate constraint imposed by the Committee.

It should be noted, though, that CRA would tend to make any federal funds rate constraint imposed by the Committee less of an impediment to attaining a total reserve path than it would be under LRA. For example, in recent weeks when money growth was very weak relative to path, an attempt to hit the total reserve target would have led to large excess reserve holdings of banks, given that required reserves were determined by deposits two weeks earlier and had fallen well below expectations. If such excess reserves had been provided, attempts by banks to dispose of them, with required reserves fixed, would have led to an exaggerated downward movement of the funds rate. Under CRA, however, any deposit expansion that occurred within a statement week as efforts were made to achieve a total reserves target would raise required reserves in that week, reduce excess reserves, and limit the downward movement in the funds rate.

An attempt to achieve more precise week-to-week, or even month-to-month, control of money does have certain disadvantages that have to be considered. Such precision would lead to unnecessary short-run interest rate variation in response to transitory, self-correcting fluctuations in the public's holdings of money. To the degree that the Committee wished to moderate short-run interest rate movements in response to transitory money supply changes, it may wish to retain the option of adjusting its reserve path to movements in required reserves and deposits. Such an approach would be facilitated by retaining LRA and adjusting the reserve path in light of known movements in required reserves. Under CRA, because required reserves are unknown in any given statement week, there would be more uncertainty than under LRA about the relationship between the amount of nonborrowed or total reserves and the funds rate in any particular statement week.

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Banks appear to believe that a shift from LRA and CRA would make their reserve management somewhat more difficult. Thus, liberalization of carry-over provisions has been proposed as compensation. However, since the principal reason for returning to CRA would be to improve the mechanism for controlling the money stock, there seems little reason at the same time to liberalize carry-over provisions and weaken the short-run multiplier relationship between reserves and money. The present carry-over system-- whereby small allowable deficiencies or surpluses must be made in the succeeding week--probably does not produce undue slippage in the multiplier. But systems that would permit carry-over for longer periods than a week, even if there were penalty provisions associated with the carry-over, would clearly begin reproducing the problems of multiplier unpredictability associated with lagged reserve accounting.

If the duration of carry-over remains limited to one week, there may be a little scope for widening the present 2 percent carry-over limits-- say, by one percentage point more--to provide banks with some additional reserve management flexibility without seriously impairing or complicating monetary control. There may also be a practical reason for widening because the forthcoming reductions in required reserves under the Monetary Control Act will lower the dollar amount of the carry-over for individual banks, while there may be no commensurate reduction in the size of reserve disturbances. On the other hand, it should be recognized that the discount window is in any event available to relieve reserve adjustment pressures. Moreover, the new low reserve requirements under the Monetary Control Act of 1980 will mean that most smaller banks--which are typically less skilled in managing reserve positions--will, for operating purposes, be holding vault cash and reserve balances in excess of required reserves. Thus, they will hardly

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ever be faced with a technical reserve deficiency (unless the Board imposes the supplemental reserve requirement permitted by the new Act).

On balance, we would recommend reestablishment of CRA--and see no real need for compensating adjustments in carry-over provisions-- as a way of making control of the monetary aggregates under present reserve targeting procedures more effective. The Committee should recognize, though, that a return to CRA would reduce the predictability of the federal funds rate relative to any given reserve path in a statement week, because required reserves within the week could then vary with unexpected movements in deposits.