BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

October 12, 1961.

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Young

For your information and study, there is enclosed a copy of a letter from Mr. Ellis dated October 9, 1961, commenting on proposed changes in procedures for the Federal Open Market Committee. Also enclosed is a copy of a letter from Mr. Wayne dated October 11 on the same subject.

Ralph A. Young

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

Enclosure

FEDERAL RESERVE BANK
OF BOSTON

GEORGE H ELLIS
PRESIDENT

October 9, 1961

Mr. Ralph A. Young, Secretary
Federal Open Market Committee
Board of Governors of the Federal
Reserve System
Washington 25, D.C.

Dear Mr. Young:

During the September 12 Open Market Committee meeting we were urged to study the memoranda from Mr. Knipe and Mr. Broida with the objective of developing ideas as to improvement of the Committee's procedures. In accordance with the decision at the meeting of the Committee on September 12, I am submitting the following comments to you for distribution.

The FOMC faces the difficult problems of adjusting its actions to changing circumstances and seeking better public understanding of its actions. In this process we must avoid oversimplification that results in distortion of understanding. Reliance upon any single set of rules or imposing limitation of Committee action through such rules in policy determination is dangerous and risks denial of needed flexibility in adjusting policy to constantly changing conditions, the elements of which combine in shifting proportions.

Your memorandum of September 6, 1961, entitled "Discussion of Changes in The Committee's Procedures" with the several attachments provide a convenient basis for discussion of the issues. My comments deal separately with Attachment I -- Standing Rules Governing Open Market Practice of the FOMC; Attachment II -- The Committee's Continuing Authority Directive to the Federal Reserve Bank of New York; and Attachment III -- The Current Economic Directive to the Manager of the Account.

Attachment I

I urge the Committee not to attempt at this time the development and adoption of a set of "standing rules" to replace those suspended since February. The original purpose of the "rules" has been stated as helping to improve the functioning of the market for U.S. Securities by leading to greater self-reliance. The "rules" singled out certain Open Market Committee practices which had been characteristic of the pegged market and which in varied form had been continued during the early period after the Accord. Suspension of the "rules" in late February 1961 recognized new forces and different conjunctures of forces which required new working procedures to accomplish the objectives of credit policy. Experience with the new procedures that followed suspension of the rules has not been long enough to establish beyond reasonable doubt that the new techniques make a positive contribution. Evidence is lacking that the mechanical functioning of the market has been damaged. Market reactions have probably been no greater than those which would normally occur during a period of change characteristic of the last six months. At the same time, certain positive accomplishments of credit policy can be cited.

Under these circumstances it seems desirable that members of the Committee will wish to continue study of the new techniques against the framework of the market as it has now developed and changed relationship of economic forces as may have evolved in the last 10 years. Before any new set of "rules" or policies is adopted, the Committee should come into closer agreement on the matters of principle in operations. This reasoning leads me to conclude that the Committee should not attempt at this time to develop and adopt a set of "standing rules" to replace those in effect prior to February 20.

If this action is not agreeable to the majority of the Committee and a substantially similar series of rules as outlined in your memorandum is to be continued, it would be preferable to have them as brief as possible and not involve taking positions to which exceptions may have to be made. Any statement of policies adopted by the Committee should be pointed to what we want open market operations to accomplish in terms of credit policy and using them to make such policy effective. Necessarily, such a statement will have to be broad and general.

It would also seem to be logical that rules which may be adopted should be made a part of the Regulation Relating to Open Market Operations of Federal Reserve Banks, rather than appearing in portions of the minutes of Open Market Committee meetings which are published in the Annual Report of the Board of Governors. These rules seem in essence to be policies or working procedures and are thus generally similar to Regulation A which outlines the guiding principles or working procedures for carrying out the discount function. Placing the "rules" in the "Regulation" would cover open market operations in a suitable complement to Regulation A.

Even though the Committee may decide not to publish its policies as suggested above, it will need to consider the relationship between its published Regulation and Rules on Organization and Information and Rules on Procedure (as amended June 22, 1955) and the policies to be spelled out in the committee minutes. For example, would the Committee intend through adoption of Rule #8 to modify its Sec. 2, Par. (c) published statement on "Rules on Organization" as to frequency of meetings? This reasoning leads to the conclusion that the Committee might well adopt as a general practice an annual review of its entire set of rules and procedures to ensure their continued applicability and compatibility.

Turning specifically to the language of Attachment I, I realize that the present formulation of the rules represents a compromise in wording as will any which may be developed in the future. For this reason, I am limiting my comments below to examples of the way in which the concepts should be broadened and generalized.

Preamble and Rule #1

In its present form, the preamble in Attachment I must be considered as a formulation of basic objectives of the System. Taken in conjunction with Rule #1 as written, it is inconsistent with a statement of System objectives which appears as a foreword to Regulation A. Paragraphs (a) and (b) say in part: "This (discount) function is administered in the light of the basic objective which underlies all Federal Reserve credit policy, i.e., the advancement of the public interest by contributing to the greatest extent possible to economic stability and growth. The Federal Reserve System promotes this objective largely by influencing the availability and cost of credit through action affecting the volume and cost of reserves available to the member banks. Through open market operations and through changes in reserve requirements of member banks, the Federal Reserve may release or absorb reserve funds in accordance with the credit and monetary needs of the economy as a whole."

A redrafting of the preamble broadened to include some of the ideas in Paragraphs (a) and (b) of Regulation A or at least some reference to the fact that the Committee is interested in both availability and cost of credit in the markets seems essential. If changes along these lines are accepted, Rule #1 becomes unnecessary.

Rule #1 as worded can be accepted as an accurate description of the Committee's policy only if we interpret it to mean that supplying "reserves consistent with the credit and monetary needs. . ." also means supplying reserves in such a way as to affect interest rates consistent with credit and monetary needs. For example, the record of policy actions covering the Open Market Committee meeting of February 7, 1961, contains the following sentence: "This policy called for providing reserves to the banking system to meet the needs of the current business situation, and also avoiding direct downward pressure on short-term interest rates, or even permitting them to rise, in view of the relationship of the short-term rate structure to the balance-of-payments problem."

This excerpt and others like it in other portions of the record substantiate the view that the System is concerned with something more than simply to supply or absorb bank reserves. We must continue to be interested in levels of interest rates as an explicit part of open market policy. This being so, the language suggested in Rule #1 is an insufficient statement of the basic reason for open market operations. As a minimum, the word "primarily" should be inserted following the word "conducted" so that the statement would read: "Open market operations are conducted PRIMARILY to supply or absorb bank reserves. . . ."

Rule #2

The Committee presently seems to believe that operations in maturities other than short-term serve a constructive purpose. Under these circumstances it can adopt the proposed wording of Rule #2 only by simultaneously acknowledging that the rule does not apply at present by virtue of special circumstances. Why not solve this issue by not adopting any new rule on this subject until we can operate under it straightforwardly? Alternatively, it might be worded "Open market operations are transacted in U.S. Government Securities and in Prime Bankers Acceptances. MOST operations in Government Securities are conducted in short-term issues."

Rule #4

This rule, as written, may require exceptions from time to time and this may justify inclusion of a qualification from the outset. Insertion of the word "generally" after open market operations in line 4 will permit departure from usual practice when necessary. The justification for this is that the Committee should be in a position to consider jointly with the Treasury the market impact of its issues and the aspects of market performance that involve credit policy as well as debt management. The course of action should be determined by the Committee in particular instances rather than freezing its position and requiring the formality of amendment.

Rule #6

Rule #6 dealing with repurchase agreements concerns the release of reserve funds at a price and, if the first two rules are to be preserved, should be placed as Rule #3 which will associate it with other operations affecting availability and cost of reserve funds. An alternative would be to consider repurchases as part of the standing authorities and together these materials would be carried in an appropriate place in the "Regulation."

Rules #7 and 8

Both of these statements seem out of context in relation to the preamble and the content of the other "rules." They seem more adapted for presentation in the presently published Rules on Organization and Information and Rules on Procedure. In fact, as mentioned above, Rule #8 seems to modify a parallel statement in the published Rules on Organization.

Attachment II

Separation of the continuing authority directive from the current economic directive would be a major step toward improvement of the general framework of our working procedures. It should lead to a better public understanding of Committee actions. It also clears the way for improved expression of the Committee's current economic directive.

Here again, I urge consideration of placing these continuing authorities in the "Regulation" with annual review of all such regulations rather than publication through the Annual Report of portions of the minutes of our March meetings.

Incidentally, I prefer Mr. Allen's proposed wording to that in Attachment II and believe that the section dealing with repurchase agreements should be included as part of this material.

Attachment III

The four alternatives presented in Attachment III as possible forms of the current economic directive all have one thing in common. Each one has a phrase, sentence or paragraph describing the economic situation, followed by a statement of the direction policy is to take. Whichever alternative is accepted will be a constructive move. However, alternative "D" offers the best opportunity to improve on the clarity of instructions to the Account Manager. Unless the consensus can be stated more explicitly, "The entire burden of determining how much and what reflects more ease or more restraint is placed on the Manager," as stated by Karl Bopp in his March 1st memorandum.

The policy record clearly reveals the two reasons that have moved the Committee to change clause (b) -- changes in recognition of different economic conditions and changes to accompany monetary policy moves. The record also shows, however, that because only a single phrase was to be changed, reluctance to signify any change in policy sometimes delayed explicit recognition of changed economic conditions.

An explicit two-part directive should permit the Committee to recognize the course of economic activity over the cycle. It would also facilitate expression of the Committee's objective in terms of change in the relative degree of ease or restraint. Such an improvement seems possible. As stated in the Broida memorandum, "If the nature of the consensus can be succinctly summarized in the record it is not clear why it cannot also be reflected in the directive."

At the present time, when it appears to the Chairman at the outset of a meeting that it might be appropriate to consider some change in the language of the directive, he has suggested phraseology that has been referred to him by the Secretary. This has proved to be an advantage to those who wish to discuss changes in language during the go-around. It seems possible that this technique might be elaborated to the Committee's advantage.

Thus the Committee may wish to consider the advisability of inviting the Secretary, perhaps in collaboration with the Manager, to prepare in advance of the meeting a suggested statement of the main directive and one or two alternatives of the second part of the economic directive. These statements could be mailed to the members of the Committee in time to reach their offices on the Friday preceding the meetings. They could serve as a basis for discussion within staff groups in the various banks in their preparation for the meeting.

One advantage of this approach is that each participant in the meeting would have before him a suggested wording of the directive upon which he could base his comments. He could seek either to make it more specific or less specific. He could suggest modification of relevant magnitudes cited in the directive. This approach could provide a focus for discussion which would add definiteness to the consensus at the termination of the meeting. It would leave with the Committee the responsibility for determining the directive.

It seems that no more than three alternative wordings would be sufficient to cover the range of views that the Committee might wish to express at various times. By having the alternatives carefully worded in advance, the Committee would not be forfeiting its right to decide the course of policy, but would have before it some materials which would sharpen debate.

Sincerely yours,

George H. Ellis

President

FEDERAL RESERVE BANK OF RICHMOND

RICHMOND 13, VIRGINIA

October 11, 1961

Mr. Ralph A. Young, Secretary
Federal Open Market Committee
Board of Governors of the
Federal Reserve System
Washington 25, D. C.

Dear Mr. Young:

This is in reference to the Open Market Committee's procedures and directive, pursuant to your letter of September 6, 1961 and discussion at the Committee meeting on September 12, 1961. We gave you our views on several aspects of this problem in my letter to you of March 20, 1961. The comments below repeat some of those observations and also deal with proposals and suggestions which have been made since that time. Unless otherwise noted, all references are to the three attachments to your letter of September 6, 1961.

General Position

I strongly favor abandoning the present system with its cumbersome and ambiguous clause (b). I prefer dividing the statement of procedures and authorities into three parts: (A) The first part would set forth the standing rules of the Committee. (B) The second part would be the continuing authority directive to the New York Bank. (C) The third part would be the current policy directive to the New York Bank. In addition, as outlined below, I favor publishing a record of policy actions quarterly, with a lag of one quarter.

Under this plan the Committee would state its basic goals and purposes once a year in the standing rules and then omit reference to them in the current policy directive. I believe that the inclusion of what President Allen calls "pious pronouncements" in the current directive has done much to add to its complexity and obscurity.

General

I have one general but minor comment which applies to all three documents. The first time a reference is made to Government securities the words used are "United States Government securities." In most other cases they are described as "Government securities." In formal documents of this type it might be well to use the term "United States Government securities" in all instances.

Standing Rules

With the exception of paragraph 2, I agree with the draft of the standing rules as given in Attachment I. With regard to paragraph 2, I feel strongly that a change is in order, as I indicated in my letter to you of March 20, 1961. As the draft is now worded, it would not substantially change the present situation. The words "may authorize" mean that the Desk could not conduct operations outside the short-term field except on special authorization. If that authorization is not permanent, the making and rescinding of it would almost certainly involve extended debate. Further, the changes might well excite undue concern and speculation in the market when they become known either through rumors or from open market operations. In my judgment, the situation should be reversed; the authorization to deal in longer-term securities should be permanent and any limitation on it should be by special action. In addition, as I said in my letter of March 20, the statement as it now stands in the draft would almost certainly lead critics of the System to charge, with justification, that the System still clings to "bills usually." I suggest that this section should read as follows: "OPEN MARKET OPERATIONS MAY BE CONDUCTED IN UNITED STATES GOVERNMENT SECURITIES OF ANY MATURITY AND, AS AUTHORIZED, IN PRIME BANKERS' ACCEPTANCES. MARKET CONDITIONS AND PRACTICES, HOWEVER, WILL USUALLY REQUIRE THAT THE BULK OF THE OPERATIONS BE CONFINED TO SHORT-TERM SECURITIES."

Directive to the New York Bank

Section 1. The first two sentences of this section seem unnecessarily complex and obscure, while the last sentence appears to be vague and ambiguous. I prefer the following statement of the paragraph which, to me, seems clearer and more direct without changing the substance:

"(1) TO BUY, SELL, OR EXCHANGE UNITED STATES GOVERNMENT SECURITIES AND, AS AUTHORIZED, PRIME BANKERS' ACCEPTANCES IN THE OPEN MARKET FOR THE SYSTEM OPEN MARKET ACCOUNT TO THE EXTENT NECESSARY TO CARRY OUT THE COMMITTEE'S CURRENT POLICY DIRECTIVE. THIS INCLUDES REPLACING UNITED STATES GOVERNMENT SECURITIES WHICH MATURE BY DIRECT EXCHANGE WITH THE TREASURY OR ALLOWING SUCH SECURITIES TO RUN OFF WITHOUT REPLACEMENT. The authority of the Bank to increase or decrease the aggregate amount of United States Government securities (including forward commitments) held in the System account, other than such special short-term certificates of indebtedness as may be purchased for the temporary accommodation of the Treasury, under the provisions of (2) below, is limited to $1 billion during any period between meetings of the Committee, except as otherwise authorized. UNITED STATES GOVERNMENT SECURITIES AND BANKERS' ACCEPTANCES SHALL BE PURCHASED AND SOLD AT PRICES PREVAILING IN THE MARKET AT THE TIME PURCHASES OR SALES ARE MADE."

Current Policy Directive

I favor a current policy directive which is short and clear and with a format allowing a brief statement of the reasons underlying the directive. Perhaps alternative "C" in Attachment III would meet these requirements.

To facilitate action by the Committee in deciding on a directive, it might be well to have the staff submit draft copies of several versions of possible current policy directives along with its memorandum on economic conditions and which would be consistent with the analysis in that memorandum.

Reporting on Policy Actions

I have two suggestions concerning reports on policy actions.

(1) The draft of the policy record should be written by staff members as soon as feasible after the close of the period. This should be a succinct and clear statement of the reasons for adoption of the directive and, in line with President Allen's suggestion, might well include the directive, either verbatim or in substance. The Committee should then approve the draft, with such modifications as it prefers, so that it could be entered into the policy record.

(2) I favor publication of the policy record each quarter, with a lag of one quarter. There are several possibilities for publication but I would favor a quarterly paper in the Federal Reserve Bulletin. This would be a comprehensive and authoritative but compact summary of national monetary and credit developments, into which would be woven the account of the policy changes. If this method should be chosen, every effort should be made to maintain the highest possible level of competence and lucidity in the preparation of this paper. The staff member charged with preparing it should maintain a running account during the quarter to be covered. Shortly after the end of the quarter he should put it into shape for a thorough review and appraisal by all members of the Committee and all presidents of Federal Reserve Banks who are not members.

I see no valid reason for the present long delay in publishing parts of the policy record. Publication along the lines described above would not only end one of the persistent and potent criticisms of the System but would also provide all parties with a useful and authoritative account of monetary and credit developments as well as a rational account of policy action while it is still pertinent, yet not current to the extent that it might defeat the purposes of the Committee.

Sincerely yours,

Edw. A. Wayne

Edw. A. Wayne
President