

Bank that it was able to retain control of the Manager's office. During the same period President Allan Sproul, of the New York Bank, was often at odds with the passive implications of the "bills only" policy in open-market operations, which was mainly devised and defended by the Board and its staff in Washington; Sproul favored more active intervention. This issue disappeared when the "bills only" policy was abandoned in 1961. Sproul, broken in health, had in the meantime resigned in 1957; and thereupon the Board in Washington, in a rare exercise of its authority to do so, vetoed the initial selection of his successor proposed by the New York Bank's directors—not, however, to secure a more docile appointee, but to bring in an outsider.

#### LAY AND PROFESSIONAL

Central bankers were nonexistent in the United States when the Federal Reserve came into being. Of the five appointive members President Wilson put on the original Board, the three strongest were W. P. G. Harding, a Birmingham, Ala., banker who presently became Governor of the Board; Paul Warburg, of the investment banking firm of Kuhn, Loeb, who was German-born, of a wealthy banking family and thoroughly acquainted with European banking traditions and practices; and Adolph Miller, an academic economist. Able as they were, none understood what was later to become the System's principal function. The governors of the 12 Reserve banks were commercial bankers. The leading academic experts on banking, whose views were influential in the formative years of the System—Willis, Sprague, Kemmerer—were all committed to doctrines about it (e.g., that it had solved the problem of recurring bank liquidity crises for all time) that the depression experience presently proved to be fallacious.

The development of central banking as a profession with an outlook, a body of principles, and a set of loyalties distinct from commercial or investment banking, came slowly. Its beginnings can perhaps be traced to the emergence and self-education of Benjamin Strong, governor of the New York bank during the 1920's and to the establishment, at about the same time, of the Research and Statistics Division on a professional basis in the office of the Board in Washington. Over the succeeding 40 years, but particularly since World War II, the professionalization of the System has come a long way, and with profound effects on its working. Outward evidence of the transformation can be seen in the extent to which the System has become the prime source for the recruitment of its own leadership. The evidence is plain even in the composition of the Board of Governors, who are Presidential appointees requiring Senate confirmation; it is overwhelming in the selection of the Reserve bank presidents and in the long service and low turnover rates of other Reserve bank officers.

Of the eight men on the Board of Governors during part or all of 1963, the two newest, Mitchell and Daane, were both economists and professional products of the System, one with a decade and the other with two decades of service in a Reserve bank. Vice Chairman Balderston, former dean of the Wharton School, had been a director of the Philadelphia Reserve Bank. Two others, Shepardson and King, had been directors of Reserve bank branches, at Houston and New Orleans, along with their business concerns. Robertson had been a career official in the Office of the Comptroller of the Currency since 1933 and was Deputy Comptroller, in charge of national bank examinations, when he was promoted to the Board. Chairman Martin had grown up in a Federal Reserve atmosphere: his father was the chief executive of the St. Louis Reserve Bank from its founding. Only Governor Mills, a civic leader from Portland, Oreg., was a commercial banker.

Of the 12 Reserve bank presidents in 1963, no fewer than 9 rose to their posts from a decade or more of Reserve bank employment, 7 of them in the same banks they came to head and 2 by transfer from another Reserve bank. Six of the nine were economists and advanced by way of the research divisions of their banks. Two lateral entrants, one an economist and the other a lawyer, came from business firms to their Reserve bank presidencies only after 3-year apprenticeships as senior vice presidents of their banks. Only one came directly from the outside; but this one, significantly, was President Hayes, of the New York Reserve Bank, who moved into the most important operating post in the System from a Wall Street commercial bank, where he had headed its foreign department.

Professionalization means orderly routines in procedure and hierarchy in organization, and an ethical code of commitments to professional standards and to organizational objectives—the characteristic virtues of bureaucracy. The Federal Reserve exhibits these virtues. But in the current context, professionalization also means institutional inbreeding, and, in turn, the growth of dogmas and a tendency to propagandize. The Federal Reserve exhibits these flaws. Furthermore, it is an old adage that experts, even the inquiring sort, should be on tap, not on top. Final decisions on important matters affecting the welfare and prosperity of the people are political decisions. They should be made after listening to expert advice, but they should be made by officials who are politically responsible. In a democratic country—not a technocracy—the consent of the governed is as necessary as professional competence.

So far as its immediate clientele, the financial community, is concerned, the System has had its difficulties on this score in the past, but none of serious consequence since World War II. In part, its good public relations with bankers may be laid to the participation of member banks in the election of Reserve bank directors; but this did not save it, from bankers' criticisms on controversial occasions in

earlier years. In part, the personal prestige of top officials in the System helps win consent. The main reason for its solid support among bankers, however, is no doubt the happy blend of conviction and prudence that has kept it from asking for additional powers over banks, or using those it already has in ways that would arouse their intense opposition. Moreover, a decade of slowly rising interest rates and significant reductions in reserve requirements has helped to improve the profitability of banking. Profits for banks make for support from bankers.

In the wider political arena the System enjoys the general advantages that go with a reputation for expertise in an occult craft, so long as all goes well. The technical merits of monetary and credit policy are beyond the attention or comprehension of the lay citizenry. Myths and slogans—a “sound dollar”—are readily available to brush aside serious questioning of System policies before lay audiences. In these circumstances the Federal Reserve commands an easy consent from the general public for the measures it takes during prosperous times. No affirmative marks of approval need to be obtained, no elections need to be won.

But in adverse times, if widespread distress stirs inarticulate doubts about the wisdom of System policies, a very heavy burden of political responsibility will fall on the Chairman of the Board of Governors. The tasks of political leadership—of defining and defending goals and policies, of rallying and mobilizing outside support for them—are his necessarily, for want of anyone else to sustain them. The President, the Secretary of the Treasury, or individual Members of Congress may come forward to his aid; or they may prefer to stand aside, uncommitted. The New York Reserve Bank President, who holds the other place of political leadership in the System, may rally the financial community but he is too close to Wall Street to carry persuasion to the general public. The financial community nevertheless is a potent political force, and the New York bank president, speaking for it, has many indirect means of exerting its influence, including automatic access to the leading metropolitan newspapers and the financial press. The other members of the Board of Governors, to whom a measure of consent can be imputed by reason of their senatorial confirmation, do not have the political stature required. The other Reserve bank presidents are unequipped, indeed positively disqualified, for political roles by their status as bureaucrats and by the standards for their selection. The striking contrast between the short term of Chairman McCabe and the longevity in office of Chairmen Eccles and Martin is in large degree a measure of the differences in their political talents and skills. Eccles and Martin, however, exhibit very different styles of political operation. Eccles freely resorted to public statements. Martin, on taking office told a Senate committee: “\* \* \* I should never, as Chairman \* \* \* go to the people with an issue.”<sup>14</sup>

<sup>14</sup> Hearings, “Nomination of William McChesney Martin, Jr.,” Senate Committee on Banking and Currency, 82d Cong., 1st sess., Mar. 10, 1961, p. 18.

## PUBLIC ACCOUNTABILITY

Central banks the world around, even when they have been thoroughly integrated into their governments, are traditionally and notoriously closemouthed about their policies, their negotiations with each other, and their market operations. Among central banks the Federal Reserve stands out, by contrast, as rashly candid in the detail and promptness with which it discloses information about its affairs. In the world of American government and politics, however, where all agencies disclose more of what they do than their counterparts in other countries, the Federal Reserve is not noted for baring its secrets. How much privacy it is entitled to has been a perennial subject of controversy; and the System, confronted with the argument that monetary policy in a democracy is a legitimate topic of public debate which, to be fruitful, must be fully and currently informed, has usually been on the defensive. It has given ground on some matters, slowly and with apparent reluctance; on a few it has been adamant.

One branch of controversy relates to housekeeping affairs and the bounds of legislative control: how much is spent for what and paid to whom in the course of System operations? The annual reports give summary aggregates for broad categories. What details will be disclosed or withheld? What form of audit shall suffice? The Board's expenses are covered by semiannual assessments on the Reserve banks. These assessments together with the other—and far larger—expenses of the Reserve banks are deducted and paid from their revenues before their profits are paid over to the Treasury. In law, the Board has a virtual *carte blanche* to decide these matters, and “assessments shall not be construed to be Government funds or appropriated moneys” (sec. 10).

In practice the Board employs a private firm of accountants to audit its own accounts. The Board's examining staff audits the accounts of each Reserve bank and reports the audit results to the bank's directors (or a committee thereof), as well as to the Board; some argument has arisen over the question whether the audit report should first be discussed with the Reserve bank President. As a result of congressional committee pressures, the Board has also taken to employing private accountants to accompany Board examiners to one Reserve bank each year, to comment on the adequacy of audit procedures. After some pushing from the House Banking and Currency Committee the Board on at least two occasions has allowed limited access to the auditors' reports and notes for committee members and staff, including, in 1968, GAO auditors borrowed temporarily to assist the committee. But the Board has drawn the line against public disclosure, pleading a right to privacy for loans to individual member banks that would thereby be revealed, and it has refused to submit to a GAO audit, pleading a statutory immunity. These aspects of accountability remain in dispute.

A second branch of controversy draws a wider audience. How much of the FOMC's deliberations and of its directives to the Manager of the System Open Market Account should be disclosed, and how soon after the event? And how explicit can, and should, the directives be? These questions have already been noted above, as raising issues of congressional control over the FOMC, in the light of the 1985 amendment to the statute, which requires the Board to "keep a complete record of the action taken \* \* \* upon all questions of policy relating to open-market operations and shall record therein the votes taken \* \* \* and the reasons \* \* \* in each instance \* \* \* and shall include in its annual report \* \* \* a copy of the records required to be kept \* \* \*" (sec. 10).

But other interests are involved. Within the System, the directives are still too vague to guide the Manager unless he attends FOMC meetings and hears the discussions preceding their formulation; yet as a market operator he feels the need for some discretionary leeway, to be guided by daily reports and consultations. To the extent that he has discretion there is room for FOMC members to feel that the intent of a directive has been missed in execution. Within and outside the System, economists trained to seek quantitative solutions find the qualitative nature of the directives unsatisfactory, while the Manager stresses the importance of intangible factors and the need for intuitive skills in assessing the "feel" and "tone" of the market.

Vagueness is only part of the complaint. The other part of the complaint pertains to the FOMC's secrecy. It would be largely alleviated if the directives were published immediately or soon after the meetings at which they are adopted; and more so if the underlying minutes, rather than brief condensations, were also published. Open policies openly arrived at, the argument runs, would be better policies both because they could then be intelligently criticized and because they would be more in keeping with the premises of responsible government; directives published promptly would minimize the advantages otherwise given to insiders and specialists in the Government securities markets. The Board gave a little ground to this line of argument in February 1964 when it released the record of FOMC actions in 1963 to the congressional committees some 6 weeks in advance of the scheduled appearance of its annual report. But it has held to its stand against the release of FOMC minutes. In part, the refusal appears to be grounded on the proposition that the market's response to an announced policy is likely to be different from the response to tacit or masked actions; allegedly, the latter is more easily controlled while the former may be perverse but the opposite may well be true. In part, the Board's position is a claim for privacy in deliberations preceding action. In the words of Chairman Martin, publication of the minutes would be—

virtually certain to result either in weakening internal debate for the sake of the public record or in weakening the record for the sake of the debate.<sup>12</sup>

<sup>12</sup> Letter, Martin to Patman, Sept. 11, 1962.

But Martin's view is dubious as will be clear to anyone who reads the Congressional Record, for example.

And on the general issue of public statements of policy the instinctive preference of the System was succinctly put in his words some years ago:

The theory and practice upon which the Federal Reserve has acted has been that it is actions and not statements that determine policy \* \* \*<sup>16</sup>

Of course this is true. We must believe what the Fed does, not what it says. Put otherwise, one must judge the Fed's policies by what happens to such targets as the money supply and, in turn, employment and prices. But though we must judge the Fed by results, we still would like to know what it intends or, at least, intended.

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<sup>16</sup> Hearings, "Nomination of William McChesney Martin, Jr.," Senate Committee on Banking and Currency, 84th Cong., 2d sess., Jan. 20, 1956, p. 8

# THE DEVELOPMENT OF OPEN MARKET POWERS AND POLICIES

## A STAFF MEMORANDUM

### THE EARLY YEARS

The Federal Reserve System was created as a semiautomatic reserve banking mechanism with few policymaking functions. In 1913, the discount rate was viewed as the principal monetary policy tool and final determination of this rate was vested in a body of public officials—the Federal Reserve Board. Five of the members of the Board were appointed to serve 10-year terms by the President of the United States and confirmed by the Senate. In addition, the Secretary of the Treasury and the Comptroller of the Currency were ex officio Board members. But the Federal Reserve was not conceived as an economic policymaking body. Essentially, the functioning of the System through the district banks would be passive. Its activities would be limited in scope to providing a supply of currency and reserves and the development of a market for bankers acceptances to assure an efficient and flexible commercial banking system—one which would work.

The original Federal Reserve Act passed in 1913<sup>1</sup> was virtually devoid of policy prescriptions. This is not surprising in view of the specific defects to be remedied by the new statute, as conceived by its framers. From the outset, there was doubt or hesitancy among those charged with managing the System as to what guidelines should serve to direct overall monetary policies of the Reserve banks. This is especially apparent in the complete lack of guidelines for the conduct of open market operations. Should the Reserve banks adapt their open market purchases and sales to the end of stabilizing commodity prices, maximizing production, facilitating the reestablishment of the gold standard throughout the world, or protecting the gold dollar ratio? Or should they be guided solely by the possibility of earning income for themselves?

What technical methods, furthermore, were the Reserve banks to develop to enforce their judgments with respect to the monetary needs of the country? Open market operations were to be conducted by the Reserve banks under rules and regulations prescribed by the Board. But there were indications that the Board was unsure of the nature and effects of open market operations.

On the other hand, Paul Warburg clearly perceived the significance and possible effects of open market operations.<sup>2</sup> In 1915, he believed that large investments by the System would upset the economy but at the same time could solve the problem of obtaining adequate earnings

<sup>1</sup> 38 Stat. 251 (1913).

<sup>2</sup> 1 Harris, "Twenty Years of Federal Reserve Policy," pp. 146, 147 (1933).

for the Reserve banks, a solution he rejected as improper.<sup>3</sup> In this connection, it is notable that early in 1916, the Board encouraged the Reserve banks to undertake open market purchases in connection with the retirement of circulating national bank notes. Since Warburg knew these purchases could have an inflationary effect and we were then in the midst of an inflation, it is clear that these purchases may be explained in part by concern over Reserve bank earnings. Warburg, who up to 1916 had been hostile to the open market purchases, now expressed approval of an increase in the volume of such operations.<sup>4</sup>

In the latter part of 1916 and early 1917, the policy was reversed.<sup>5</sup>

An additional aspect of the purchase of U.S. Government securities, and the retirement of related national bank circulating banknotes, was the competition among the several Federal Reserve banks, the inevitable purchasing inefficiency that developed, and the agreement to form a committee to act as purchasing agent for the 12 district banks. This committee was probably the precursor of the informal Open Market Committee that was formed on May 16, 1922. It was deemed economically expedient to dispose of investments that had been purchased for the purpose of increasing income since war, and hence increased inflation was imminent.<sup>6</sup> At this time the Board announced that sales by the Reserve banks should also be made to offset imports of gold and thus to reduce the danger of inflation.<sup>7</sup> But later in the year (1917), because of wartime requirements, questions of the appropriate economic policies to be followed were subordinated to, or at least handled within, the context of Treasury requirements. During the war the Reserve banks restricted their open market operations "largely to relieving the money market when large transfers were made to the Treasury."<sup>8</sup>

It is important to recognize that almost from the start the initiative in the determination of open market policy lay with the Reserve banks. The Board conceded this somewhat grudgingly and, at the same time, expressed its sense that it had the right to regulate open market transactions.<sup>9</sup> This fact is significant for understanding later developments in open market operations, particularly as they gained in importance in the postwar years. There was from the beginning a struggle over control of open market operations. The law gave the Reserve banks power to initiate and conduct open market transactions but under rules laid down by the Board. The power to conduct transactions, however, was supreme, especially as the Board's rulemaking powers were—in retrospect—limited to determining what paper was eligible for open market transactions. With respect to conflicts between the banks and the Board, Carter Glass, then Secretary of the Treasury and hence ex officio Chairman of the Board, recognized the Board's inability to control operations when he said that "Strong [head of the New York Federal Reserve Bank] was trying to dominate [the] Treasury and Federal Reserve Board."<sup>10</sup>

<sup>3</sup> *Ibid.*, at p. 146.

<sup>4</sup> *Ibid.*, at p. 147.

<sup>5</sup> *Ibid.*, at p. 148.

<sup>6</sup> *Ibid.*

<sup>7</sup> *Ibid.*

<sup>8</sup> *Ibid.*

<sup>9</sup> *Ibid.*, at p. 148.

<sup>10</sup> Friedman & Schwartz, "A Monetary History of the United States, 1867-1960," p. 255 (1963).

The Reserve banks, however, as indicated, did not control eligibility regulations. The Board had the authority to prescribe the rules and regulations under which Reserve banks might carry on open market operations, and had interpreted that provision liberally.<sup>11</sup> This limited, but not importantly, the power of the Reserve banks to determine open market policy.

#### THE DEVELOPMENTAL PERIOD—DRIFT TOWARD CENTRALISM

It was not until industry and agriculture began to recover from the reaction of 1920 that the formulation of applicable principles of open market policies commenced. From October 1921 to May 1922 the Reserve banks individually bought approximately \$400 million in Government securities, in the absence of suitable amounts of discounts, advances, and bills. Their purpose was to obtain earnings. They were apparently not concerned with the influence of these purchases on the money market.<sup>12</sup> Noteworthy, however, is the fact that these large open market purchases coincided with the Reserve banks' low-interest-rate policies which, in turn, had resulted from the 1920 depression and a congressional investigation of the System's role in that downturn. Still there probably was no dominating economic purpose behind the purchases of the early 1920's. Rather, as stated above, open market operations at the time largely stemmed from individual Reserve bank efforts to increase their own earnings.<sup>13</sup> Certainly, at this time, there was no preponderating sentiment with respect to what the System's primary economic responsibility ought to be.<sup>14</sup> Instead, the System was marked by a display of divergent activities on the part of the district banks.<sup>15</sup>

Numerous complaints were voiced in the 1920's to the effect "that the Reserve banks were becoming too vigorous competitors of member banks, and that the institutions which supply the capital of the Reserve banks were being deprived of earnings because of the depressed money rates which the Reserve banks had helped to generate."<sup>16</sup> Put otherwise, open market purchases were causing interest rates to fall and commercial bankers objected vociferously. Shortly after the Reserve banks individually entered the open market in 1921 and 1922, by resolutions at bankers' conventions and otherwise, commercial bankers began to demand that the Reserve banks operate less extensively on their own initiative.<sup>17</sup> Later it was insisted in some of these pronouncements that the Reserve banks should return to their "original" functions of rediscount and issue and that they should operate more as emergency, panic-allaying institutions.<sup>18</sup> The commercial banks, in short, did not like what the Reserve banks were doing and looked to the Board for relief. And, in fact, open market purchases by the Reserve banks were roundly condemned by both the Treasury and the Federal Reserve Board.<sup>19</sup> Their operations had disturbed the

<sup>11</sup> Harris, *op. cit.*, supra, note 2, at p. 149

<sup>12</sup> Friedman & Schwartz, *op. cit.*, supra, note 10, at p. 251.

<sup>13</sup> Reed, "Recent Federal Reserve Policy, 1921-23," 37 *J. Pol. Econ.* 249 (1929).

<sup>14</sup> *Ibid.*, at p. 269.

<sup>15</sup> *Ibid.*

<sup>16</sup> *Ibid.*, at p. 272.

<sup>17</sup> *Ibid.*

<sup>18</sup> *Ibid.*

<sup>19</sup> Harris, *op. cit.*, supra, note 2, at p. 150.

Government securities market as well as the commercial bankers.<sup>20</sup> Aroused by the potential dangers of a haphazard investment policy, and general dissatisfaction with the prevailing low interest rates, in May 1922 a committee of governors (presidents) of the five eastern Reserve banks was organized to exercise joint purchases and sales and to avoid conflicts with orders for Treasury account.<sup>21</sup> This unofficial committee, created by the inspiration of the Board and Treasury, was to supervise in such a manner as "to safeguard the interests of the security market, the Reserve banks, and the Treasury."<sup>22</sup> It was agreed that the committee would keep in close touch with the market, Treasury, and Board, would hold frequent conferences and make recommendations to the Reserve banks concerning the advisability of purchases or sales of securities, and that these recommendations should receive serious consideration by each bank.<sup>23</sup>

Thus, in October 1922 the Committee of Governors (Reserve bank presidents) on Centralized Execution of Purchases and Sales of Government Securities actually took over the duty of centralized open market operations. At the October 1922 conference with the Board, President Strong pointed out that it was not intended that the committee control or direct the action or management of the 12 Reserve banks but merely that it should "prepare information assuring an intelligent (economic) policy."<sup>24</sup> Accordingly, from January 31, 1923, to April 23 of that year, the securities holdings of Reserve banks were reduced almost 50 percent without apparent regard for the effect on their earnings.<sup>25</sup> The purpose was to counteract the "monetary ease" brought about by the purchases made in the fall of 1922. This hope, however, was exceeded. Sales were more than enough to offset any inflationary danger and the result was a recession lasting into 1924.

In March 1923 the Board took the initiative in a successful attempt to revise the open market procedure, arguing that it had the authority to limit and otherwise determine the securities and investments purchased by the Reserve banks, because the time, manner, character, and volume of such purchases might exercise an important influence on the money market, and that an open market investment policy for the 12 Reserve banks was necessary in the interest of the maintenance of a proper relationship between discounts and purchases of the Reserve banks and the general money market.<sup>26</sup> Accordingly, on April 1, 1923, the committee of governors (presidents) was superseded by the Open Market Investment Committee for the Federal Reserve System. This committee was appointed by the Board, initially, with the same five members as its predecessor. The Board now also took a stronger position in the determination of overall monetary policy. It requested that securities and acceptances be disposed of and the buying rate be increased before it would consider suggestions for an increase in the discount rate. In a public statement the Board justified its demand for a System policy on the grounds that purchases and sales influence the "credit" situation primarily in the money centers where purchases or sales are made.<sup>27</sup>

<sup>20</sup> Friedman & Schwartz, *op. cit.*, *supra*, note 10, at p. 251.

<sup>21</sup> *Ibid.*

<sup>22</sup> 1 Harris, *op. cit.*, *supra*, note 2, at p. 150.

<sup>23</sup> *Ibid.*

<sup>24</sup> *Ibid.*, at p. 151.

<sup>25</sup> Reed, *op. cit.*, *supra*, note 13, at p. 276.

<sup>26</sup> 1 Harris, *op. cit.*, *supra*, note 2, at p. 151.

<sup>27</sup> *Ibid.*, at p. 152.

Despite the Board's intervention, each of the Reserve banks continued to operate in the open market independently of the others until December 15, 1923. After that date, joint purchases were undertaken for the "System" account. But the issue of whether or not the Board had authority to control in detail and remove any initiative of the Reserve banks with respect to open market operations was not pressed to a final decision.<sup>28</sup> Individual banks still engaged in independent operations which the committee executed on their behalf, but they were generally small in amount, both absolutely and compared to "System" account transactions.<sup>29</sup> They were small, because all purchases and sales of any considerable amount had to be made in New York City through the New York Federal Reserve Bank. There simply was no other market for "Governments." Thus, the Reserve banks in the interior had no alternative in practice to the program adopted by the committee. Further, the committee could always plead peculiar and intimate knowledge of the market in favor of its decisions and frequently did so.

In this way the New York Federal Reserve Bank assumed an undue importance in determining the open market policy of the group.<sup>30</sup> Statistical analysis readily reveals how completely the open market policies of the Reserve banks were executed through the joint account of the System. The Federal Reserve Bank of New York acted as the agent and handled the System's orders which were executed in New York.

The Federal Reserve System had found a new banking technique, previously known but to a few in its effect upon money and credit. Those who had long realized its potency were in the forefront in the strenuous attempts to bring this power under centralized authority. But note that the authorities did not (evidently) believe there was anything inconsistent in trying to affect money and credit simultaneously. This mistaken notion has plagued the System's policies from then until now.

Concerning policy in the twenties, the most notable feature was the close connection in timing between the movements in economic activity and the explicit policy measures taken by the Federal Reserve System.<sup>31</sup> As was earlier noted, restraint in early 1923, exercised by sales of Government securities and a rise in discount rates, was followed closely by a downturn in business and the onset of the 1923-24 recession.<sup>32</sup> A reversal of policy in late 1923 and early 1924 in the direction of ease was followed by an upturn in business in July 1924 and a vigorous cyclical revival.<sup>33</sup> Moderate restraint in the third quarter of 1926 was followed by a downturn in October, and easing measures in 1927, by a cyclical upturn in November.<sup>34</sup>

The economic consequences of the open market operations undertaken in 1926 and 1927 led the Board once more to attempt to assert its authority to regulate open market operations.<sup>35</sup> In May 1928, the Federal Advisory Council proposed that a committee of all governors

<sup>28</sup> Friedman & Schwartz, *op. cit.*, supra, note 10, at p. 251.

<sup>29</sup> *Ibid.*

<sup>30</sup> Wills & Chapman, "The Banking Situation," at p. 748 (1934).

<sup>31</sup> Friedman & Schwartz, *op. cit.*, supra, note 10, at p. 296.

<sup>32</sup> *Ibid.*

<sup>33</sup> *Ibid.*

<sup>34</sup> *Ibid.*

<sup>35</sup> 1 Harris, *op. cit.*, supra, note 2, at p. 153.

(Reserve bank presidents) should be substituted for the acting committee representative of the larger Reserve banks, and the Board presented this proposal at a meeting of the governors (Reserve bank presidents) and agents.<sup>36</sup> In November 1928, a definite program of reform was formulated along these lines. The program provided for an Open Market Policy Conference which would be representative of all the banks and operate under the chairmanship of the Governor (Chairman) of the Federal Reserve Board, who alone was to have the privilege of calling meetings.<sup>37</sup> The new arrangement was justified by the Board on the ground that it "embodies a fuller recognition of the joint interest and responsibility of Federal Reserve banks and the Federal Reserve Board in the matter of open market policy."<sup>38</sup> It was put into effect on March 26, 1930, when the Open Market Policy Conference was formed, and replaced the Open Market Investment Committee.<sup>39</sup>

On close examination, the new setup was a victory for the interior Reserve banks since it provided that each Reserve bank would appoint a representative to the Open Market Policy Conference.<sup>40</sup> In this sense, then, the new arrangement gave the interior Reserve banks something to say about open market policy. The Board achieved at most a very limited victory by the reform. The Chairman of the Board was empowered to convene meetings of the Conference but nothing more. In view of the sorry performance of the Conference in the early 1930's when it sold securities, and the fact that some members of the Board (Eugene Meyer, for example) were urging open market purchases, it was unfortunate that the Board did not win a more meaningful victory in its efforts to wrest control over open market operations from the Reserve banks in the 1928-30 period.

#### THE BANKING ACT OF 1933—OPEN MARKET COMMITTEE LEGALIZED

Open market operations under a legally constituted central body finally were provided for in the Banking Act of 1933.<sup>41</sup> It had been 6 years since the McFadden Act<sup>42</sup> gave perpetual life to the Reserve banks; otherwise, their charters would have expired in 1933. During those years, the relative importance of open market operations had been demonstrated. From several quarters came very definite opinions on just what kind of banking system the country should have.

Several provisions of the Banking Act of 1933 were concerned with the Federal Reserve Board and the control of the Federal Reserve System. Senator Glass, the principal author of the act, felt that it was necessary to reconstitute the Federal Reserve and take measures needed to save it from being crushed by the Government. He also felt, in the view of one observer—

that the commercial character of the system was being destroyed by subjecting its policies to Treasury domination and to speculation in the securities market; that the [present] policy of using the Federal Reserve banks as the market for extravagant issues of securities and as a means of inflation was a climax in this trend; that the Federal Reserve Board has sunk in relative importance, prestige,

<sup>36</sup> *Ibid.*

<sup>37</sup> *Ibid.*

<sup>38</sup> *Ibid.*

<sup>39</sup> *Ibid.*, at p. 154.

<sup>40</sup> *Ibid.*

<sup>41</sup> 48 Stat. 162 (1933).

<sup>42</sup> 44 Stat. 1224 (1927).

and authority, as the Federal Reserve banks, particularly of New York, rose; that the Board had been timid, uncertain, vacillating, and prone to follow considerations of immediate expedience.<sup>43</sup>

The same observer, Professor Westerfield of Yale, also noted that—

The American Bankers Association in its publicity featured "the demonstrated impotence of the Federal Reserve System to retain control over the situation \* \* \* quite unable to coordinate its forces and marshal its resources with a unity of purpose that is adequate," and suggested as a solution the "formation of a 'Central Bank of the United States,' with the present Reserve banks as branches. \* \* \* Twelve scattered banks, each with its governor and its chairman and its board of directors, loosely ruled by a Board of eight in Washington, composed of men of diverse opinions, do not provide the country with an organization well adapted to act promptly and decisively."<sup>44</sup>

With a view to thus reorganizing the Federal Reserve System, the Senate subcommittee, headed by Glass, proposed to achieve a more decisive and independent Board by insulating its membership from public pressures by increasing their tenure of office, requiring that two members be men of experience in banking, and removing the Secretary of the Treasury from Board membership. Further, Glass proposed to increase the power of the Board; and to strengthen its control by giving a better definition of its power with respect to open market operations.<sup>45</sup>

The Banking Act of 1933 failed to accomplish all the subcommittee proposed. The Secretary of the Treasury was not removed from the Board or its chairmanship. This failure was scored by Senator Glass in vehement language; he resented making the Federal Reserve "the footmat of the Treasury. \* \* \*"

It was never intended that the Federal Reserve banking system should be used as an adjunct of the Treasury Department and particularly was it never contemplated that it should be so used to such an extent as recently has been done as to very materially curtail the capabilities of the Federal Reserve banks to serve the business interests of the country.<sup>46</sup>

The 1933 act, although making the Board more independent and, according to Senator Glass, therefore more decisive, did not give the Board control over open market operations. Control of open market operations continued to be vested in the Reserve banks. Transactions were now subjected by law, to the supervision of a committee representing the individual Reserve banks, and this committee was instructed to meet with the Board from time to time and to formulate general open market policies.<sup>47</sup>

To state the matter otherwise, the 1933 act provided for a Federal Open Market Committee of 12 members, each representing a Reserve bank. Its members, who in fact were the respective bank heads, were required to meet in Washington at least four times a year. Meetings might be attended by members of the Board and open market operations could be conducted only in accordance with the regulations of the Board. But specific transactions were to be recommended by the Committee. The time, character, and volume of purchases and sales were to be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country. The law thus paid lipservice to the principle of Board con-

<sup>43</sup> Westerfield, "The Banking Act of 1933," 41 J. Pol. Econ. 727 (1933).

<sup>44</sup> *Ibid.*, at p. 728.

<sup>45</sup> S. Rept. 584, 72d Cong., 1st sess. (1933).

<sup>46</sup> Westerfield, *op. cit.*, supra, note 48, at p. 728.

<sup>47</sup> 48 Stat. 168 (1933).

trol over open market policy. Nothing in the law specifically required the Committee to recommend what the Board wished, and any Reserve bank, by filing a statement of objections, could refuse to make purchases or sales as recommended by the Committee.

It is self-evident that the Banking Act of 1933 failed to provide the Nation with a coordinated credit regulating facility with full responsibility for both formulating and executing open market policies. On the other hand, the act legally sanctioned control over open market operations by men selected by commercial bankers—the heads of the Reserve banks. From 1923 to 1933, these very men did in fact control open market operations, as we have seen. But until 1933, control was not sanctioned by law.

Events in Congress leading up to final passage of the 1933 act are quite revealing of the attitudes in the Congress during the darkest days of the depression. With reference to the bill introduced on April 18, 1932 (S. 4412), by Senator Glass, the Senate Banking and Currency Committee made the following statement in its report:<sup>48</sup>

*Strengthening of Federal Reserve System.*—The Federal Reserve System has been seriously impaired of recent years and has wandered far away from its original function. This is the result of many complex conditions. Among these conditions has been the uncertainty of policy in the matter of exercising plainly authorized control by the central supervising authority at Washington and the tendency to submit rather timidly to considerations of immediate expediency. Among the Reserve banks themselves there has been a decidedly dangerous drift toward the conversion of the System into a medium for transacting financial rather than commercial business. Further, the establishment of understandings or agreements with foreign central or other banks, and the attempt to carry out plans and measures of a hazardous nature, relating to discount rates and problems of technique, have had unfortunate results.

S. 4412 was superseded in the following Congress by S. 1631. On May 17, 1933, Mr. Steagall introduced H.R. 5661 in the House, by and large incorporating the provisions of the Senate bills upon which hearings had been held in the preceding Congress. Mr. Steagall explained:

The legislation has been thoroughly considered in the Senate, both in committee and by the entire body. \* \* \* The House committee had the benefit of the Senate hearings. In view of the peculiar conditions that exist and the emergency nature of the measure \* \* \* it was decided by the committee that we should proceed to the consideration of the bill in executive session and report it immediately. \* \* \* The committee decided it would not hold open hearings. \* \* \*

Several Members of Congress were generally apprehensive about giving legal recognition to an Open Market Committee composed of individuals so closely connected with private commercial banking interests. Representative Lemke characterized the House bill:

I can well understand why this bill was considered in executive sessions by the committee, because, if my friends and colleagues, the gentleman from Texas (Mr. Patman), the gentleman from Pennsylvania (Mr. McFadden), and others had been permitted to take part in the considerations, the bill would never have appeared on the floor of this House in its present form. \* \* \* A bill of this kind could never have been born in the bright sunlight of day. It had to be born in executive session. And now we are asked to vote for it without knowing its contents and without having had time to digest its far-reaching results.<sup>49</sup>

<sup>48</sup> Senate report, op. cit., supra, note 45.

<sup>49</sup> 77 Congressional Record 3492 (1933).

<sup>50</sup> Ibid., at p. 3907.

Mr. Patman inquired of Mr. Steagall, the House manager, of H.R. 5661:

I want to ask the gentleman a question about the bill: Is the bill similar to the Glass bill reported to the Senate yesterday?<sup>51</sup>

Mr. Steagall replied:

The bill, insofar as amendments to the banking laws are concerned, is practically the same as the Glass bill.<sup>52</sup>

Mr. Patman answered:

The reason I asked the question is this: I asked permission to be heard before the committee on this bill. \* \* \* I am awfully sorry I was not allowed that opportunity.<sup>53</sup>

H.R. 5661 was reported 2 days after introduction.<sup>54</sup> It passed the House on May 23.<sup>55</sup>

In the Senate debates on the original Senate version, Senator Huey Long also questioned the wisdom of the provisions in the bill to reorganize the Federal Reserve:<sup>56</sup>

(T)here is something in this bill that was never brought to the attention of the Senate. It divorces the Federal Reserve bank from any control practically of the U.S. Government. I am ready to say that there is not a Senator in this Chamber who knows anything at all about what is in the bill. I do not make any exception \* \* \*. The bill proposes to take the Secretary of the Treasury of the United States off the Federal Reserve Board. The bill would take the excise tax upon the surplus earnings that have been going to the U.S. Treasury away from the Treasury of the United States and give it to the banking combine in order that they could protect the chain banks \* \* \*. We fought here for years and years that the U.S. Government might have some control over the banks handling the people's money, and we managed to write into the law that the Federal Reserve banking system would become responsible to the people of the United States. We made the Secretary of the Treasury of the United States the dominating member of the Federal Reserve Board. They have been trying, Mr. President, to remove from that Board the representative of the people ever since this act was enacted into law. They have tried to have control of the currency more or less removed from the people.

Heretofore they have not been able to do that; but, with a Federal Reserve Act supposed to have been created so as to permit the Secretary of the Treasury of the United States to participate in the administration of these funds, the circulating currency for which the Government is responsible, they have come back here this time with a proposal to take the Treasury of the United States off the Board and to put it, boots, saddle, and breeches, into the hands of the machinating financiers \* \* \*. When the people finally consented to have the rich treasure of their national banking reserves impounded in a central reservoir, they did not see that the result would be the loss of their financial freedom. They did not know that it would lead them into their present condition of starvation, unemployment, and general misery. Because a discount market requires the greatest possible concentration of gold and a centralization of all the money and credit resources of the Nation, they were led artfully by propagandists to believe that the country needed an entirely different kind of banking system. The literature of deception holds no parallel to what was issued to carry out that propaganda.

That is what brought the collapse to this country sooner than it would have happened otherwise \* \* \* (and now) they have come here with legislation trying to slip through a proposition that has done more harm to the people of the United States than every other calamity that has happened in the meantime. They do not want to take any chance. Oh, no! They must not take

<sup>51</sup> *Ibid.*, at p. 3491.

<sup>52</sup> *Ibid.*, at pp. 3491-3492.

<sup>53</sup> *Ibid.*, at p. 3492.

<sup>54</sup> H. Rept. 150, 73d Cong., 1st sess. (1933).

<sup>55</sup> 77 Congressional Record 4058 (1933).

<sup>56</sup> 76 Congressional Record 1624-1626.

any chance now. It is a serious situation until they have put the fire out; and so they are removing the Secretary of the Treasury from the Federal Reserve Board in the Glass bill.

Why? \* \* \* Because it is the Secretary of the Treasury who has the power to stop this machinated manipulation of pyramided credits that have been hawked about by that gang up here in the name and form of the United States until they have brought calamity to this country; and now, for fear that there might be something done, they are trying to cure the whole thing by law. "Hurry, hurry, hurry, and get the Glass bill through!"

Senator Long concluded that the Glass bill would take the powers of the Federal Reserve Board further away from the Government:<sup>57</sup>

It puts them in the hands of the big banks, the international cliques, takes them out of the hands of the Government, gives them the money the Government has been getting from them, gives them money out of the Government Treasury that we have there now, and extends their powers to cover up all they have done in the past.

S. 1631 was debated in the Senate, but the text of the Senate bill was substituted for the text of the House bill and H.R. 5661 was passed in lieu thereof. The measure became law on June 16, 1933.<sup>58</sup>

It becomes clear upon analysis that the depressed economic conditions and a political scene characterized by an atmosphere of great emergency made it easy for proponents of the 1933 Banking Act, behind strong leadership in the Senate, to induce the House to go along with the Senate version—the House virtually giving up its own legislative prerogatives. Much the same was to occur 2 years later when once again the Congress would consider drastic banking legislation.

#### THE BANKING ACT OF 1935—THE "THIRD BANK OF THE UNITED STATES" IS CREATED

The Banking Act of 1935<sup>59</sup> reorganized the Federal Reserve System. Open market powers were fully centralized by this measure. The Board was given majority representation on the Open Market Committee, thereby partly subjecting open market policy to control by a public body. On the other hand, the Board was rendered independent of the executive branch. The "emergency" atmosphere of the depression doubtless contributed to what was undeniably the establishment of a true central bank—-independent and able to determine for itself its policies and goals.

The original bill, H.R. 5357, after having been introduced on February 5, 1935, in the House by Representative Steagall, chairman of the House Committee on Banking and Currency, was referred to that committee for consideration. Hearings were conducted by this committee from February 21 to April 8, 1935. On April 19, Chairman Steagall introduced a substitute bill, H.R. 7617, which, according to press reports, altered the provisions in the original bill so as to follow suggestions made by Governor Eccles.<sup>60</sup> The House committee reported the new bill favorably on the same day,<sup>61</sup> and after comparatively little debate the House passed it on May 9, 1935.<sup>62</sup>

The House committee report on H.R. 7617 suggested placing responsibility for national monetary and credit policies squarely upon the

<sup>57</sup> *Ibid.*, at 1626.

<sup>58</sup> Public Law 66, 78d Cong., 1st sess. (1933).

<sup>59</sup> 49 Stat. 684 (1935).

<sup>60</sup> *Am. Banker* 1:2 (Apr. 23, 1935).

<sup>61</sup> H. Rept. 742, 74th Cong., 1st sess. (1935).

<sup>62</sup> 77 Congressional Record 7271.

Federal Reserve Board, that national policies should be adopted and carried out in a national body in the public interest. The report asserted this to be the reason that the 1913 act gave the Board final authority over discount rates. Since open market operations had in more recent years come to be recognized as a much greater factor in credit policy than discount rates, it was believed to be entirely consistent with the philosophy of the original Reserve Act to vest in the Board final authority with respect to the open market policies of the System.

In testifying before the House committee, Mr. Marriner Eccles of the Federal Reserve stated that open market operations are the most important single instrument of control over the volume and the cost of credit in this country.<sup>63</sup> Eccles criticized the provision in H.R. 5857 (the original Steagall bill) for three public members and two bank members of the Open Market Committee by saying that—

The Federal Reserve Board, which is appointed by the President and approved by the Senate for the purpose of having general responsibility for the formulation of the monetary policies, would under this proposal have to delegate its principal function to a committee on which members of the Board would have a bare majority.<sup>64</sup>

Eccles further testified :

\* \* \* that the best way in which to handle this proposal would be to place responsibility for open market operations in the Federal Reserve Board as a whole and to provide for a committee of five governors of Federal Reserve banks to advise with the Board in this matter. The Board should be required to obtain the views of this committee of governors before adopting a policy for open market operations, discount rates, or changes in reserve requirements. Such an arrangement would result in the power to initiate open market operations by either a committee of the governors or by the Board, but would place ultimate responsibility upon the Federal Reserve Board, which is created for that purpose.<sup>65</sup>

It was thus apparent that by 1935 the tremendous importance of open market operations to the general economy had come to be widely appreciated. The most bitterly disputed issues concerning the open market provisions in the Banking Act of 1935 were the locus of open market authority and a statement of objectives to guide the execution of that authority.

Opponents of the reforms in the revised House bill, H.R. 7617,<sup>66</sup> argued that increasing the power of the Federal Reserve Board over the member banks and open market operations and enlarging the authority of the executive branch of the Government over the Board tended to subject the monetary system of the country to political control. The argument is factually correct but essentially invalid. Governor Eccles in reply stated :

The most widespread criticism of the bill has come from those who see in it an attempt to subordinate the Federal Reserve System and through it, the country's banking system, to political control. On this subject there appears to be much misinterpretation of what the present bill provides, coupled with a lack of clear understanding of existing law and of the proper relationship between the Reserve System and the Government. This bill aims to clarify the powers and responsibilities of the Reserve Board in matters of national monetary policy and at the same time preserves and increases the regional autonomy of

<sup>63</sup> Hearings before the House Committee on Banking and Currency, H.R. 5857, 74th Cong., 1st sess., at p. 181.

<sup>64</sup> *Ibid.*, at pp. 181-182.

<sup>65</sup> *Ibid.*

<sup>66</sup> H.R. 7617, 74th Cong., 1st sess.

the Reserve banks in matters of local concern. There is nothing in this bill that would increase the powers of a political administration over the Reserve Board.<sup>67</sup>

On the question of "politics," Mr. Eccles further stated:

It seems to me that an administration is charged, when it goes into power, with the economic and social problems of the Nation. Politics are nothing more or less than dealing with economic and social problems. It seems to me that it would be extremely difficult for any administration to be able to succeed and intelligently deal with them entirely apart from the money system. There must be a liaison between the administration and the money system—a responsive relationship. That does not necessarily mean political control in the sense that it is often thought of.<sup>68</sup>

Mr. Eccles supported provisions that, with respect to qualifications for appointment to the Board, would remove the requirement that members be appointed with due regard to agricultural, industrial, and geographical interests and substitute a statement that they should be persons who by training or experience or both, are qualified to formulate economic and monetary policies. Mr. Eccles also supported a provision in the House bill that the Board should exercise its powers in such manner as to promote conditions conducive to business stability and to mitigate by its influence unstabilizing fluctuations in the general level of production, trade, prices, and employment, so far as may be possible within the scope of monetary action and credit administration.

Dr. Goldenweiser of the Board's staff also testified strongly in favor of these provisions which would provide improved guidelines for exercising economic powers:

It is along the same line as the proposal which Governor Eccles has read to you stating the objectives of the Federal Reserve System in terms of maintaining the stability of various elements of the business structure, that is, to have men on the Board who will devote their energy to maintaining that stability insofar as it can be maintained by monetary means, and men who should be qualified to formulate national policies.

I would like to say in this connection, that the idea the Federal Reserve Board has broader responsibilities than the mere accommodation of commerce and business and the serving of agriculture, trade, and industry, is an idea which has been forced upon the Federal Reserve System by actual experience and which has been gradually developed in the System.

The accommodation of commerce and business, which is the only objective that was mentioned in the Federal Reserve Act, is a vague phrase, and has all the attributes of a statesmanlike pronouncement. It is vague, it is a glittering generality like the Declaration of Independence, and its content can be changed as circumstances change. It has, therefore, not served any very useful purpose, but has not done any particular harm.

It is now time, in the light of 20 years' experience, to substitute a more clearly defined objective than this vague phrase, which, to my way of thinking, held the place for a more definite objective throughout these years.<sup>69</sup>

In the House debates, also, the point was clearly made that changes were necessary in the machinery for determining and carrying out the open market policies of the System. Representative Hancock stated that—

The Federal Reserve Board, which is appointed by the President and approved by the Senate for the purpose of having general responsibility for the formulation of monetary policies, would under this proposal be solely responsible in the execution of the will of Congress from whom such power is derived. Through exercise of this power depends to a large degree the country's economic,

<sup>67</sup> Hearings of subcommittee of the Senate Committee on Banking and Currency, S. 1715 and H.R. 7617, 74th Cong., p. 280.

<sup>68</sup> House report, op. cit., supra, note 58, at p. 191.

<sup>69</sup> Ibid., at p. 434.

business, and social welfare. It is the first control in the sale and purchase of money which is the dynamo of commerce, industry, and agriculture.<sup>70</sup>

In rebutting the contention that under the House bill the Board would be able to force the banks to purchase Government obligations, Representative Hancock asked that if the banks would not be willing to buy the bonds of the Government:

(D)o you mean to tell me that Congress has lost its sovereign power? Do you mean to tell me that private bankers have a monopoly upon the creation of money?<sup>71</sup>

And—

(T)he heart of this bill, as I have just said, revolves around the operations of the Open Market Committee. \* \* \* Every power provided for in this bill exists today in the present law; but there is a transfer of power to take the control of the volume and the cost of money from private hands and place it in Government hands, where, in my opinion, it should have been for the past 20 years.<sup>72</sup>

Representative Sisson defended the increased powers given the Board in saying:

I am heartily in favor of the main provisions of title II, which carry out nearly in whole the recommendations made by Governor Eccles to the Banking and Currency Committee, and in accordance with the program initiated by the (administration) to give us a sound and adequate currency and to place the control of the issue of money and the control of credit, which is at least nine-tenths of our money, in the Government of the United States rather than in the private bankers. \* \* \*<sup>73</sup> Gentlemen here have attacked this control as being a political control. The only way that it is a political control is that it is control by the Government itself, as representing all of the people, and as between public control and private control, I am for public control. Private control has been tried and found wanting.<sup>74</sup>

In summary, the House bill, insofar as open market operations were concerned, would vest complete authority in a public body not dependent at all on the banks, along with explicit directions in the form of a mandate as to objectives, reflecting in substance the testimony of Mr. Szymczak, a member of the Board, before the Senate committee that—

(A)ctual determination of what these open market policies should be seems to me a national and not a local question. Therefore, authority should be vested in the Federal Reserve Board.<sup>75</sup>

The House adopted title II as reported by the committee without amendment.

A companion bill to H.R. 5357 (S. 1715) was introduced in the Senate on February 6, 1935, by Senator Fletcher, chairman of the Senate Banking and Currency Committee, and referred to his committee. The Senate hearings, however, were conducted by the Subcommittee on Monetary Policy, Banking and Deposit Insurance, with Senator Glass as chairman. This subcommittee, and more specifically its chairman, in marked contrast to the attitude on the part of the majority of the House committee, challenged the validity of the philosophy apparently underlying title II of the bill, and in this connection solicited the views of a number of leading economists and

<sup>70</sup> 79 Congressional Record 6738.

<sup>71</sup> *Ibid.*, at p. 6735.

<sup>72</sup> *Ibid.*, at p. 6734.

<sup>73</sup> *Ibid.*, at p. 6964.

<sup>74</sup> *Ibid.*, at p. 6965.

<sup>75</sup> Hearings, *op. cit.*, supra, note 64, at p. 971.

bankers, not only as to the effect of the provisions under the bills introduced in the House, but also as to measures which might be substituted to improve the central banking system of the country. As a result of Senator Glass' persistence, title II of the bill was substantially rewritten.<sup>76</sup> He submitted the amended bill on July 2, 1935, for the Senate Committee on Banking and Currency, and the bill was passed by the Senate on July 26 as the committee had reported it.

The House bill and the Senate amendment subsequently went to a conference committee consisting of three Members of the House and six Senators. The conference committee accepted the provisions of the Senate amendment in almost all of the important differences between the two bills, and on August 19 the conference bill<sup>77</sup> was passed by both the Senate and the House. On August 23, 1935, the President signed it, and its provisions became, with certain exceptions, immediately effective.<sup>78</sup>

By the Glass Act, the name of the Federal Reserve Board was changed to the Board of Governors of the Federal Reserve System. Further, the number on the Board was fixed at seven members appointed for 14 years by the President and confirmed by the Senate. The Secretary of the Treasury and the Comptroller of the Currency were removed from the Board. The Open Market Committee was changed so that the Committee consisted of the seven members of the Board and five representatives of the Reserve banks. The Federal Reserve banks were forbidden to engage, or decline to engage, in open market operations except in accordance with regulations adopted by the Committee.

Senator Glass and most of the prominent witnesses who appeared before the Banking Subcommittee charged that the purpose of the Eccles bill was to establish a central banking system while maintaining the Federal Reserve System as a "front" and to use the banking system of this country to experiment in social planning.

In the debates in the Senate, Senator Glass, before discussing the open market question, made several interesting comments regarding the reorganization of the Board itself, particularly with respect to the reasons for eliminating the Secretary of the Treasury and the Comptroller of the Currency from membership on the Board. Mr. Glass asserted that the Secretary of the Treasury exercised undue influence on the Board, and mentioned his own term as Secretary as an example of Treasury domination of the Federal Reserve Board. This comment is of particular interest in view of the fact that Senator Glass had earlier complained that Benjamin Strong, of the New York Federal Reserve Bank, was too powerful an influence at the time that Mr. Glass was Secretary of the Treasury.

With regard to the composition of the Open Market Committee, Senator Glass explained his committee's action by stating that the Open Market Committee was set up to enable the Reserve banks to enforce the discount rate in their districts and to provide earning assets and not to finance Government deficits, or speculate in the market. Mr. Glass charged that the Government of the United States had—

(N)ever contributed a dollar to one of the Reserve banks; yet it is proposed to have the Federal Reserve Board, having not a dollar of pecuniary interest in

<sup>76</sup> S. Rept. 1007, 74th Cong., 1st sess. (1935).

<sup>77</sup> H. Rept. 1822, 74th Cong., 1st sess. (1935).

<sup>78</sup> Public Law 305, 74th Cong., 1st sess. (1935).

the Reserve funds or the deposits of the Federal Reserve banks or of the member banks, to constitute the Open Market Committee. \* \* \*

Senator Glass went on to describe the Reserve banks as privately owned and operated institutions.<sup>80</sup>

Senator La Follette, on the other hand, expressed fears that banker representation on the Open Market Committee would lead to undesirable results, where with cooperation of two Board members, the bank members could achieve policies concerning reserve requirements, discount rates, and open market operations contrary to policies followed by the Board in the public interest:

It should be the duty and the responsibility of this newly constituted Board to attempt not only to prevent the excesses of a credit inflation but likewise to mitigate the disasters and the excesses of a credit deflation. Under the committee's bill it is entirely probable that the representatives of the bankers upon this Open Market Committee, in a period such as that, will be opposed to any attempts upon the part of the Board to exercise its control over open market operations in the interest of mitigating and preventing the excesses of a credit deflation. \* \* \* (T)wo-thirds of the Directors who will select the representatives in turn to serve upon the Open Market Committee will be selected by the member banks; and I assume that, of course, they will be individuals of integrity and good repute. Nevertheless, they have the point of view of the banking community at a particular time when a situation may require action of the Open Market Committee which is not supported by the banking community.<sup>81</sup>

The Senate nonetheless passed the Glass version without amendment and, as indicated, it was accepted in substance by the conference committee, and passed by both Houses of Congress.

One observer concluded that—

As finally enacted, the stated qualifications of members of the Board remain unchanged, and the proposed statement of objectives was omitted, an apparent victory for Senator Glass and the American Bankers Association.<sup>82</sup>

When one recalls that the House bill retained the Secretary of the Treasury and the Comptroller as members of the Board, gave the Board sole control over open market operations, repealed rules as to eligible security for Federal Reserve notes, allowed the Board to compel the Reserve banks to buy directly from the Treasury, and provided meaningful economic guidelines for the conduct of open market and other monetary policies, one appreciates how radically the House proposals were altered before the law was passed.

#### INADEQUATE POLICY GUIDELINES—THE NEED FOR IMPROVEMENT

As we have seen, the framers of the original Federal Reserve Act did not feel a pressing need for setting up any definite standards of policy. A bitter fight had for years been waged in Congress to write into the Reserve Act some sort of price stabilization standard, and by 1933 some concessions had to be made to those who wished to define the policies of the Reserve Board. The concession, however, was woefully inadequate. The acts of the Open Market Committee were to be governed "with a view of accommodating commerce and business, and with regard to their bearing upon the general credit situation of the country."

<sup>80</sup> 79 Congressional Record 11778.

<sup>81</sup> *Ibid.*, at p. 11779.

<sup>82</sup> *Ibid.*, at p. 11915.

<sup>83</sup> Smith, "The Banking Act of 1935," 21 A.B.A.J. 611 (1935).

In 1935, an even more drastic revision was undertaken further centralizing and strengthening the open market powers of the Reserve System. The 1935 act, as it passed the House, contained policy guidelines, referred to above, which were about as clear as circumstances permitted. Curiously enough, the same men who criticized the New Deal for its enormous grants of power and meager definitions of policy forced the elimination of that policy statement. They were willing—or forced—to concede the power itself, but unwilling to enact a general statement of objectives. The act as passed contained only one amplification of policy—reserve requirements were to be altered “in order to prevent injurious credit expansion or contraction.” This, too, is anachronistic and ambiguous.

The closest thing to an adequate statement of policy with respect to the exercise of the Federal Reserve’s tremendous power over the Nation’s economic well-being is that appearing in the Employment Act of 1946,<sup>83</sup> when Congress declared:

(T)hat it is the continuing policy and responsibility of the Federal Government \* \* \* to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining in a manner calculated to foster and promote free competitive enterprise and the general welfare conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power. [Emphasis added.]

Unfortunately, however, the Federal Reserve has displayed a propensity to set its own policy standards, which at times have been at variance with the goals specified in the Employment Act. At times, Federal Reserve policies have even been in direct conflict, for instance, with maintaining maximum domestic employment and production by pursuing deflationary courses in attempts to solve the balance-of-payments problem or in combating the specter of inflation—real or imagined.

As Prof. David McC. Wright put it, in discussing the newly increased powers of the Open Market Committee:

(W)hen we consider the range of fact and choice of action available to the Federal Reserve Board, we might perhaps conclude that it has been given the type of authority repudiated by Cardozo in the *Schechter* case—a “grant of a roving commission to inquire into evils” and upon discovering them to do what it can to prevent them.<sup>84</sup>

Professor Wright continues:

It is a rather remarkable exception, in our system of democratic government, that the governors of (money) should be comparatively exempt from the requirements imposed upon other branches of government. In large measure, this may be attributed to the fact that (monetary) control does not affect very greatly the conscious daily life of the average man. He becomes excited over wage regulations, but changes in the rediscount rate seem to him far away and too remote to be important—yet one doesn’t have to blame everything on the banking system to realize that (monetary) control is just as important as industrial regulation. What good does it do to establish careful wage standards by law, when unwise (money) policy may allow prices to fluctuate so greatly that the wage safeguard becomes meaningless? In view of the weaknesses and conflicts just outlined it may be best that the average man is not “bank conscious.” There are, perhaps, good reasons why our (money) policy should be determined with the minimum of popular discussion, and that the Reserve Act should therefore contain no controlling standard. If the experts

<sup>83</sup> 60 Stat. 23 (1946).

<sup>84</sup> Wright, “Is the Amended Federal Reserve Act Constitutional?—A Study in the Delegation of Power,” 23 Va. L. Rev. 628, at p. 650 (1937).

cannot agree, what may we expect of the rank and file? Yet cogent as this reasoning may be, it is certainly contrary to the accepted interpretation of the Constitution.<sup>62</sup>

In the interest of good public administration under our system of government, it would appear that explicit clarification of goals for the Federal Reserve System, with respect to open market operations especially, is an imperative which Congress must no longer postpone.

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<sup>62</sup> Ibid., at pp. 652, 653.

CHAIRMAN MARTIN, FEDERAL RESERVE BOARD, ASSERTS THE FED'S  
INDEPENDENCE FROM THE REST OF THE U.S. GOVERNMENT—THAT  
THE FED GOES ITS OWN WAY

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COLLOQUY BETWEEN SENATOR RUSSELL LONG AND CHAIRMAN WILLIAM M'C.  
MARTIN, FEDERAL RESERVE BOARD, HEARINGS BEFORE THE SENATE  
FINANCE COMMITTEE, INVESTIGATION OF THE FINANCIAL CONDITION OF  
THE UNITED STATES, AUGUST 16, 1957, PART 3, 1361-1363

Senator LONG. Mr. Martin, I would like to talk a little bit about the independence of the Federal Reserve Board. You made the statement in your prepared statement that the Federal Reserve Board apparently had an obligation to follow the administration with regard to administration policies, and that it was not independent of them, but that it nonetheless exercised its own independent judgment with regard to the way that those policies should be implemented. Would you elaborate upon that, as to your understanding of the degree to which the administration fixes its policy with regard to employment, and with regard to direction of our economic and fiscal policies, and the degree to which the Federal Reserve Board exercises its judgment?

Mr. MARTIN. Well, we feel ourselves bound by the Employment Act and by the Federal Reserve Act. And in the field of money and credit, we consider ourselves to be, regardless of what the decisions of the administration may be—we consult with them but we feel that we have the authority, if we think that in our field, money and credit policies, that we should act differently than they, we feel perfectly at liberty to do so.

Senator LONG. In other words, you feel that you have freedom in promoting what you believe to be the full employment policy of the law?

Mr. MARTIN. That is right.

Senator LONG. To adopt policies that may not be the policy of the administration itself?

Mr. MARTIN. That is right.

Senator LONG. And you feel that there is the right within the Board to adopt a policy that may be completely at variance with the attitude and the direction of the policy of the administration?

Mr. MARTIN. Well, I wouldn't say that—we will discuss it at considerable length.

Senator LONG. You have the right to disagree with them?

Mr. MARTIN. Exactly.

Senator LONG. And you believe that the Federal Reserve Board, if it does disagree, has the right to pursue a policy that is completely contrary to the policy that the administration proceeds to follow, not meaning that you are doing this or that you have done it, but that you feel that under the law you do have that right?

Mr. MARTIN. Under the law we feel it is our prerogative; yes, sir.

Senator LONG. At the same time you believe, if I understand it correctly, that you should in a sense persuade them that the policy that you are pursuing is the correct policy, and that their policy should be consistent with yours, and that you should make your views available to the Executive for the Executive to persuade you if possible that the policy that the Executive is pursuing is the policy to which you should direct your activities?

Mr. MARTIN. That is right.

Senator LONG. At the present time, if I understand it, the testimony from the executive branch has been that their policy is consistent with the policy that you are pursuing?

Mr. MARTIN. Well, I think in a broad sense that is correct. We have differences of opinion—differences of judgment with respect to our actions.

Senator LONG. Yes. Has the administration of recent date, the spokesmen for the Treasury Department or the President in any other capacity, been urging you to take a position or adopt a policy contrary to the one that you have been pursuing?

Mr. MARTIN. Well, over the last year there has been no pressure, Senator, such as saying, "If you do not follow this policy, we will drop you out of office." They have tried on a number of occasions to persuade us that we should not take action which we did take, but it was a perfectly friendly discussion and honest disagreement, not about broad policies so much as about timing and judgment with respect to whether it was a wise course for us to pursue under present conditions.

Senator LONG. Could you give us some indication of recent decisions and recent actions that the Board has taken which you feel were not the policy that was recommended or was, perhaps, contrary to the attitude that you believed that the administration would have taken if it had been charged with the same responsibility that you have?

Mr. MARTIN. Well, I think the most glaring instance of that was in April of 1956. Pursuing our method of cooperation, I began discussions with Secretary Humphrey. In February of that year Governor Balderston and I had a meeting with Secretary Humphrey and there was a disagreement as to the nature that the economy was developing. We were so convinced; we discussed it with various people, and in a series of meetings from about the middle of February until the last week in March.

By the last week in March the position in the Federal Reserve—which was not a 1-man operation; you see, the 12 bank directors were considering all aspects of this—was that it would be wise for us to go up in the discount rate.

I think Secretary Humphrey subsequently testified that his judgment, at that time, was that the timing was poor, but that he was not opposed to the long-run objective.

We finally reached a point where there was no meeting of the minds that could be had, and there was nothing for the Federal Reserve to do except to go and act. And we acted.

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#### THE FEDERAL RESERVE'S OWN ANALYSIS REVEALS DEFECTS IN DEALER MARKET FOR UNITED STATES GOVERNMENT SECURITIES

Following is the report of the Ad Hoc Subcommittee on the Government Security Market of the Open Market Committee, dated November 12, 1952.

The ad hoc subcommittee was made up of leading officials of the Federal Reserve System. Its report is a highly interesting analytical document, possibly unique in its nature, prepared by the Federal Reserve officials as a critique of their own operations. Significantly, all 12 Federal Reserve bank presidents had an opportunity to review this document and presumably to voice any disagreement. In the absence of any dissent it can only be concluded that all concurred. The document was kept confidential until its existence came to the attention of a subcommittee of the Joint Economic Committee.

The report is important not only as a historical document, but also because it calls attention to many weaknesses and defects in the structure of the market for Government securities and the organization and operating techniques of the Open Market Committee, which are still present today. A matter of particular concern is the Government-sponsored monopoly of dealers in Government securities, a monopoly which persists even today and makes it exceedingly difficult, if not impossible, for open market operations to be aimed at controlling the money supply. All too frequently open market operations are conducted with a view to protecting members of this monopoly from price changes in Government securities, rather than to provide the economy with an appropriate money supply.

## STATEMENT BY CHAIRMAN FLANDERS ON ACTION ON AD HOC SUBCOMMITTEE REPORT, DECEMBER 9, 1954

The subcommittee has decided to release and make part of this record the report of the ad hoc Subcommittee on the Government Security Market of the Open Market Committee dated November 12, 1952. At the hearing on December 7 the subcommittee received arguments both pro and con, with respect to publication of the document from officials of the Federal Reserve System. Our decision to publish the document is based upon the following statement by Chairman William McChesney Martin, contained in the record above: "Well, as far as I am concerned, I am perfectly willing to make it available to the committee for publication, if they wish it."

The subcommittee believes that proper procedure has been followed in this matter since the head of the agency involved has assented to its publication. This view is concurred in by Senator Barry Goldwater and Congressman Wright Patman, members of the subcommittee. Senator J. W. Fulbright and Congressman Richard Simpson were unavailable for the hearings and did not participate in this decision.

We have advised both Mr. Martin and President Allan Sproul that the document will be published, and have invited them to append any additional papers that they believe should be published simultaneously with the ad hoc report.

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### FEDERAL OPEN MARKET COMMITTEE REPORT OF AD HOC SUBCOMMITTEE ON THE GOVERNMENT SECURITIES MARKET, NOVEMBER 12, 1952

#### PREFACE

Securities of the Federal Government have come to play a unique role in the flexibility and sensitiveness of the American money market. Our financial institutions now hold the bulk of their secondary or operating reserves invested in these issues, particularly in the shorter term securities. This is true especially of commercial banks but also of insurance companies and savings banks, as well as savings and loan associations. It is also increasingly true of many of our larger industrial corporations. As a result, any change in the demand for funds or their supply is felt promptly in the open market for Government securities. When our financial institutions gain funds, they usually invest immediately in Government securities, and, conversely, when they have net payments to make, they liquidate Government securities. When their customers borrow or opportunities for profitable investment arise, financial institutions switch out of Government securities, and when loans are paid or investments are sold the proceeds are usually invested, at least temporarily, in Government securities. The resulting daily turnover of securities in the market is enormous. It reflects the transactions by which thousands of individual financial institutions and business organizations keep their funds fully employed at interest, without sacrifice of their ability to meet the changing financial requirements of their more basic business operations.

Arbitrage transactions add to this daily turnover in the market. There is no credit risk in a portfolio of Government securities, i.e., no possibility that the holder will not be able to obtain cash at par at maturity. The relative prices at which different issues trade, therefore, reflect predominantly changes

in the demand for and the supply of loanable funds in the money market as a whole and also as between the various short-term, intermediate, and long-term sectors of the market. Since trading is done at commissions or spreads as small as one sixty-fourth (\$156.25 per million) and even smaller in very short issues, there are constant opportunities for arbitrage of small differentials in prices when the impact of buying or selling is especially heavy in some particular sector of the market. The secondary reserve portfolios of practically all the large financial institutions are managed by skilled professionals to take advantage of such opportunities.

The Federal Open Market Committee is a major factor in this market. At present its portfolio consists wholly of United States Government securities. It is the largest existing portfolio under one control. When the Federal Open Market Committee adopts a policy directive, it is executed in the market for Government securities. It takes the form of a series of specific transactions in Government securities. Total transactions for the account—purchases and sales—mount up to billions of dollars in the course of a year.

The impact of these operations is not measured by the volume of transactions alone. It is much greater, for example, than the impact of a similar volume of purchases and sales by a private investor. The Federal Open Market Committee releases or absorbs reserve funds when it operates in the Government securities market. When the Committee buys, it augments not only its own holdings of Government securities but also the ability of other investors to enter the market on the bid side. Conversely, when the Committee sells Government securities, it does much more than add to the market supply of such securities. The reserves that it absorbs subtract also from the capacity of the banking system to carry Government securities.

It is necessary to keep these basic features of the money market in mind in considering the subcommittee's report. They help to explain why relatively small operations, sometimes even rumors of operations, by the Federal Open Market Committee may give rise to such quick and pervasive response not only throughout the money market and the investment markets generally but also in business psychology. Any purchase or sale of Government securities by the Committee adds to or subtracts from the reserves of the member banks and is promptly reflected in the tone of the money market. A relatively small injection of funds through the purchase of bills will ordinarily find a response in the market for long-term securities. Large purchases of bills could scarcely fail to elicit such a response.

These transactions condition the tone of the money market and the general availability of credit because they immediately affect the value of securities in the operating portfolios of leading financial and business institutions. They cause changes in the prices of the specific issues bought or sold, and affect opportunities for arbitrage as between various issues and sectors of the market. As a result, a new pattern of yields emerges as between all different issues and sectors of the market. When the readjustments have worked themselves out, both the prices of Government securities and the pattern of their yields will have been affected. Both the absolute and the relative market values of the securities that constitute the liquid operating reserves of all our major financial institutions will have changed. In other words, there will have occurred a shift in the financial liquidity of the money market and of the economy.

Experience has demonstrated that the climate or tone of the money markets tends to respond directly to the volume of member bank borrowing at the Federal Reserve banks. Changes in the volume of borrowing represent the first response of member banks to losses or accessions of reserve funds from any source, including open-market operations of the Federal Open Market Committee. It constitutes, in fact, an essential link in the mechanism by which these operations exert a magnified effect on the money markets. When such borrowing is low, the tone of the money market is easy; that is, funds tend to be easily available at going interest rates for all borrowers who are acceptable as credit risks. When member banks themselves are heavily in debt to the Federal Reserve banks, the tone of the money market is tight, that is, marginal loans are deferred and even better credit risks may have to shop around for accommodation.

These responses seem to be independent, to some extent, of the level of interest rates, or of the discount rate. For example, the tone of the money market might be easy even though the discount rate were 4 percent. This would happen mainly in a situation where the volume of member-bank borrowing was low. Conversely, the tone of the money market might be on the tight side when the discount rate was 1½ percent. This would occur when member banks were heavily in debt.

The fact that the tone of the money market is responsive to the level of member bank borrowing at the Reserve banks gives a unique character to the role of open-market operations in the effectuation of credit and monetary policy. They can be used flexibly to offset the net impact on bank reserves of other sources of demand and supply of reserve funds in such a way as to result in an increase or decrease of member-bank borrowing, or, if desired, to maintain a level of such borrowing that is fairly constant from week to week, or month to month. This means that when the Federal Open Market Committee decides that a tone of tightness, or ease, or moderation, in the money markets would promote financial equilibrium and economic stability, it has the means at hand to make the decision effective.

Changes in the discount rate cannot be used in this way. They can exert powerful effects upon the general level of interest rates, but cannot be counted on to insure that the relative availability or unavailability of credit at those rates will be appropriate to the requirements of financial equilibrium and economic stability.

Neither can changes in reserve requirements be used with this precision. There are many administrative and technical problems which militate against the continuous or frequent use of this instrument of policy. Even if these did not exist, however, the instrument is much too blunt to be used to maintain member-bank borrowing from week to week or month to month at an appropriate level.

In short, open market operations are not simply another instrument of Federal Reserve policy, equivalent or alternative to changes in discount rates or in Reserve requirements. They provide a continuously available and flexible instrument of monetary policy for which there is no substitute, an instrument which affects the liquidity of the whole economy. They permit the Federal Reserve System to maintain continuously a tone of restraint in the market when financial and economic conditions call for restraint, or a tone of ease when that is appropriate. They constitute the only effective means by which the elasticity that was built into our monetary and credit structure by the Federal Reserve Act can be made to serve constructively the needs of the economy. Without them, that elasticity would often operate capriciously and even perversely to the detriment of the economy.

They require an efficiently functioning Government securities market characterized by depth, breadth, and resiliency. It is with these characteristics of the market that this report is mainly concerned. The subcommittee was authorized shortly after the Federal Open Market Committee decided that the continued maintenance of a relatively fixed pattern of prices and yields in the market for Government securities was inconsistent with its primary monetary and credit responsibilities. The Federal Open Market Committee felt that a freer market for Government securities would lessen inflationary pressures and better promote the proper accommodation of commerce, industry, and agriculture. It came to the conclusion, in fact, that a securities market, in which market forces of supply and demand and of savings and investment were permitted to express themselves in market prices and market yields, was indispensable to the effective execution of monetary policies directed toward financial equilibrium and economic stability at a high level of activity without detriment to the long-run purchasing power of the dollar.

Accordingly, the subcommittee was authorized to examine and report on the relevance and adequacy of the Federal Open Market Committee's own procedures and operations in the new context. Transactions for the Committee's account exert a powerful impact on that market. It is important that they be so executed as to avoid disruptive technical repercussions. In particular, it is important that technical operating procedures and practices, conceived in the atmosphere of war finance and developed to maintain a fixed pattern of prices and yields in the Government securities market, be reviewed to ascertain whether or not they tend to inhibit or paralyze the development of real depth, breadth, and resiliency in today's market that operates without continuous support.

This is the problem with which the subcommittee has been most concerned. The absorption and release of reserve funds which results from Federal Open Market Committee transactions should constitute a constructive factor in the Government securities market, as well as in the economy generally. Without open market operations, appropriately conceived and executed when there is need to absorb or release reserve funds, it would sometimes be impossible for the market to evaluate correctly fundamental trends in the economy as they affect the supply of money relative to its demand.

It is evident, therefore, for the well-being of the Government securities market itself, that the possibility be minimized of disruptive technical market repercussions from Committee transactions. It is also evident that the Federal Open

Market Committee should be in a position to operate promptly and in appropriate volume at all times, without fear of such adverse technical market repercussions, when the need for operations exists. This requires a Government securities market characterized by great depth, breadth, and resiliency. Without a market possessing these characteristics, the Committee might, on occasion, find itself unable to discharge its responsibilities.

#### INTRODUCTION

(1) The Federal Open Market Committee, at its meeting on May 17, 1951, authorized an ad hoc subcommittee to study and report on the operations and functioning of the Open Market Committee in relation to the Government securities market. The subcommittee was organized in April and May 1952, as follows: Wm. McC. Martin, Jr., chairman; Abbot L. Mills, Jr., Malcolm Bryan, Robert H. Craft, vice president and treasurer of the Guaranty Trust Co., of New York, was appointed technical consultant to the subcommittee, and was given leave of absence by the Guaranty Trust Co. to devote his full time to its work.

(2) Efforts have been made to keep the executive committee of the Federal Open Market Committee, all the Governors of the Board, and all of the presidents of the Federal Reserve banks informed of the activities of the subcommittee. The interval, amounting to nearly a year, between the authorization of the subcommittee and its actual establishment reflected the desirability of deferring the study until the conclusion of the hearings of the Patman subcommittee of the Joint Committee on the Economic Report, as well as the desirability of permitting some experience to accumulate on operations of the Committee under the more flexible conditions that followed the Treasury-Federal Reserve accord of March 5, 1951.

#### *Procedures of the subcommittee*

(3) As its first step, the subcommittee, with the help of suggestions from the executive committee, prepared an outline of study which was sent to a list of the individuals and institutions active in the market for Government securities, either for information or response. So that there would be no misconceptions, the outline and letters were made available to the press.

(4) Beginning June 9, 1952, the subcommittee held 10 sessions with recognized dealers, 11 meetings with unrecognized dealers, and 8 meetings with non-dealers intimately familiar with the operations of the Government securities market, discussing the material covered in the outline of study. The subcommittee also received letters from other individuals to whom the outline was sent. Stenographic notes of the discussions were taken for the convenience of the subcommittee but are not part of the record, since they were not subsequently cleared with the discussants.

(5) The outline of study, together with the list of individuals and institutions to which it was sent, and the covering letters by Chairman Martin, are attached to this report as appendix A. Mr. Craft has prepared a technical analysis of the correspondence and discussions focused on the outline of study which is attached as appendix B. Mr. Craft has also prepared a memorandum, entitled "Ground Rules," with respect to certain problems before the subcommittee which is attached as appendix C. A memorandum from the staff, discussing the possibilities of reopening an open-market call money post to finance dealers' portfolios, is attached as appendix D.

#### THE GOVERNMENT SECURITIES MARKET

##### *Size, participation, and composition*

(6) Of the total gross Federal debt of \$265 billion, about \$145 billion are outstanding in marketable form. Ownership of the marketable debt is about as follows: Commercial banks have about \$60 billion; corporations about \$15 billion; mutual savings banks, life insurance companies, and State and local governments about \$7 billion each; casualty insurance companies about \$5 billion; Federal agencies and trust funds about \$3 billion; and savings and loan associations and foreign governments about \$2 billion each. All other investors, including individuals, trust funds, private pension funds, endowments, etc., own around \$13 billion in the aggregate. The Federal Reserve banks, which have nearly \$24 billion, or about one-sixth of the marketable securities, have by far the largest single holding in the market, about 10 times larger than the next largest portfolio under one control.

(7) The marketable debt is comprised of \$20 billion of Treasury bills, \$17 billion of certificates, \$30 billion of notes, \$36 billion of bonds due or callable

in 5 years, \$17 billion of longer term bonds not restricted as to bank ownership, and \$27 billion of restricted bonds. Commercial banks hold about one-third of the bills and certificates, half of the notes, and two-thirds of the bank-eligible bonds. It is roughly estimated that business corporations hold about half of the bills, one-fourth of the certificates, and much lesser proportions of the notes and bonds. Savings institutions, including life insurance companies, pension funds, etc., own the bulk of the long-term bonds. Federal Reserve holdings are heavily concentrated at the present time in certificates, notes, and short-term bonds.

#### *Market structure and activity*

(8) The Government securities market provides the mechanism through which marketable Government securities have their secondary distribution. It is an over-the-counter market; it is really a group of markets made by the various dealers and knit together into a unit by an extensive communications system. About 20 dealers, including some banks with trading departments, comprise the basic structure of this market. The focus of the market is in New York, and most dealers have a network involving branch offices, representatives, correspondents, local investment houses, or the like through which they maintain contact with major Government security holders throughout the country. There are a number of secondary dealers who also trade in Government securities, frequently as a part of the broader over-the-counter business.

(9) The volume of transactions in marketable Government securities runs to a very large figure—on an average several hundred million dollars a day. These transactions are typically made by dealers without commission on a very narrow spread between the price at which they will buy and the price at which they will sell. So-called inside markets are typically made on spreads ranging from  $1/32$  (\$312.50 per million dollars) for long-term bonds down to an 0.01 in yield (\$25 per million dollars) on 90-day bills. As a usual thing, transactions of good size—as much as \$1 million or more for long-term bonds and up to \$5 million or more for short-term issues—are executed on-the-wire with customers. Trading is thus on a split-second basis, in large amounts in relation to dealer capital, and on close margins. Alert arbitrating is also constantly going on among the various issues of securities, both by dealers and by other active elements in the market. Success or failure in professional trading in such a market turns importantly on ability to appraise changing market factors quickly and accurately.

(10) The Federal Reserve stands in a key position with respect to the entire money and capital market in this country and particularly with respect to the Government securities market. System contacts with the market for United States Government securities take four main forms—transactions in Government securities made for the account of the system, extension of credit by a Federal Reserve bank to the nonbank recognized dealers through purchases of short-term securities under repurchase agreement, transactions made as agent for Treasury and foreign accounts or for member banks, and the gathering and dissemination of information on developments in the Government securities market. Aside from some transactions executed by the other Reserve banks for the account of member banks, these points of system contact with the market are focused at the trading desk at the Federal Reserve Bank of New York.

#### *Trading desk facilities and activities*

(11) The trading room at the Federal Reserve Bank of New York is equipped with some 10 or 12 key-type telephone stations with direct lines to each of 8 dealers in New York City, plus several trunklines for outside calls. These phones are manned continuously by 4 or 5 people regularly assigned to direct contact work with the dealers. Instantaneous contact can be made either by the personnel at the trading desk or by any 1 of the 8 dealers simply by pushing the proper key. At least one officer of the Bank is always on call at the desk during trading hours.

(12) Other personnel assigned to the trading desk handle special tasks of various kinds such as transactions for Treasury agencies, foreign accounts, or for member banks in the New York district. Clerks maintain current price quotations on all Government securities on a large quote board, which can easily be seen by any of the personnel on the trading desk. The quotation board itself lists quotations on all Government securities as received hourly from several dealers. From these quotations a composite or average quotation for each issue is computed. Routine reports on developments in the stock market and corporate and municipal bond markets are received and transmitted to the operating personnel on the trading desk.

*Transactions*

(13) Purchases and sales of securities for the System open market account are supervised by the manager of the account and are made in accordance with instructions issued by the Federal Open Market Committee. Such transactions, both on a repurchase and on an outright basis, (as well as all transactions in Government securities made by the New York bank for foreign accounts, member banks, or the Treasury) are now confined to 10 recognized dealers. This strict limitation of the dealer group with which the account now trades was formalized by the committee in 1944. Previously, the Federal Reserve Bank of New York had followed a less formal arrangement with a larger group of dealers.

(14) The policy of confining open market account business to a small group was adopted by the Federal Open Market Committee in 1944 in an attempt to deal only with that portion of the market where the final effort at matching private purchases and sales takes place. This approach was based on the hope that by operating closely with a small group of key dealers responsive to its discipline, the Federal Open Market Committee could peg a pattern of low interest yields in a period of heavy war financing with minimum monetization of the debt.

(15) In accordance with the instructions of the Federal Open Market Committee, open market transactions are practically always made on an agency basis, that is, not with dealers as principals but with other holders, using dealers as brokers. This has meant that dealers could not ordinarily sell to the account from position. The Committee has specified that the commission allowed shall not exceed \$156.25 per million dollars on notes and bonds, and \$100 per million dollars on certificates and bills. In practice it generally has been smaller on maturities of less than one year. Repurchase agreements are by their nature made with the nonbank recognized dealers as principals.

(16) Transactions executed by the trading desk are never made for cash, i.e., for delivery the same day, but rather for regular delivery the following day (occasionally for delayed delivery). For short-term issues, however, a large part of transactions made by others in the market is on a cash basis. The account will not knowingly buy securities handled by dealers on a cash basis.

(17) In addition to transactions for the System's open market account, a large volume of purchases and sales is made by the New York bank for domestic and foreign accounts. Acting as fiscal agent for the Treasury, the New York bank transacts business for various Government agencies and trust funds. These transactions may be of a routine nature or may involve special operations designed to support the market. Foreign central banks and other foreign agencies also employ the New York Federal Reserve Bank as agent and channel purchase or sale orders on Treasury issues through it. Member banks in the New York Federal Reserve District—usually smaller banks in outlying areas—also use the New York bank for what are typically odd-lot transactions. All of these transactions by the bank as agent are handled through the trading desk.

(18) Transactions for the open market account are normally handled by any 1 of 4 or 5 persons who maintain constant direct contact between dealers and the account. Transactions for the Treasury, foreign agencies, or member banks are usually handled by an individual on the trading desk who is not one of the persons regularly contacting dealers for information or normally trading for open market account. Thus, the dealers can generally distinguish between agency transactions and those for the open market account on the basis of the origin of the call from the trading desk. There are also other clues in the trading operation which dealers can use in appraising the source of a transaction. At times, however, the regular procedures of the desk may be changed in order to conceal the operations of the open market account. Orders for the account may be channeled through the individual who ordinarily handles foreign agency and member bank business, or those who usually trade for the open market account may take over business to be done for agency or foreign accounts. Pending the weekly report of condition of the Federal Reserve banks, the actual operations of the account may thus be screened from the market or the market may be led to believe that the Federal Open Market Committee was active at a time when it was not.

(19) The volume of transactions in Government securities carried out by the New York bank's trading desk for foreign, Treasury, and member bank accounts is very substantial. In the 12 months ending June 30, 1952, such business amounted to about \$2.4 billion, of which \$1.5 billion was in bills, \$600 million

in certificates and notes, and \$300 million in bonds. These transactions amounted to about one-third the volume of total trades for open market account; they were almost as large as open market transactions other than in periods of Treasury refunding.

(20) Federal Reserve banks outside New York also transact business in Government securities as a service for some of their member banks. In the 12 months ending June 30, 1952, \$1.9 billion of such business was handled. While some Reserve banks confine such dealings to those dealers qualified to transact business with the open market account, others do business with a wide group of investment houses.

#### *Information arrangements*

(21) The 4 or 5 individuals assigned to contacting dealers at the New York trading desk are constantly receiving oral reports from dealers, maintaining current records of reported transactions in the market; and checking and relating the information thus received with various written reports also submitted by the dealers. In addition, 1 or 2 of these contact men report to various interested officials in and out of the System on current trends in the market.

(22) Before the market opens each day, several meetings are held with representatives of recognized dealers. These meetings, which are limited to approximately 10 minutes each, are scheduled on a rotating basis, with 2 or 3 dealer organizations participating each day. At the meetings, the dealer representatives report on the major transactions handled in the market during the previous trading session. They also pass on other information about the Government securities market or other aspects of the money and capital market. The meetings are largely devoted to reporting by dealers rather than to an exchange of information, as the comments of the Committee's representatives in attendance are very guarded.

(23) During trading hours in the market, contact is maintained regularly between the trading desk and each recognized dealer in New York City. Any transactions involving a million dollars or more are currently reported to the trading desk. A worksheet is maintained on the transactions for the day, divided into various categories of securities, with a general description of the type of customer involved in each trade. This transaction sheet provides a quick general picture of the demand or supply of various types of securities in the market. Important discrepancies between the information on this transaction sheet and the written reports submitted by the dealers on their volume and positions or the oral reports made during the morning session are usually clarified by checking further with the dealer.

(24) On days when auctions for Treasury bill issues are being held, one of the contact persons on the trading desk makes several special calls to all dealers to get their appraisals of developments in the auction. At about 11:30 a.m., each one of the dealers gives his estimate of the level at which customer bids (i.e., bids of nonbank investors who usually submit them as customers of banks) will be submitted and also as to the lowest price level at which awards will be made. Again, at about 1 p.m., dealers will be contacted to see if there has been any change in sentiment. Based on the information received, bids are submitted for the amount of maturing bills held in the portfolio. The manager of the foreign department is also informed as to the market estimate of the bill auction and he then determines at what price bids for foreign agencies will be submitted.

(25) Supplementing the information received verbally by the trading desk, various written reports of a statistical nature are also made by dealers. Daily reports are received from each of the recognized dealers, as well as many of the nonrecognized dealers, on their current positions broken down into various categories. Reports are also made on the total transactions handled each day in each of those categories. Thus, shortly after the opening of the market on any day, the trading desk personnel has available to it data on the current long and short positions of each dealer, the aggregate positions of nearly all dealers in the market, and the volume of transactions in various classes of securities made by each dealer and the aggregate of such transactions.

(26) The trading desk also received from other departments of the New York bank a daily report on the reserve position of each of the central reserve city banks in New York City and reports on the money market factors affecting the New York market, including a prediction of the effect of these factors for the

ensuing day. The most recent figures on factors affecting reserves of all member banks are also supplied to the desk, as well as frequent projections of major factors affecting bank reserve positions over the next 2 weeks. Estimates supplied on Treasury receipts and expenditures are compared each Monday and Thursday with the operating personnel at the Treasury in a discussion of the amount of calls on tax and loan accounts to be made and the timing of such calls; this contact is handled at the trading desk by an officer of the securities department.

(27) At regular intervals during the day, information on market prices is given by the trading desk personnel to representatives of the Treasury and of the Federal Reserve Board. In addition to the routine price reports, a summary of market developments during the day is given shortly after the market closes to the Treasury and the Board. Flash reports are sent to each Federal Reserve bank president twice daily—at about 11 a.m. and after the close.

(28) Two regular reports on developments in all securities markets are issued by the New York bank, and trading desk personnel contribute a summary of developments in the Government securities market to each of these reports. One of these is a daily report to the Board of Governors which is distributed to various System representatives and to the Treasury. A somewhat more complete report is made weekly to the Federal Open Market Committee, and circulation of this report is limited to a list approved by that Committee.

#### FINDINGS AND RECOMMENDATIONS

##### *Structure of the market*

(29) It is the conviction of the subcommittee, based on its intimate discussions with a very large segment of key participants in the United States Government securities market, that that market at the present time possesses, with one exception noted below, the organizational elements essential to successful performance of its functions. It is competently staffed, and its operations cover the relevant sections of the community.

(30) The only serious qualification that the subcommittee makes to these generalizations relates to certain deficiencies in the credit facilities available to dealers. During recent months, the rates paid by dealers to carry their portfolios of United States Government securities have averaged above the yield on these portfolios. This amounts to a negative "carry" and obviously affects seriously the ability of the dealer organization to maintain broad markets. This problem has become more serious since the discussions with the dealers. At the time of those discussions, the dealers dealt at length with the problem of negative carry but they were referring, for the most part, to periods of stringency of very limited duration, not to the kind of continuing stringency that prevailed in most of the third quarter of 1952. The subcommittee advances suggestions to correct this deficiency later in the report.

(31) It is likewise the conviction of the subcommittee that the market for United States Government securities is already sufficiently broad, experienced, competitive, and arbitrage minded as to minimize the success of attempts of private operators to "rig" the market.

(32) The market has developed a considerable degree of resiliency and ability to handle itself since the accord. After years of pegging, it took a few months for the establishment of market equilibrium, but this was achieved without the development of disorderly conditions and with none of the drastic changes in prices and yields that had been feared by so many. In the long-term area, this equilibrium has now been maintained for more than 1 year without material Federal Reserve intervention. Subsequent to mid-year 1951, total dealings of the open-market account in securities of longer than 14 months' maturity have amounted to \$32 million, excluding securities acquired in exchange for maturing issues. Most of these transactions occurred in late November and late December of last year.

(33) The actual record of transactions by the Federal Open Market Committee since mid-1951 is shown in the following table:

Open market account transactions in U.S. Government securities<sup>1</sup>—July 1, 1951—Sept. 30, 1952

(In millions of dollars)

Class of security	Total		During periods of refunding <sup>2</sup>		Other than periods of refunding	
	Purchases	Sales	Purchases	Sales	Purchases	Sales
Maturing issues (rights).....	3,059		3,059			
Other securities maturing:						
Within 91 days.....	1,568	2,206	541	372	1,027	1,834
91 days to 14 months.....	594	2,277	341	1,154	253	1,123
14 months to 5 years.....	1				1	
5 years to 10 years.....	3				3	
Over 10 years.....	23	5	6	3	17	2
Total.....	5,245	4,488	3,947	1,529	1,301	2,959

<sup>1</sup> Excludes repurchase agreements with dealers and brokers and purchases and sales of special certificates from and to Treasury.

<sup>2</sup> Commitments from date of announcement to closing of books, plus all transactions in new securities on when-issued basis.

(34) The table indicates that the Federal Open Market Committee has concentrated its transactions very heavily in short maturities since mid-1951. Purchases of issues of over 14 months were negligible, despite the fact that this record covers a period during which the price of Victory's moved between \$95½ and \$99½, and that both the market and the Committee were feeling their way out from the conditions that prevailed under the pegs. The \$32 million of transactions in the intermediate and long-term sector are the only ones that could properly be described as undertaken by the Committee to "maintain an orderly market."

(35) It would be inaccurate, however, to describe the present market for United States Government securities as possessing depth, breadth, and resiliency to the full degree that would be desirable for the efficient conduct of effective and responsive open-market operations. It is important that there be no misunderstanding of the intent of the subcommittee in making this qualification. The subcommittee is not referring to the degree of fluctuation that has characterized prices in the market for Government securities since the accord. Considering the pressure on the economy and on the supply of savings, the range of price fluctuation in the market for Government securities has been moderate. The subcommittee refers rather to the psychology that still pervades the market, to the confusion among professional operators in the market with respect to the elements they should take into consideration in the evaluation of future market trends, and to their apprehension over the attitude toward prices in the market on the part of the Federal Open Market Committee and of its representatives on the trading desk. This psychology would not characterize a market that possessed real depth, breadth, and resiliency.

(36) In strictly market terms, the inside market, i.e., the market that is reflected on the order books of specialists and dealers, possesses depth when there are orders, either actual orders or orders that can be readily uncovered, both above and below the market. The market has breadth when these orders are in volume and come from widely divergent investor groups. It is resilient when new orders pour promptly into the market to take advantage of sharp and unexpected fluctuations in prices.

(37) These conditions do not now prevail completely in any sector of the market. They are most nearly characteristic of the market for Treasury bills, but even in that market reactions have been sluggish on more than one occasion since the accord. They are least characteristic of the market for restricted bonds. In these issues, there has prevailed persistently since the accord a wide gap between the prices at which the least firm holders are willing to sell and potential buyers are willing to purchase. Within this gap, quotations have fluctuated widely, either in response to relatively small buy or sell orders, or, more frequently, as a result of professional efforts to stimulate interest by marking quotations up or down.

(38) In the view of the subcommittee, the persistence of this condition operates to weaken the effectiveness of open-market operations and emphasizes the importance of steps to improve the depth, breadth, and resiliency of the market. Since the Committee's transactions are among the most important

factors that condition the market, the Federal Open Market Committee has an obligation to scrutinize its own organization and its own operations to see in what respects, if any, they can safely be modified, if the effect of such modification would contribute to the depth, breadth, and resiliency of the market.

*Role of the System in the market*

(39) It is the unanimous view of the subcommittee that the Federal Open Market Committee should keep its intervention in the market to such an absolute minimum as may be consistent with its credit policy. This position rests not only on the fact that the System's primary role has to do with credit policy in the broad sense, but also because of important technical considerations related to the highly desirable development of strength in the private market for United States Government obligations. The normal functioning of the market is inevitably weakened by the constant threat of intervention by the Committee. In any market, the development of special institutions and arrangements that serve to provide the market with natural strength and resilience and to give it breadth and depth tend to be greatly inhibited by official "mothering." Private market institutions of this kind are repressed particularly by the constant possibility of official actions which, by the market's standards, will frequently seem—and be—capricious. Such actions constitute a risk that cannot reasonably be evaluated in advance and anticipated in the formulation of individual, private judgments of market prospects.

(40) The subcommittee has come to the conclusion—fully supported by the testimony before it—that the Federal Open Market Committee bears a real measure of responsibility for part of the lack of depth, breadth, and resiliency in the Government securities market. There is not only the history of many years of closely controlled markets, but also the fact that the Committee has not yet been specific with respect to what it means by a free market for United States Government securities. In replies to the Patman questionnaire, in official publications, and in public speeches by its personnel, the Committee has indicated that it contemplates operating in a free market from here on out, but at the same time the policy record of the Federal Open Market Committee, published in the 1951 annual report, shows that it is still committed to the "maintenance of orderly markets," which clearly implies intervention.

(41) This inconsistency has not added to dealer or customer confidence. To take positions in volume and make markets, dealers must be confident that a really free market exists in fact; i.e., that the Federal Open Market Committee will permit prices to equal demand and supply without direct intervention other than such as would normally be made to release or absorb reserve funds. They have no such assurance. To the dealers, and to professional buyers and sellers of Government securities, the pronouncements of the Federal Open Market Committee mean (1) that it has dropped the pegs, (2) that it is willing to see fluctuations in the market, but (3) that it is watching these fluctuations closely and is prepared to intervene on occasion whenever it considers intervention necessary. From the dealer's point of view, this means that the Federal Open Market Committee desires a fluctuating market but will not necessarily permit one to develop that is free. Their conclusion is that they are operating in a fluctuating market subject to unpredictable, however reluctant, intervention by the Federal Open Market Committee.

(42) The distinction has a vital bearing on the ability of the market mechanism to function with depth, breadth, and resiliency. It is in the nature of a dealer's business that he is constantly exposed to market risk from both sides of the market. One test of his professional skill and, indeed, of his fitness to be in the market at all in the ability to judge the factors in a free market with sufficient foresight and prudence to preserve or even augment his relatively thin margin of capital, whichever way the market turns. He does this by reversing or covering his positions at times or by alert arbitrage of markets for particular issues that are out of line. Thus he is able to function continuously and to make markets. He cannot do this, however, with anything like the same degree of skill in a market that is subject to unpredictable and overpowering intervention by the Federal Open Market Committee. The Committee, with practically unlimited resources to back up its intervention, is not guided in its operations by considerations of profit, and unlike other investors, is not forced to cover its operations to minimize loss. Such intervention can impose drastic risks on a dealer or other holders, particularly if the intervention is in intermediate or long securities where the dollar impact on the capital position of modest changes in yields is large.

(43) It is easy to understand why dealers, with their lack of confidence in the Committee's intentions to restore a free market, would be reluctant to go very

far in taking positions. To do so would not only involve the risk of being wrong in their evaluation of economic and market trends, but also of being wrong in guessing at what point the Federal Open Market Committee might feel it necessary to intervene. A difference of a few thirty-seconds in the level of prices of such intervention would not necessarily be of great moment to the Federal Open Market Committee, but it might be of real importance to a dealer's operations.

(44) It is the judgment of the subcommittee that the lack of professional dealer confidence in the intentions of the Federal Open Market Committee is justified, and that it is not enough for the development of an adequate market that the Committee's intervention be held to a strict minimum. It is important that the dealers be assured, if it is at all possible to give such assurance, that the Committee is prepared to permit a really free market in United States Government securities to develop without direct intervention for the purpose of establishing particular prices, yields, or patterns of yields.

(45) When intervention by the Federal Open Market Committee is necessary to carry out the System's monetary policies, the market is least likely to be seriously disturbed if the intervention takes the form of purchases or sales of very short-term Government securities. The dealers now have no confidence that transactions will, in fact, be so limited. In the judgment of the subcommittee, an assurance to that effect, if it could be made, would be reflected in greater depth, breadth, and resiliency in all sectors of the market.

(46) Such assurance would not impede open market operations by the Committee designed either to put reserve funds into the market or to withdraw them to promote economic stability. It would simply guarantee that the first impact of such purchases and sales would fall on the prices of very short-term issues, where dollar prices react least in response to a change in yield, and where the asset value of a portfolio is least affected. A dealer organization, even though it operates on thin margins of capital, can live with impacts such as these and consider them a part of its normal market risks.

(47) Nor would such an assurance prevent the effects of open market operations, initiated in the short-term sector, from spreading to other sectors of the market in the form of changes in prices, yields, and the pattern of yields. These changes would come about as a result of market arbitrage, i.e., of the exercise of market skill by the professionals who make up the market, the dealers who specialize in matching bids and offers and the professional managers of portfolios who are constantly balancing their investments to take advantage of shifts in prices and yields between the different sectors of the market. A dealer can survive, even if the capital value of long-term issues reacts sharply, when these reactions are brought about as a result of market trading and arbitrage. His risk exposure, on positions in intermediate and long-term issues, is much greater when these changes are induced by direct intervention at arbitrary prices by the Federal Open Market Committee.

(48) The subcommittee realizes the difficulties involved for an operating body, such as the Federal Open Market Committee, in giving any assurance that would limit its own future freedom of action. As assurance, of course, that the Committee would limit its intervention to the very short-term market would fall within, not without, the boundaries of the best central banking traditions. It was long held axiomatic that central bank portfolios should properly be confined to very short-term bills of the highest liquidity and quality. In fact, most effective central banks have operated within this restriction, imposed either by tradition or by law. Traditional principles of central banking made no provision for operations in the intermediate or long maturities of any borrower.

(49) There are only two types of situation where the freedom of action of the Federal Open Market Committee would be seriously limited by such an assurance. In the one case, potential System intervention revolves in general around its commitments with respect to "orderly markets." In the other, it is associated mainly with the purchases and exchanges in periods of Treasury financing.

(50) So far as the first type of intervention is concerned, the form and wording of the directive issued by the Federal Open Market Committee with respect to "orderly markets" assumes a particularly crucial importance. The subcommittee was much impressed with the wide differences in opinion among dealers and nondealers as to what constitutes an "orderly market." From the discussion, it is thoroughly apparent that the term "orderly markets" does not have a clearly defined meaning which is generally understood and accepted.

(51) In view of these differences in concept, and particularly in view of the narrow definition of this term held by some market elements, it seems to the subcommittee that the apprehensions of the dealers have substance. The present

wording of the directive of the Federal Open Market Committee on "maintenance of orderly conditions" carries with it an unduly, and even dangerously strong, implication of continuing intervention in all sectors of the market. This prospect of intervention seriously impairs the ability of the market to stand on its own feet or to evaluate correctly the real forces of demand and supply in the economy. It is clearly evident that a directive to "maintain orderly markets" can mean all things to all men, and in effect constitutes a blanket delegation of discretionary authority which can be interpreted to cover almost any action by the Committee in the market.

(52) In the subcommittee's view, a directive which is subject to such an interpretation by either the market, the executive committee, or the management of the account is entirely inconsistent with the minimum role in the market which the Federal Open Market Committee must assume if the Committee and the market are each to perform their respective functions most effectively.

(53) The subcommittee recommends, consequently, that the wording of the directive of the Federal Open Market Committee to the Executive Committee be changed to provide for the "correction of disorderly conditions" rather than the "maintenance of orderly conditions" in the market for Government securities. The directive by the Executive Committee to the management of the account in this regard should involve an instruction to notify the Executive Committee whenever conditions become sufficiently disorderly to warrant the consideration of corrective action by the Federal Open Market Committee.

(54) In making this recommendation, the subcommittee takes the position that fluctuations resulting from temporary or technical developments are self-correcting in a really free money market without the necessity for intervention of any kind. This is particularly true of a functioning market characterized by depth, breadth, and resiliency. Of the movements that are not self-correcting, most reflect basic changes in the credit outlook and should not be the occasion for intervention. Of the remainder that do not fall in either of these two categories, the great preponderance, throughout all sectors of the market, will respond readily to arbitrage induced by positive intervention on the part of the Committee in the very short sector of the market. In other words, it is only rarely that selling creates a sufficiently disorderly situation to require intervention in other than the very short market. A disorderly condition created by buying is very unlikely to occur if the Committee is in a position to absorb reserves by selling in the short-term market.

(55) The subcommittee considers a declining market really disorderly in the sense that it requires intervention to meet it when selling feeds on itself so rapidly and so menacingly that it discourages both short covering and the placement of offsetting new orders by investors who ordinarily would seek to profit from purchases made in weak markets. There are occasions when such really disorderly reactions occur in the market. They may lead, if left unchecked, to the development of panic conditions. These must be corrected. In the judgment of the subcommittee, it is in these circumstances, and these circumstances only, that the Federal Open Market Committee would be impelled, by its basic responsibilities for the maintenance of sound monetary conditions, to intervene, and intervene decisively, in other than the very short-term sector of the Government securities market.

(56) The reserve funds put into the market in such operations would complicate the smooth execution of monetary policy, but the occasions for intervention would be infrequent. Once properly explained, consequently, this specific exception to a general public assurance that the Committee henceforth would confine its operations to the very short maturities, preferably bills, should not impede the development of a market with greater depth, breadth, and resiliency.

#### *The problem of Treasury financing*

(57) The Federal Open Market Committee now follows the practice of intervening in the market to support rights values on maturing Treasury securities. So long as this practice continues, it will be impossible to give the type of assurance discussed above. These interventions are recurrent. When sales to the Federal Reserve are appreciable, they result in the injection of reserve funds into the market in amounts that are embarrassingly large. They impose a pattern of yields on the market, and, consequently, are disturbing to its depth, breadth, and resiliency.

(58) The practice of supporting Treasury financings developed during the period of war finance, when the Treasury and the Federal Open Market Committee undertook jointly to see that lack of funds would not impede effective prosecution of the war. In the judgment of the subcommittee, it would be appropriate to sit down with the Treasury and review the practice in the light of

current experience. If any change is to be made, there would be need for extensive consultation with the Treasury, since the Treasury's present debt management policies and its current practices in managing its cash balance would be directly affected.

(59) The subcommittee's views on this point have been considerably influenced by the judgment of its technical consultant, Mr. Craft, and it urges that the Federal Open Market Committee give most serious consideration to the views expressed in the memorandum, entitled "Ground Rules," attached as appendix C. The conclusion presented in this document is that for the open market operation to be successful there must be new ground rules, i.e., new methods of operation by the Committee, known in advance, that will permit the Committee to pursue vigorous credit and monetary policies without incurring the danger of disruption in the market for Government securities. The principal recommendations with respect to the most appropriate ground rules are three: (1) that the Committee (except in the case when it is dealing with a disorderly market) confine its operations to bills, (2) that, in the rare case of the emergence of a disorderly market, corrective actions be deferred until the need for them is clearly indicated and then be taken only after a poll of the executive committee rather than at the discretion of the management of the account, and (3) that the practice of supporting directly either new or refunding issues of Treasury securities be abandoned. The memorandum outlines in detail the considerations that have led to these conclusions, and the specific technical operations that would best carry them into effect.

(60) The memorandum outlines the serious operating problems that the Federal Open Market Committee will face, necessarily, if it continues to acquire Treasury issues of new or refunding securities. The subcommittee is particularly impressed by the conclusion that the portfolio of the open market account may become, in fact if not in theoretical composition, frozen or semifrozen. As is pointed out, the securities which the open market account has acquired as rights in underwriting a refunding have subsequently been exchanged for the new issue and the Federal Open Market Committee has been hesitant to dispose of these new issues under normal conditions in the market—a justifiable hesitation because sale of the securities in the market before they have been held quite near to their maturity might be disruptive.

(61) It is also pointed out that when these securities or, in fact any securities other than bills, however acquired, were sold into the market as they approached maturity, they have been purchased largely by corporations or other investors who had a specific need for cash at the maturity date. They have tended, consequently, to increase the natural and inevitable attrition connected with any maturing Treasury issue. Consequently, the securities have tended to be reacquired by the Committee in supporting the refunding.

(62) The persistent growth in the open market account of securities acquired directly or indirectly in support of Treasury refundings is disquieting.

(63) The present semifrozen position of the portfolio brings out in new form the desirability of a larger proportion of bills in the System's portfolio, and underscores the cogency of the recommendation that henceforth the Committee operate exclusively in bills except when it is intervening in the market to correct conditions of very serious disorder. Bills, in addition to their ready market ability and other qualities that make them preferred components of the portfolio, have the unique advantage, from the point of view of the Committee's operations, that they are marketed at auction for cash and are redeemed in cash at maturity. Neither at issue, nor at redemption, do they raise problems of support for the Committee, nor of attrition for the Treasury.

(64) It is clear that the Federal Open Market Committee cannot consider the type of assurance that would contribute most to the development of depth, breadth, and resiliency in the market until it has come to a decision on the question of whether or not the Committee should continue to buy rights or any other securities other than bills during periods of Treasury financing. There are two opposing viewpoints on this basic and difficult problem.

(65) If it is believed that the System's responsibilities are strictly limited to the formulation and execution of credit and monetary policy, logic would preclude the Federal Open Market Committee from purchasing rights or other issues to support Treasury financing. Under this view, the Treasury, being responsible for debt management, would be responsible also for naming such terms and coupons on new securities that a natural-rights value in the market would be established automatically. There would be no occasion, therefore, for intervention or support by the Federal Open Market Committee. The Committee might, of course, engage simultaneously in open-market operations to relieve an unexpected stringency in the money market, but it would not be expected to do so,

and if it did it would operate only because of its responsibility for the general credit situation.

(66) This view rests on the doctrine that the governmental structure must provide that responsibility for public decision be clearly fixed and that public officials be held strictly accountable for their decisions. It, therefore, leaves little scope for purchases to support a new issue by the Federal Open Market Committee during the period of subscription. In this view, the Federal Open Market Committee would buy no rights on a maturing issue, with the result that all attrition would fall on the Treasury if the issue were not attractively priced.

(67) This would be expected under the logic of the doctrine of responsibility. Such decisions with regard to debt management are unquestionably a prerogative of the Treasury, the Treasury, under that doctrine, would expect to accept the consequences of an erroneous decision. If attrition were large, the Treasury would be expected to replenish its cash balance with a second offering on terms more in tune with the market.

(68) In contrast to this view is the position which holds that debt-management and reserve-banking decisions cannot be separated. While the Treasury is primarily responsible for debt-management decisions, that responsibility under this second view is shared in part by the Federal Reserve System, and while the Federal Reserve is primarily responsible for credit and monetary policy, that responsibility must also be shared by the Treasury. According to this position, the problems of debt management and monetary management are inextricably intermingled, partly in concept but inescapably so in execution. The two responsible agencies are thus considered to be like Siamese twins, each completely independent in arriving at its decisions, and each independent to a considerable degree in its actions, yet each at some point subject to a veto by the other if its actions depart too far from a goal that must be sought as a team. This view was perhaps unconsciously expressed by the two agencies in their announcement of the accord in March 1951. In that announcement they agreed mutually to try to cooperate in seeing that Treasury requirements were met and that monetization of debt was held to a minimum.

(69) In the view of the subcommittee, it would be wise to avoid pushing either of these positions to the full logical extreme. Neither position exactly fits the immediate situation facing the money market, the Treasury, or the Federal Open Market Committee.

(70) The Federal Open Market Committee has only recently abandoned its previous policy of continuous control of prices and yields throughout the list of Government securities. During periods of refunding, it is still purchasing rights, and on occasion interfering with market arbitrage by supporting issues whose maturity approximates the maturity of new Treasury issues. The object of these transactions is to shield the cash balance of the Treasury from the attrition that might otherwise occur when maturing issues are not presented for exchange.

(71) The Treasury, faced with enormous financing problems both for new money and refundings, has modified to a considerable degree the debt-management techniques developed during the war. Maturing certificates, however, are usually rolled over into a similar issue and when projections are made of needs for new money it is assumed that only moderate attrition will fall on the Treasury in connection with these refunding operations.

(72) The market, too, is in a period of transition. It is confused with respect to the occasions when it should expect intervention from the Federal Open Market Committee, and it is uncertain with respect to the sectors in which this intervention might occur. It is hesitant, therefore, and lacks the depth, breadth, and resiliency that would be desirable. It is in the interest of the Treasury as well as of the Federal Open Market Committee that every effort be made to improve these characteristics of the market.

(73) It is in the context of this situation that the subcommittee is formulating its recommendations. It has found (1) that the Federal Open Market Committee can promote the well-being of the market for Government securities by an assurance that henceforth it will avoid unnecessary intervention in the market, and will confine that intervention as much as possible to the very short maturities, preferably bills, (2) that the ability of the Federal Open Market Committee to give such an assurance is blocked by the present practice of purchasing rights and certain issues during periods of Treasury financing, and (3) that, in addition the portfolio of the open market account is becoming unduly weighted with the securities that have been acquired in these support operations.

(74) The subcommittee recommends, therefore (1) that the Federal Open Market Committee ask the Treasury to work out promptly new procedures for financing, and (2) that, as soon as practicable, the Federal Open Market Committee abstain, during periods of Treasury financing, from purchasing (a) any

maturing issues for which an exchange is being offered, (b) any when-issued securities, and (c) any outstanding issues of comparable maturity being offered for exchange.

(75) Should the Federal Open Market Committee adopt the recommendations of the subcommittee with respect (a) to the type of situation justifying intervention to correct disorderly market conditions, and (b) to the kinds of transactions appropriate during a period of Treasury financing, it would be in a position to give a public assurance to the market that henceforth, with two exceptions, the Committee will intervene in the market only to absorb or release reserve funds to effectuate its monetary policies, and that it will confine its intervention to the shortest sectors of the market, preferably bills.

(76) The two exceptions should be carefully explained to the market. They would occur (1) in a situation where genuine disorderly conditions had developed to a point where the executive committee felt selling was feeding on itself and might produce panic, and (2) during periods of Treasury financing. In the first case, the Federal Open Market Committee would be expected to enter more decisively in the long-term or intermediate sectors of the market. In the second case, intervention, if any, would be confined to the very short maturities, principally bills. The subcommittee recommends most strongly that the Federal Open Market Committee adopt the necessary measures and give this assurance.

#### *Judgments of System market techniques*

(77) The whole Federal Reserve System can take pride in the prestige enjoyed by the Federal Reserve Bank of New York, and by the management of the open market account in their relations with the Government securities market. The subcommittee in its discussion made every effort to provide an atmosphere where the market participants would feel encouraged to talk freely with the understanding that their comments would be considered impersonally and objectively. In most cases, the participants in the discussions responded to this atmosphere and discussed their problems objectively, including problems that have arisen in dealing with the Federal Open Market Committee. Without, in any sense, diminishing the importance of these problems and the urgent necessity of taking actions recommended below to eliminate their recurrence, the subcommittee found that by and large the market personnel which participated in the discussions had confidence in the integrity of the personnel of the Federal Reserve Bank of New York, and respect for the competence of its management.

(78) At the same time, the subcommittee was surprised to find extensive criticism of many of the technical operations of the Committee, especially in its relations with the dealer organization. As was anticipated, it found that the drawing of a rigid line between "recognized" and "nonrecognized" dealers was resented by the latter. In addition to this, however, there were evidences, even among the recognized dealers, of irritation with the dealer-Federal Open Market Committee relationship, and some doubt and confusion as to exactly what function the relationship now serves under conditions of unpegged markets.

(79) It is the view of the subcommittee that these two sources of dissatisfaction and irritation cannot be brushed off lightly or viewed complacently as inevitable accompaniments of the difficult and broad operations that are performed by the Committee in the market for the huge outstanding Government debt. The complaints are specific and relate to specific techniques of operation. Unless corrected, they will continue to fester and rankle.

(80) In all too many cases, the criticisms are interrelated; that is, the technical operations of the Federal Open Market Committee most broadly criticized in the market are the very types of operations which require for their effectuation a sharp differentiation between dealers who are recognized and others who are not. If these technical operations of the Committee were abandoned in accordance with the suggestions of the bulk of the participants in the discussions, there would seem to be less need or justification for the present rigid system of dealer recognition. The subcommittee proposes, therefore, (1) to examine the technical operations to which objection has been raised in its discussions, (2) to come to a judgment as to whether or not the objections are valid, (3) to recommend alternative procedures if they are considered valid, and (4) to consider what form of relationship between the Federal Open Market Committee and the dealers would be most appropriate to a situation of unpegged markets.

(81) "*Reluctant buying.*"—The "reluctant buying" technique employed on frequent occasions by the Federal Open Market Committee during the period of pegging, and apparently still used in more limited extent and in modified form during certain refunding operations since March 1951, furnished the most prevalent and active target for criticism on the part of dealers, both recognized and unrecognized, as well as of nondealers. This criticism was practically unanimous on the part of all who referred to the subject in their discussion.

(82) Reluctant buying is the term used to refer to the practice followed by the Committee of limiting its purchases of securities to only a portion of the amounts offered while at the same time requiring that dealers not lower their quotations. This practice involves the exercise of judgment as to whose securities will be taken. The technique is premised on the theory that failure to secure prompt execution will discourage offerings and give time to the dealers to shop around and find market lodgment for securities pressed for sale. It requires a tight Committee control over the major trading elements in the market—maintained through the recognized dealer mechanism—in order to enable the Committee to prevent changes from being made in quoted dealer prices without having to use reserve funds to clear the market of securities being offered for sale at those prices.

(83) Criticisms of the technique (and these were more or less tied together with all the arrangements under which the System took control of the market under the pegs) relate in part to the effects it has on market institutions. It precludes proper functioning of the dealer mechanism, both recognized and unrecognized. It makes brokers of recognized dealers and prevents their taking positions and making markets. Unwillingness to deal with unrecognized dealers, or even to permit recognized dealers to split commissions, makes unrecognized dealers refuse business and turn their customers away since they cannot cover costs. When first applied, it automatically eliminated the auction market for Government securities on the stock exchange, since the specialist, unlike the recognized dealers, could not cover his bids through the Federal Open Market Committee.

(84) However, the most striking criticism, in the opinion of the subcommittee, was that the technique failed in its basic purpose of pegging prices with a minimum of Federal Open Market Committee purchases. It was the general conclusion of most discussants that the theory underlying the entire "reluctant buying" technique rests on an incorrect judgment of market reactions. It was the consensus that the response of investors to this technique is perverse in that holders are induced to attempt to force a greater volume of securities on the market than they otherwise would. Failure to secure prompt execution of sales at quoted markets, instead of reducing sales, heightens uncertainty, encourages further offerings, and in the case of the restricted bonds seems to have stimulated attempts to dispose of bonds to the Federal Open Market Committee through resorting to various types of "blinds." For example, the Committee was believed to have been less reluctant to buy restricted bonds from recognized dealer banks (because of the \$500,000 limit on their portfolios) than from nonbank dealers.

(85) It was the almost universal recommendation that, should an occasion ever arise again that justified support operations, a policy of aggressive rather than reluctant buying on the part of the Committee would reduce uncertainty among investors as to their ability to sell and to that extent diminish the volume of offerings. The subcommittee finds this technical judgment persuasive. Certainly the technique of "reluctant buying" should be avoided. In the execution of an aggressive technique, moreover, purchases should not be confined to recognized dealers. If the objective is to engender confidence and remove uncertainty from the market by a show of bids, the desired effect will be achieved more readily and with less monetization of debt by spreading the bids among all dealers with whom the public is accustomed to trade rather than by raising questions in the minds of investors as to whether or not they can secure execution through accustomed channels.

(86) The "reluctant buying" technique is perhaps merely the ultimate development in a series of arrangements for controlling the market that had their genesis during the war period. These were further strengthened in the postwar period. The principles and theory underlying these arrangements were that control over the market could be achieved with a minimum outlay in reserve funds if the final effort at matching off private transactions were narrowed to a small group of dealers, provided that the Committee could control these dealers by various devices and could confine its buying to the residual transactions. It is the view of the subcommittee that with the passing of the pegging operation the need for such arrangements, if it ever existed, has also passed. Fortunately the circumstances which give rise to most of the serious criticisms directed against the operations of the Committee revolve about the arrangements made to control the market under pegs. By dispensing with these arrangements, no longer needed, these sources of criticism can be corrected.

(87) *Trading on an agency basis.*—Dissatisfaction was general throughout the group of recognized dealers with respect to agency transactions on behalf of the Federal Open Market Committee. This dissatisfaction was expressed most openly and acutely with respect to the commissions allowed by the Committee. These were claimed to be too small in many cases to cover costs. It was also alleged by some, but not all, that the commissions allowed by the Committee have been a factor in the narrowing of spreads in the market to the point where it has weakened the dealer organization.

(88) Dissatisfaction was expressed with the rule that prohibits a recognized dealer from selling from his position when engaged in an agency transaction for the Federal Open Market Committee. Whenever the Committee is the major buyer of a particular issue, the rule has the effect of freezing the recognized dealer's position in that issue, precluding him from making a market in that issue, and turning him, in effect, into a broker for the Federal Open Market Committee. It constitutes a strong inducement not to make markets and thus acquire positions if the dealer thinks the account may enter the market; it raises the specter of losses on positions previously acquired; and in some circumstances it creates a situation where the Committee is subsequently under moral compulsion to absorb dealer positions to protect them against loss.

(89) Nonrecognized dealers resent the fact that they have to absorb all handling costs themselves or refuse customer business when the Committee is the sole buyer in the market, since recognized dealers are not allowed to split commissions on agency transactions. The unrecognized dealers also suspect or are aware that recognized dealers have been "bailed out" on occasion.

(90) These are problems that arose most acutely during the pegging operations, but they did not end with the accord. They still arise during periods of Treasury refundings and, in fact, whenever the Federal Open Market Committee operates, as it customarily does, on an agency basis. One recognized dealer was troubled by the fact that in many instances he is put in a morally indefensible position of acting as agent for both buyer and seller, i.e., for the Committee as well as for his customer.

(91) In the judgment of the subcommittee, this bundle of problems and irritations all stem from a common source, i.e., the emphasis on agency transactions in operations of the Federal Open Market Committee, and would be corrected by willingness to transact business at the market with dealers as principals. This would eliminate the problem of inadequacy of commissions and allow competition in the market to establish spreads adequate to support an efficient and functioning dealer organization. It would remove the problem of frozen positions and permit dealers to make markets by building up and reducing positions in accordance with market considerations. It would end the problem of "bail-outs."

(92) From the point of view of operations to effectuate Federal Reserve Credit policy, reserve funds are put into or absorbed from the market just as effectively when securities are bought from dealers as principals as when dealers are used as agents. From the point of view of promoting a strong self-reliant Government securities market characterized by intelligent pricing, alert arbitrage, depth, breadth, and resiliency, the Committee's purposes are better served by techniques of operation which avoid the freezing of positions, always at the hazard of loss, on the part of those whose professional attitudes toward the market are probably most influential in hour-to-hour and day-to-day shifts in market situations.

(93) It is the subcommittee's conclusion, therefore, that agency transactions should be abandoned and that the Federal Open Market Committee should enter into transactions with dealers as principals on a net basis. Such transactions should, of course, be made at the best market available. It is very doubtful whether they should be confined as a matter of procedure to the presently recognized dealers. A case may perhaps be constructed for rigid rules of dealer qualification where agency relationships with the Federal Open Market Committee are involved, but there is little basis in public policy for such discrimination among dealers in transactions where dealers are principals.

(94) *Use of the repurchase facility.*—The role occupied by repurchase agreements and the terms of settlement in the technical operations of the Federal Open Market Committee is a subject of considerable controversy within the dealer organization, and many conflicting points of view are present. Recognized nonbank dealers are quick to point out that their bank-dealer competitors have direct access to the Federal Reserve banks and therefore are in a position to

borrow at the Reserve banks at the discount rate in order to carry portfolios when money is tight. Nonbank dealers, on the other hand, borrow at the money market banks at rates that frequently rise above the bill rate. A negative "carry" thus develops which makes it expensive and at times prohibitively costly to maintain adequate portfolios. This problem is particularly acute when money is tight over a period of weeks or months, and also when a holiday falls on Friday or Monday, necessitating a 4-day carry. In these circumstances the nonbank dealers are at a serious competitive disadvantage in their ability to make markets. In the endeavor to mitigate this situation, they try to borrow from out-of-town banks and also use credit accommodation from corporations on repurchase agreements.

(95) Bank dealers, in part because of their access to Federal Reserve credit, are readily able to service customers on a cash, rather than the usual regular delivery basis. There has been an increasing use of cash transactions which has constituted an increasingly serious competitive disadvantage to nonbank dealers. Except when the repurchase facility at the Federal Reserve bank is available, the only way they can meet the competition is by buying Federal funds, which is costly when money is tight.

(96) All of the recognized nonbank dealers felt strongly that the Federal Open Market Committee should alleviate these difficulties by a more liberal policy with respect to the extension of Federal Reserve credit on repurchase agreements. Their proposals ranged from the suggestion that each nonbank dealer be given what would be in effect a line of credit for repurchase contracts by the Federal Open Market Committee to be used at his own discretion, to the more modest suggestion that repurchase facilities be extended freely over weekends, particularly over weekends lengthened by a holiday. They complained that frequently they are not informed until the last moment whether or not repurchase facilities would be available. They also desired a change in the policy of the Committee under which it now refuses to buy bills, either outright or on a repurchase basis, which dealers have bought for cash delivery. Some even suggested a change in policy by which the Committee would be willing to buy bills outright with payment in immediate funds.

(97) Most bank representatives, but not all, opposed the availability of repurchase agreements to nonbank recognized dealers. They maintained that the advantage enjoyed by a member bank of direct access to Federal funds at the rediscount rate was an inherent advantage of membership. The equivalent extension of facilities to dealers on repurchase contracts would constitute, in effect, the opening up of membership privileges to nonmembers. They also maintained that the competitive advantage they enjoyed over the nonbank dealer in their access to Federal funds merely offset the competitive advantages enjoyed by the nonbank dealer in being able (1) to take positions in excess of \$500,000 in restricted bonds, and (2) in being permitted to enter large subscriptions for attractive Treasury issues, such as the 2½s of 1958. They further claimed that free extension of repurchase facilities to nonbank dealers would have the effect of pegging the bill rate.

(98) Nonbank unrecognized dealers complained that they worked under a double competitive disadvantage. They enjoyed neither the full access to Federal funds of the bank dealers nor the occasional access to repurchase facilities of the recognized nonbank dealers. Nonbank dealers, both recognized and unrecognized, stated that they were forced to bid to miss in the weekly bill auction when the impact of these competitive cost disadvantages was too severe.

(99) The subcommittee feels that this testimony reveals unsatisfactory aspects of the bill market. In some degree these basic frictions are inevitable in a market structure that is shared by bank and nonbank dealers. No problem would exist, for example, if all dealers were also member banks. Then the dealer organization would price securities and develop competitive patterns in an environment in which access to immediate funds to carry portfolios and to buy for immediate cash were available at the discount rate to all dealers alike. There would be no call for repurchase contracts since the member bank discount window would meet the need.

(100) Similarly, there would be a less difficult problem if there were no bank dealers. Then all dealers alike would have to pay the market money rate to carry portfolios and likewise would have to buy Federal funds in the Federal funds market if they bought securities for cash delivery. In that case, the Federal Open Market Committee could confine its consideration of whether or not to make repurchase facilities available to the effect of such facilities on the

rate structure and to the desirability of mitigating the sudden development of very tight conditions in the money market over periods of temporary strain.

(101) The problems created by the presence of both bank and nonbank dealers as indispensable components of the market structure must be recognized by the Federal Open Market Committee. Little comfort can be derived from the fact that the competitive disadvantage of nonbank dealers with respect to direct access to Federal funds is alleged to be compensated by a competitive disadvantage that prevents bank dealers from freely competing in the market for restricted securities. Both disadvantages react adversely on the structure of the Government securities market. Both impair the market's ability to perform efficiently under all conditions. Certainly a serious situation is revealed when the nonbank dealer component in the weekly auction for bills bids to miss at times of stringency, not because the bills acquired could not be marketed but because the necessary risks and costs of carrying the bills prior to resale is higher for nonbank dealers than for their bank competitors.

(102) The subcommittee feels that these figures in the structure of the market can be alleviated somewhat by changes in the technical operations of the Federal Open Market Committee. They should not be accentuated by the Committee's operations. The subcommittee sees no purpose served by a procedure under which the Committee first divides the bills bought by a dealer into two categories, according to whether or not they were acquired for immediate cash, and then confines its purchases to those which have been acquired on a regular delivery basis. It may be that the original consideration back of this discrimination was to discourage deals for immediate cash and encourage market transactions on the basis of regular delivery in order to achieve a more effective control over the New York money market. If so, the maneuver has lost utility and should be dropped. Sales for cash are increasing and will probably continue to do so as long as banks use this medium for adjusting reserve positions and dealer banks with ready access to immediate cash are in a position to service them.

(103) The subcommittee likewise sees no consideration sufficiently relevant to justify overlong delay in letting dealers know whether or not repurchase agreement facilities will be extended. If the facilities are to be made available, the dealers should be informed in sufficient time to perform their market functions efficiently.

(104) The subcommittee doubts whether our experience with operations in a free market has yet developed to the point where it is possible to lay down definitively all the situations in which the availability of repurchase facilities would or would not be advisable. The testimony, however, has presented a clear case for the more ready availability of repurchase facilities to nonbank dealers over weekends as well as in periods of acute credit stringency. It recommends that they be made available regularly to nonbank dealers over weekends. Any tendency to abuse the privilege should be subject to control by variations in the rates on these facilities.

(105) These moves should go some distance toward alleviating structural impediments which have acted to prevent the nonbank dealers from carrying their full load in the bill market. They should make it more possible for all nonbank dealer participants in the weekly bill auction to gage their bids at each auction on their evaluation of the demand for bills rather than on their lack of access to credit facilities enjoyed by competitors.

(106) In addition, the subcommittee feels it would be worth while to see whether or not a call-money post could be reactivated where nonbank dealers could borrow for portfolio purposes. It is anomalous to find money-market banks maintaining over a considerable period of time a portfolio of bills that yields them a lower return than the rates at which they are willing to lend on call an equivalent collateral. Normally one would expect the opposite relationship to prevail; provided the market were truly impersonal the loan with less risk exposure should carry the lower rate. It is disturbing to find a money market so unorganized that dealers, to counteract this situation, cultivate both out-of-town banks and corporations individually on a customer basis as sources from which to borrow money. Revival of an effective call-money post for dealer loans such as existed in the 1920's would go far to correct this condition. A more detailed discussion of this problem is given in appendix D of this report.

(107) The restrictions against bank ownership on most of the remaining restricted issues will expire by 1954 and this will go far to restore equal competitive relationships between bank and nonbank dealers in that sector of the market. These restrictions may be removed at any time by the Treasury.

(108) The subcommittee sees no public purpose served by limiting repurchase facilities to the present restricted list of recognized nonbank dealers. The market structure would be better served by equal extension of the privilege to all nonbank dealers of integrity who participate effectively in the bill market. It recommends that in the future when repurchase contracts are made available by the Federal Open Market Committee, they be offered fairly and impartially to all nonbank dealers who participate regularly in the weekly bill auction, and in amounts related to that participation, say, in some relationship to the average of the dealer's bill awards over the preceding 3 months.

(109) *Operations during Treasury financing.*—The techniques applied by the Federal Open Market Committee during Treasury refunding operations were subject to some criticism, but the more important conclusion that emerged from the discussion of this phase of the Committee's operations was the fact that neither the Committee nor the dealer organization has yet come to well-defined and consistent positions on this difficult technical problem. Because the subject dealt with the placement of new Treasury issues, its discussion inevitably touched on problems that fall also in the area of debt management. For example, the view was unanimous that the dealers cannot function effectively as secondary underwriters unless the coupon and terms placed on new issues are sufficiently attractive to establish a natural rights value in the market. There were other suggestions that may minimize the problem of attrition, as, for example, that refundings be conducted through new issues for both cash and exchange rather than solely on the basis of exchange. The subcommittee has not considered problems of debt management and the following comments and recommendations deal solely with technical procedures which the Federal Open Market Committee has followed during periods of Treasury financing.

(110) All of the criticisms of the dealers that relate to the technical practices of the Federal Open Market Committee during periods of refunding stemmed basically from the agency relationship of the Committee with the recognized dealers. Nonrecognized dealers complained that they were forced out of the market during periods of refunding. They had no outlet that would cover costs for issues they might take from their customers since the Federal Reserve refused either to deal with them directly or to permit recognized dealers to split commissions with them.

(111) Recognized dealers for their part complained that the commissions allowed by the Federal Open Market Committee on agency transactions barely covered clearing, telephone, and other current costs and made little or no contribution to carrying overhead costs. They also complained that because of the agency relationship their own holdings of the maturing issues were frozen so long as the books were open or the Committee was operating since under this relationship dealers are not allowed to sell to the Federal Reserve from their own position. The practical result is that in the case of any offering that requires Committee support dealers are frozen into any maturing securities they had in position at the time the Committee started supporting operations. In their capacity as dealers they feel obligated to tender such securities in exchange. Under these circumstances they avoid making markets in order not to add to their positions. They become, temporarily, merely brokers for the Federal Open Market Committee. They resent losses they sustain when the right value established by the Committee is high in relationship to the market, and they feel that the Committee should feel morally obligated to bail them out.

(112) Recognized dealers also complained (1) that the Committee has been slow on occasions in deciding what rights value to pay when the books are opened on refinancings, and (2) that at times it has operated for short periods with different rights values to different dealers, thus giving the dealers' customer the idea that some dealers can secure better execution than others.

(113) Most of these problems will disappear if the Federal Open Market Committee decides to abandon agency transactions as recommended by the subcommittee. All, of course, would disappear if the Committee should decide to refrain from purchases or rights. Presumably the emphasis on the agency relationship stems from the period of general pegs when it was feared that dealers, if permitted to operate as principals, would canvass investors to stimulate market activity and persuade them to sell rather than exchange maturing issues. This apprehension may have been justified when the Committee was operating with more or less continuous pegs, but has no substance in a free competitive market. In a free market, any dealer who solicited customer business merely to create activity would soon find himself with fewer customers.

(114) It is the subcommittee's recommendation, therefore, that if the Federal Open Market Committee decides to purchase rights during a period of Treasury refinancing, it purchase them from dealers as principals without regard to whether or not the securities come from a dealer's own position. This will eliminate the problems of frozen positions, of the bailing-out of losses on those positions, and too narrow commissions. It will also free the dealers to perform their function of making markets at all times.

(115) The subcommittee also recommends that these transactions be conducted without regard to whether or not a dealer is on the recognized list. It is hard to see how a refunding operation, accompanied as it must be by a very general turnover of securities in the market, is aided by a technique that either eliminates some dealers from the market or forces them to trade exclusively off other dealers' markets.

*The problem of dealer recognition*

(116) There is no room for complacency on the part of the Federal Open Market Committee over the problem of dealer recognition. That fact emerged more and more vividly as each of the unrecognized dealers discussed his problems before the subcommittee. The unrecognized dealers showed up well as individuals both in terms of personality and integrity and in terms of professional grasp of the business and ability to evaluate the impact of credit and monetary problems on the money markets. It would be hard for anyone sitting through all the hearings to reach the conclusion that this group of unrecognized dealers differed significantly, on the average, from those who represented the recognized dealers with respect to training, integrity, professional capacity, or ability to analyze problems. The fact is that they made a very good impression as a group.

(117) These were the dealers who fell outside the line when the Federal Open Market Committee, at the same time that it was pegging the prices of Treasury securities and was frequently the only source of demand, established formal criteria to distinguish the dealers with whom it would deal from those with whom it would not. That line seriously impaired the ability of unrecognized dealers to function and survive in the Government securities business. Of that fact there can be little question. The impairment came, not only through loss of prestige, which was bitterly resented, but also through loss of customer contacts because of inability to function in rough markets; i.e., when the Committee was operating in the market. This impairment is not so serious now that the Committee has stopped pegging but it still persists to some degree. Curiously, it has not seemed to impair the credit standing of the unrecognized dealers at the banks. All stated they had no difficulty in securing the financing necessary for their business.

(118) There was practically unanimous agreement on the part of dealers, recognized and unrecognized alike, that character, integrity, and professional grasp of the business are the essential prerequisites to effective operation as a Government securities dealer. All seemed to feel that capital, though important, is secondary. Even some of the recognized dealers who defended the practice of formally designating the dealers with whom the Federal Open Market Committee would do business, indicated that capital is not the first essential for successful dealer operation. Since additional capital can apparently be attracted when justified by the scope and profitability of the business, a determining factor in success and growth of a securities dealer is the ability to gain customers, to hold them, and to service them at a profit.

(119) The lines drawn by the Federal Open Market Committee, therefore, struck the unrecognized dealers in a most vulnerable spot; namely, in their ability to service their customers. It cut down the range of their customer potentialities and thus reduced their ability to attract or earn capital to meet the minimum capital requirements in the Federal Open Market Committee. It acted in the same way to impair the ability of a nonrecognized dealer to earn recognition by developing customer relations that were nationwide in scope and that extended to all sectors of the list. In short, once the lines were drawn and recognition was accorded to some dealers and not others, a hurdle of some magnitude was imposed on the unrecognized dealers which impaired their ability to develop their business to the point where it would be able to meet the standards imposed by the committee.

(12) The subcommittee probed both recognized and nonrecognized dealers alike to ascertain whether there were not also special responsibilities imposed

upon the recognized dealers that might be considered to offset in some degree the privilege of direct contact with the Federal Open Market Committee, but this line of inquiry enlisted only feeble response. The unrecognized dealers professed a willingness to submit reports to the Federal Open Market Committee. In fact, many do report now even though they are unrecognized. In general, the dealers, both recognized and unrecognized, did not seem to feel that the responsibilities to the Federal Open Market Committee imposed on the recognized group operated seriously to their disadvantage in competition with the nonrecognized group. It is clear that the unrecognized dealers would be only too willing to accept such burdens in return for recognition.

(121) The Federal Open Market Committee cannot afford to be complacent about this situation. It has explosive potentialities. Perhaps as such is repugnant to the spirit of American institutions. The privilege of dealer recognition, if it is to be continued, must be justified on grounds of high public policy as essential and necessary to the effective conduct of open market operations. It is not sufficient to aver that dealer recognition was once useful or that it should be maintained because it is already in existence, in the absence of a positive reason for change. The fact that privilege exists by virtue of actions of the Federal Open Market Committee is in itself a positive reason for its eradication unless there are necessary and compelling considerations to require its perpetuation.

(122) The present system of official dealer recognition instituted by the Federal Open Market Committee in 1944 was an element in a technique of open market operations designed to peg the yield curve on Government securities and at the same time minimize the monetization of public debt. This technique was based on the hope that the yields on Government securities could be pegged with only a few securities monetized by the Federal Open Market Committee if all offers to the committee had to pass first through a very limited number of dealers with whom the committee would maintain intimate and confidential relations, and who would be required by the committee to make strenuous efforts to find other buyers for securities in the marketplace before they looked to the committee for residual relief.

(123) The inexorable march of events on which that hope foundered is now a matter of history. The facts are that debt was monetized in volume and that the country suffered a serious inflation until the Federal Open Market Committee abandoned the pegs. The basic reason, therefore, that seemed to justify a small privileged dealer group no longer exists. The technique of which it was an integral part did not work out according to expectations and failed of its purpose.

(124) The subcommittee has already recommended that the Federal Open Market Committee discontinue the technique of reluctant buying and abandon agency relations in its transactions with dealers. It has recommended that the Committee enter into transactions with dealers outside the recognized list if it is operating to support markets; e.g., to peg rights during periods of Treasury refunding. It has also recommended that in its dealings in the bill market both on an outright and on a repurchase basis, it enter into transactions with all dealers who perform a responsible and continuous role in the weekly bill auction. If these recommendations are adopted by the Federal Open Market Committee the competitive importance of recognition in the marketplace would diminish greatly. It would become a matter of less importance, therefore, whether the fiction of a recognized list of dealers was maintained or dropped. For its own part, the subcommittee feels it advisable to drop the relationship completely and so recommends.

(125) If the Federal Open Market Committee decides to maintain the recognized dealer relationship, on the other hand, the subcommittee recommends most earnestly that it proceed promptly to revise the present list of dealers who enjoy the privilege of recognition. It is difficult to justify exclusions that have been made from the select group when comparison is made with some that are within. There are bank dealers within the recognized group that do not take positions or make markets, that do not attempt a nationwide coverage, that do not operate in volume in all segments of the list, and that are clearly motivated in their conduct of cooperations by a desire to attract and hold correspondent banks for their institutions rather than by a desire to earn a competitive return on the capital at their disposal as dealers. If the relationship is continued, it is urgent that the Federal Open Market Committee draw the lines for recognition on bases that can be justified as impartial and objective.

*Reports and information*

(126) The Federal Open Market Committee faces no problem of lack of access to market information available to dealers. The Committee has been too powerful a market factor for its requests for information to be easily challenged. It has frequently been the determining factor in hour-to-hour and day-to-day trading in the market for Government securities; i.e., the market in which dealers risk their capital on a relatively thin margin of equity in continuous, almost split-second, trading operations. Despite the dropping of the pegs and smaller intervention in the current market, the potential power of the Federal Open Market Committee, backed by the power to create bank reserves, remains. Under these circumstances, dealers will continue to cultivate contacts with the Committee since no single quality is more important to their ability to survive than their ability to forecast correctly (1) the probabilities of intervention in the market by the Federal Open Market Committee, (2) the direction of that intervention, either on the bid or the offered side, if it occurs, and (3) the sectors in the market to which it may be directed.

(127) Under these circumstances, also, dealers tend to seek orders from the Committee, not because of the profit potentialities of business involved but because they may indicate the direction of the Federal Open Market Committee's thinking. Receipt of an order from the trading desk, in fact, acquires a significance out of all proportion to the actual commission involved. In addition, the dealer endeavors to cultivate access to the Committee and to its staff representatives. He readily accepts the obligation to give information on his activities and to make reports. He welcomes hour-to-hour contact with the trading desk, both to submit quotations and to tender market reports. The responses, however guarded, may provide clues to the state of the market. Even when the Committee is pursuing a neutral policy and is out of the market, the trading desk has business to do, orders to execute for agency and foreign accounts. As noted earlier, this amounted to \$2.4 billion in the year ending June 1952. The dealer does not necessarily know whether or not these represent market intervention on the part of the Federal Open Market Committee, but he is likely to feel that continuous and close contact with the trading desk helps him to come to a judgment on whether they do or not. Under the present arrangements the trading desk has probably more knowledge of the sources of demand and supply in the market as well as the money position than any other element.

(128) This situation places a heavy responsibility upon the Federal Open Market Committee. It cannot, in this instance, rely on the customary reluctance of respondents to furnish information to act as a check on its own curiosity. It must decide for itself not only what information should properly be supplied to the market so that it can function effectively but also the limits of what the Committee can, with propriety, ask from the dealers in the way of information.

(129) The fundamental rule is that no general information should be furnished a dealer that is not equally available to others. It is unavoidable that dealers executing orders for the Federal Open Market Committee gain special knowledge with respect to that particular transaction, but every effort should be made, as in fact the subcommittee believes it is, to be close-mouthed with respect to these transactions. It goes without saying, of course, that no member or representative of the Federal Open Market Committee should indicate an attitude toward the prices which dealers quote and at which they do business in the market.

(130) So far as additional information to be supplied to the market in the weekly condition statement is concerned, the subcommittee recommends (1) that securities held under repurchase agreement by the Federal Open Market Committee be segregated from the balance of the System portfolios; (2) that the amount of special certificates of indebtedness outstanding be regularly indicated, either in the text or on the stub of the statement; (3) that weekly averages of member bank borrowing be shown in addition to the actual volume of member bank borrowing at the close of business on statement days, as is now done for excess reserves.

(131) The extent of the limitations which the Committee should impose on itself and its representatives in seeking information from the dealers poses a more serious problem. In the discussions with the dealers, expressions of irritation, dissatisfaction, and resentment were confined to three quite specific points: One, they did not like the tone or content of the morning meeting when different dealers report individually to the manager of the open market account before market opening. They stated they got little out of the contact and some

suggested that it would be better to drop the meeting and substitute a more general type of meeting from time to time between the manager of the account and all the principal dealers together as a group. They felt that they might be given a chance to ask questions at such a meeting and to receive helpful enlightening on the attitude of the Federal Open Market Committee toward the market. Two, the dealers did not like it when they were questioned so closely by the trading desk on the geographical source of current customer orders as to reveal indirectly the identity of their customer. While the great bulk of the dealers did not object to disclosing the general source of their customer orders, they did feel that it was morally wrong to be asked a series of indirect questions so pointed as to permit identification of the source of their business. Some felt that incorrect use of this information may have been made by the Committee, either by direct approach to sellers, thus revealing that the dealer had not maintained secrecy on a confidential relationship, or by discrimination between offerings, buying some securities pressed for sale by a particular customer but not all. Three, they were apprehensive lest the disclosure of their individual positions to the personnel of the trading desk might tend to affect the decisions of that personnel in subsequent dealings with them.

(132) With respect to these three specific points, the subcommittee recommends: (1) That the individual morning dealer conference be abandoned. It recognizes that there may be merit in the more general type of conference suggested by some of the dealers as a substitute for these meetings but feels that any information furnished by the Federal Open Market Committee at such a meeting should be such as might properly be given to any other segment of the public, (2) that disclosure of the source of customer orders be so limited that there will be no possibility of identification, direct or by inference, of the individual source of customers to the trading desk, and (3) that the Federal Open Market Committee discontinue its present practice of collecting statistics on dealer positions and activity, and substitute for this practice the regular collection of dealer position and activity reports by an officer of the System not connected with the Federal Open Market Committee. This officer would furnish aggregate summaries to the trading desk that did not reveal the position or activity of any individual dealer.

(133) The subcommittee feels that the furthest its representatives can go with propriety in soliciting or accepting information from individual dealers with respect to the source of their orders, is to receive only information as to the general type of customer, the volume of the business, and the sector of the market involved. It questions seriously the propriety of the present practice in which its representatives on the trading desk are free to press dealers for quite specific information on customer transactions and on the basis of this information proceed to compute transaction sheets currently during the trading day, such sheets being subject to later verification against the dealers' statistical reports. It recommends that this practice be dropped.

#### *Housekeeping*

(134) In many respects, the Federal Open Market Committee is unique both in the form and the substance of its organization. In form, it is a completely independent organization, specifically set up by statute, with exclusive power of decision with respect to the matters delegated to it. Its composition is designed to insure, to the full extent that legislation can insure, that its members will not only be fully competent, but will also be immune to outside pressure. It is neither an appendage of the Federal Reserve Board nor a creature of the Federal Reserve banks, but a completely independent body, each member of which, as an individual, whether he be a Governor from the Board or a president from a Federal Reserve bank, reports to no one. His actions are a matter of public record but each member sits as an individual, bound only by his oath to execute the law. The responsibilities delegated to the Committee are of almost incomparable import.

(135) The statutory individuality of the Federal Open Market Committee and its separation both from the Federal Reserve Board and the Federal Reserve banks is expressed in its chart of organization. It has its own staff, and when it gathers it meets as a separately organized and staffed body. Its sessions are not joint sessions of the Federal Reserve Board and the Federal Reserve banks, but statutory meetings of the Federal Open Market Committee.

(136) In a very general sense, the Federal Open Market Committee stands in the relation of a fiduciary to the Federal Reserve banks. It, and it alone, has the