BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON D.C. 20551

DIVISION OF MONETARY AFFAIRS

September 20, 1994

Mr. Warren B. Mosler
Adams, Viner, and Mosler, Ltd.
Suite 600
250 Australian Ave., South
West Palm Beach, FL 33401

Dear Mr. Mosler:

Chairman Greenspan asked me to respond to your recent letter regarding regarding your treatise "Soft Currency Economics."

You made many interesting points in the treatise. I agree in particular that the textbook money multiplier model is an oversimplification of the money supply process. As you point out, the lag even in the current system of "contemporaneous" reserve requirements implies that monetary policy cannot achieve perfect short-run control over money or reserves. Indeed, as you stress, in the short run the causation runs more from money to reserves than vice versa. However, the Federal Reserve can control the composition of reserves as between nonborrowed and borrowed reserves fairly closely in the short run. By varying this mix the Federal Reserve can influence the federal funds rate and other money market rates in the short run and thereby affect growth of the money supply over a longer period.

You also stated that government spending, taxation, and borrowing add and drain reserves from the banking system and therefore are part of the money supply process. In a sense, this is correct. However, the Federal Reserve and the Treasury follow procedures to target the Treasury's balance at Federal Reserve Banks at a particular level, thereby largely preventing Treasury financial operations from affecting the level of reserves in the banking system.

You pointed out as well that the selection of a particular target for the Federal funds rate implies a specific volume of Federal Reserve purchases of government securities and that therefore the Federal Reserve cannot monetize debt aside from this implied amount. This is true, of course, but I believe that analysts' concerns about monetizing debt reflect the possibility that the Federal Reserve could target an inappropriate interest rate. For example, targeting an excessively low interest rate would imply that the Federal Reserve was monetizing too much debt, possibly fueling inflationary pressures.

I hope these comments are useful. Thank you for bringing your work to our attention.

Sincerely,

Donald L. Kohn
Director