BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

May 4, 1964.

TO: Governor Mitchell

FROM: Robert C. Holland

Here's the most straightforward explanation I've seen yet of the rationale for looking at money market and credit conditions as a proximate policy guide. It is also fairly easy to take this, I think, and graft onto it special underlying attention to money supply changes because of their likely implications for developing interest rate changes.

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(MISC. 3 C-75M-12-62)

FEDERAL RESERVE BANK
OF NEW YORK

OFFICE CORRESPONDENCE

DATE March 27, 1964

TO Mr. Holmes

FROM F. W. Schiff

SUBJECT Comments on the Board Secretariat' Draft Memorandum on "The Committee's Current Economic Policy Directive"

C O N F I D E N T I A L--(F.R.)

I have only had a chance for a very hurried reading of the draft of the Board's Secretariat memorandum on "The Committee's Current Economic Policy Directive" which you handed me yesterday. Much of the memorandum is well done and very useful in clarifying the relevant issues. I do, however, have serious reservations with regard to some aspects of the memorandum, notably those relating to its view of the underlying rationale for the use of alternative policy guidelines and those which deal with the range of flexibility to be given to the Account Manager. Since some of the problems entering into the nature of the proposed specific instructions to the Manager derive from the broader approach to the choice of guidelines taken in the memorandum, my comments here will be limited to what I consider the weak spots in this approach--more specifically, in the explanation of the underlying rationale for using "money or credit market conditions" as a principal target variable.

The passage to which I would take particular exception appears on pages 28 and 29, and reads as follows:

> "The full set of potential target variables might be divided into two broad groups. One group consists of "money market conditions" and its components--free reserves, short-term interest rates, and so forth, in most cases specified in terms of levels. The second group consists of the various aggregate reserve measures, bank credit, bank deposits, the money supply, and so forth, specified in terms of rates of growth.

> "It does not need repeating that particular levels of variables in the first group can exist concurrently with widely different rates of growth (or decline) in variables in the second group. And it seems safe to surmise that with respect to the condition of the domestic economy, variables in the second group are of more fundamental concern to the Committee than those in the first. Variables in the first group are of concern to the Committee on two counts: they affect international capital flows, and they are read by the market and the public as "signals" of current monetary policy."

These statements, and especially the last two sentences, should not go unchallenged since they present a much weaker case for a "market tone" or "credit market conditions" approach than can, in fact, be made. The statement, indeed, would seem to play into the hands of those of the System's academic critics who have claimed that the present focus on credit market conditions does not allow System actions to be meaningfully related to broad economic variables, whereas primary focus on, say, some measure of total bank reserves would permit an explicit analytical connection between immediate target variables and the broad economic goals.

A major objection to the passage cited is that it fails to make clear just what the distinction between the two groups of potential target variables is supposed to be. In subsequent paragraphs the memorandum takes the view that the second group of variables relates to "aggregates" whereas the first group reflects "money market conditions," which presumably are of narrow significance. But this is not necessarily a legitimate inference. The items cited as belonging to the second group, for one thing, all relate to aggregate statistics involving the banking system, rather than to the total flow of funds or stock of liquidity instruments. (Of course, the item "...and so forth" listed as belonging to the second group of variables might perhaps be regarded as including these additional magnitudes also, but this is certainly not clear to the reader--and there is also an "...and so forth" in the first group.) If one takes this interpretation of the second group of variables cited, then it might be argued that targets centering on conditions in the money market, where liquidity adjustments for <u>both</u> bank and nonbank sectors of the economy tend to take place, are <u>more</u> comprehensive in their coverage of the relevant magnitudes than the second group variables.

Of course, the money market is only one of the financial markets and a broader concept of "credit market conditions" would be required to make this type of target more clearly related to total credit flows. But if one takes the view that conditions in the money market are closely related to those in other credit markets and that the Desk does watch a broader range of credit market conditions than those reflected in the money market alone, then it seems to me quite appropriate to argue that emphasis on money market conditions can actually represent a more "aggregative" or "comprehensive" approach than primary reliance on the second group target variables (other than the "and so forth") cited.

The distinction between the first and second group variables might also be said to rest on other grounds. The second group includes various measures of volume--such as the volume of bank reserves, bank deposits, and bank credit--while the first group of variables might, at least in the first instance, be thought to refer primarily to measures of interest rates, i.e., of price.

Looked at in this way, neither set of variables by itself provides all the information needed to relate movements in financial factors to developments in broader economic magnitudes, i.e., information on the over-all flows of funds and the interrelationships between supply and demand forces in financial markets.

For a full assessment of the interaction of all the financial variables with one another and with the broad economic series, information is needed on the nature of the elements of financial markets: demand, supply, and price. A knowledge of actual market interest rates does not by itself convey information on the movements of demand and supply factors. And if this fact is forgotten, reliance on interest rates as a primary policy target might indeed lead to serious error. On the other hand, the actual (i.e., ex-post) data on bank reserves, bank deposits, and bank credit--or even data on the total volume of credit flows--also do not by themselves permit a distinction between demand and supply forces. Hence, it seems clear that whether one uses second-group or first-group variables as primary targets, it is not possible to rely on the chosen primary target in any rigid fashion. Indeed, once the target is chosen it must be continually modified on the basis of information about the other variables impinging on the total credit situation.

On balance of considerations, I would argue that there is a substantial practical advantage in making credit market conditions the principal focus of policy, and to use information on total reserves and other second-group variables as ancillary guides that will provide early warnings in cases of substantial changes in the demand for credit (or in those elements of the supply of credit not directly attributable to the Federal Reserve.) A major advantage of this approach is that focus on credit markets does make it possible to take sensitive account of all credit flows, not merely those involving the banking system directly. In contrast to reliance on data on the volume of reserves and credit, moreover, focus on credit market conditions permits the detection of changes in the elasticities of demand or supply--changes that tend to be reflected in interest rates but are not necessarily apparent from volume figures. Finally, there would seem to be a considerable case in favor of the argument that the level and movement of interest rates and other credit terms can by themselves have important direct effects on economic decision-making and economic activity, and that credit terms as reflected in market conditions are therefore clearly of fundamental concern to the FOMC.

To put the matter somewhat differently: my feeling that market conditions represent the preferable initial focus for the policy-maker stems from the notion that those conditions in effect serve as a "proxy" for an over-all model of the flow of funds in the economy. The "feel of the market" to my mind does not simply involve a mechanical concentration on interest rates but a continuous evaluation of the way in which such rates and other credit terms reflect the interrelationships among financial flows. The Manager of the Account does, in fact, have considerable opportunity to observe evolving developments on both the supply and demand side; part of what his staff does on a continuous basis is to record supply and demand schedules for different types of financial instruments. Much of this information could not be obtained by reference to ex-post quantitative data alone. The fact that the information so obtained adds up to a rather imperfect picture of the over-all flow-of-funds matrix does not justify a complete shift in the nature of the primary target. Rather, it calls for continuous improvement in the accuracy and extent of our observations on the behavior of the various magnitudes relevant to an assessment of market conditions. Eventually, this should mean that the Committee and the Manager will be able to make their decisions against the background of a very comprehensive and precise model of the financial system--although, I suspect there will always remain a need to rely to some extent on the sort of judgments involved in market "feel."

I had tried to spell out these ideas previously in a memorandum on "Further Comments on Guidelines for Monetary Policy," dated November 2, 1962. An extract from this memorandum, focusing on the conceptual justification for emphasizing credit market conditions, is attached.

Attachment
FWS:meg

APPENDIX

Excerpt from Memorandum on
"Further Comments on Guidelines
for Monetary Policy,"
dated November 2, 1962

"...it can be held that Federal Reserve or Treasury operations involving a change in the stock of money or deposits will have an influence on private spending decisions _only_ if these operations also affect interest rates, asset prices, and other credit terms that tend to be reflected in the 'condition of credit markets'. The reason is that such operations do not change the _net_ financial assets of the public in nominal volume but merely rearrange those assets. With given demands, the public consequently has no incentive to make substitutions among its financial assets and liabilities unless there is a change in _terms_ on which such substitutions can be made. And it is only to the extent that such substitutions occur and are bound up with or give rise to still further substitutions involving _real_ as well as _financial_ assets that credit policy can affect business activity.

"The case...which involves a swap of one asset (private deposits) for another (Treasury bills), is merely one example of the general rule cited. Another would be a situation in which the System provides additional reserves to the banks, and the banks then expand deposits by acquiring securities from the nonbank public. Here the public reduces its holdings of one asset (securities) to build up those of another (deposits). In order to persuade the public to make this switch, the banks must presumably bid up the prices of the securities somewhat. It is this rise in asset prices, in turn, which makes the sellers of the securities (as well as the remaining nonbank holders) wealthier and thus possibly more willing to spend. A third case--the expansion of deposits through an increase in bank loans--involves a simultaneous rise in both assets and liabilities of the nonbank public. To induce an increase in loan demand, the banks would, in a competitive situation, have to ease lending terms somewhat. With credit rationing this might take the form of changes in "nonprice" credit terms and a shift in the degree of rationing. The general rule would, however, be the same as in all these cases: Federal Reserve and Treasury operations that influence spending decisions must in some sense work through, and be reflected in, the state of the credit markets.

"The second point...is that given policy changes which cause the public to shift from deposits into Treasury bills are not only likely to have <u>some</u> impact on liquidity and the availability of funds but will have <u>different</u> effects at <u>different times</u>, even when the amounts shifted from deposits to bills are the same. These divergences in impact can be spotted if one watches interest rates and credit market conditions, but they cannot be satisfactorily taken into account by mechanically assigning a standard "liquidity weight" to given amounts of asset substitution of this type. The same rule applies to other kinds of asset substitutions, such as shifts from time deposits to savings and loan shares or from demand deposits to time deposits. To state the point even more generally: in none of these cases can liquidity effects--and possible effects on spending--be reliably gauged if one only observes changes in the supply of money or of some other liquid assets measure. The reason is that there can be simultaneous changes in the demand (or elasticity of demand) for money or liquid assets, and these tend to vary substantially with differences in business conditions, in financial practices and structure, and in expectations."