REVISED DRAFT
June 2, 1964

TO: Federal Open Market Committee

FROM: Messrs. Ellis, Mitchell, and Swan

SUBJECT: The Committee's current economic directive

CONFIDENTIAL (FR)

We do not believe that by postponing on May 5 the discussion of the problems involved in framing a policy directive the Committee intended to deny that problems exist in this area. Undoubtedly some members of the Committee like the present form of the directive, or like it well enough to live with it, and are not likely to be persuaded out of their own considered judgments by arguments that already have been advanced in one form or another over the years. On the basis of the history of discussions at Committee meetings, however, we believe that a number of members would concur in our judgment that both the form and substance of the present directive are in need of further basic revision.

Four criteria for a good directive were set forth in the Secretariat's memorandum of April 8, 1964. Applying those criteria to the existing directive, we make the following judgments:

(1) The existing directive is too incomplete to cover the policy decisions that confront the Manager from time to time;

(2) It sometimes is internally inconsistent, and hence unreasonable;

(3) It is too vague to establish Committee authority over the current operations of the Manager;

(4) It fails to convey for the public record the Committee's appraisal of current conditions and its policy intent in sufficiently explicit terms.

The difficulty facing the Committee on May 5, as we see it, was the lack of a specific proposal for a practical course of action. We believe that the Committee did not intend to prejudice consideration of reasonably clear-cut proposals, and that it might now be prepared to move a step or two toward a more satisfactory directive. With that in mind we are setting forth some proposals based on the Secretariat's April 8 memorandum which we feel would improve the directive about as much as existing technology permits.

We recommend that the Committee experiment with a directive of the type described below, recognizing that modifications undoubtedly will appear desirable as experience is gained and, hopefully, that improvements will become possible with advances in technology. We also recommend certain staff procedures in connection with the directive that we feel will enable the Committee to sharpen its focus on the policy issues in the course of its deliberations at each meeting.

A. Form and substance of the directive

In general, we recommend moving toward a directive that is more comprehensive and more explicit. We advocate successive sections dealing with the key economic and financial developments leading up to the date of the meeting, the Committee's appraisal of these developments, its policy intent in light of them, and the operating instructions it gives to the Manager. And we urge the use of more specific language throughout, including statements cast in quantitative terms to the extent feasible, and so written as to avoid internal inconsistency. Specifically, we suggest a format involving four elements:

Element 1 would consist of a broad statement of current circumstances directly bearing on the Committee's ultimate objectives -- the pace of business activity, the level of resource utilization, the price level, and the balance of payments. This appraisal of the current state of the economy would be more detailed and analytical than similar statements in directives of the present type, and would vary in content from meeting to meeting, emphasizing the developments of greatest current significance.

Element 2 would consist of an analytical statement of recent credit and monetary developments: in terms of required reserves against the various types of deposits; member bank borrowings, excess reserves, and free reserves; the money supply and time and savings deposits; trends in velocity; and money market and other interest rates. Commercial bank credit flows would be analyzed, in the context of total credit flows whenever possible, and the relation among credit demands, commercial bank portfolio adjustments, and changes in short-term and long-term interest rates would be discussed.

The purpose of this statement would be to clarify the financial situation existing at the time of the meeting and in the recent past with respect to the variables in terms of which the Committee's policy intent and operating instructions are formulated (as discussed below), and with respect to other closely related variables. It would help meet the problem that exists at present, under which a succession of "no change in policy" decisions can be associated with marked changes in individual banking and money market variables and in the relations among variables. And by emphasizing the relationships obtaining in the recent past among the several variables discussed it would help rationalize the Committee's selection of certain values in the operating instructions it issues under its specified policy intent.

Element 3 would begin with a summary statement of the Committee's appraisal of the current economic and financial scene. It would then proceed to state the Committee's longer run policy intent. This statement of intent would indicate the seasonally adjusted annual rate of increase the Committee would like to achieve in the intermediate-term period (not necessarily limited to three weeks but also not for so long a period as to be meaningless operationally) for reserves required to support private demand deposits, and the Committee's position with respect to the provision of reserves required to support changes in time and savings deposits, ~~and~~ Government deposits, and currency in circulation. Such a statement would avoid the ambiguity and potential inconsistency that exists in present statements of broad policy intent ("to accommodate moderate growth in the reserve base, bank credit, and the money supply"). At the same time, since the statement would be one of somewhat longer term intent and not an operating instruction, it would avoid the problems of short-run random fluctuations and seasonal variations that complicate the use of aggregate measures as short-term operating guides.

The use of required reserves as the variable for expressing the Committee's longer run policy intent does not, it should be noted, imply acceptance of any specific or single theoretical framework or line of causation between monetary policy and over-all economic activity. Rather, required reserves can be thought of as the proxy for the host of variables through which policy affects activity. These include money, other liquid assets, bank credit, other forms of credit and capital, interest rates, and security prices.

As a proxy, the required reserves target can be changed to achieve the desired behavior of the entire family of financial variables. Use of this variable for expressing policy intent must, by necessity, be experimental, for knowledge of the relationships between changes in required reserves and changes in other variables is neither clear nor complete. But it would focus primary attention on the aggregate reserve variable that is most closely connected with the money supply and on the one that most often serves as the residual component in required reserves (reflecting the impact upon private demand deposits of fluctuations in either Government or time deposits). Also, required reserves have the advantage of being closer, and therefore more promptly responsive, to Federal Reserve influence than most other financial indicators of the effects of monetary policy.

Since many in the System feel that policy should be formulated in terms of its effect on credit conditions, i.e., on the terms and conditions under which bank credit is made available to borrowers, the link between target levels of reserve availability and target levels of credit conditions should be specified. This linkage is the subject of much inquiry and investigation, both within and without the System, and it is far too early to attempt a complete specification for every set of economic circumstances. Nevertheless, the Committee and the staff do have some notions as to the levels, or changes in levels, of credit conditions (for shorthand, read "interest rates") appropriate to the current posture of monetary policy and to the levels, or changes likely to be produced by the reserve availability specified in the preceding paragraph. Accordingly, Element 3 would conclude with a statement of the Committee's expectations with regard to banks' ability to meet credit demands in light of the Committee's described reserve posture, and its judgments as to the level of interest rates that would be appropriate to the domestic and international goals it is pursuing.

<u>Element 4</u> would consist of the short-term operating instructions to the Account Manager that in the judgment of the Committee are best calculated to bring about the desired rate of expansion in required reserves and the desired levels or ranges of interest rates, as noted in Element 3, in light of the recent performance of the economy as discussed in Elements 1 and 2. The first instruction would be formulated in terms of a range in weekly average free reserves. The range would be as large as experience proves is necessary to accommodate the desired degree of reserve availability under the conditions of uncertainty which always surround the Desk's operations. Subsidiary instructions would specify circumstances relating to three-month Treasury bill rates and to certain other indicators of money market conditions under which departures from the instruction concerning free reserves would be called for. This formulation would avoid

the ambiguity and potential inconsistency of instructions cast in terms of such language as "maintaining about the same conditions in the money market" or "attaining a slightly greater degree of firmness"; and it would avoid the potential inconsistency inherent in the present dual operating instructions referring to both money market conditions and aggregate reserves.

Because free reserves have been subject to so much criticism as a target variable it may be desirable to examine more fully the case for their use in the first instruction. We agree with the argument that it is inappropriate to assume that various levels of or changes in free reserves can be associated with more or less specific degrees, or changes in degree, of "ease" and "restraint"; or to assume that some precise and invariant relation exists between the level of free reserves and rates of change in total or nonborrowed reserves, bank credit, or deposits. We also grant the existence of other shortcomings: that free reserves are not known accurately until a few days after the event, and are subject to fairly wide fluctuations that often make them hard to predict accurately; and that their use as target variables can tend to make policy pro-cyclical, because (to consider one phase of the cycle), strong customer demands may tend to make banks willing to hold smaller excess reserves and to do more borrowing.

On the positive side, free reserves have the following advantages for the purpose of short-term operating instructions: (1) they are a summary indicator of the two most influential aspects of bank liquidity; (2) they are specific; (3) they are subject to fairly close control by the Account Management; (4) their use would bring about automatic System accommodation in the first instance to changes in market supply of and demand for reserves; and (5) their use would leave precise market prices to be determined by the actions of private participants, thus widening the conduit for signals to come through from the market.

We also believe that the manner in which it is proposed that free reserves be used -- for short-run operating target purposes -- would give the Committee a substantial measure of protection against the shortcomings mentioned. At any time, the higher the level of free reserves that the Desk attempts to maintain, the greater the rates of increase (or the smaller the rates of decrease) in the banking aggregates. Over time, if other things are equal, an increase in the target level of free reserves will mean an increase in the rates of increase in the aggregates. The problem, of course, is that over time other things do not stay equal. The nature and timing of adjustments in bank assets and liabilities that would result from a change in free reserves (as well as the change in free reserves that would result from a given System operation), and the speed and manner in which their effects spread through the remainder of the financial and economic system, will depend on many external conditions.

We do not pretend to have precise knowledge of these chains of response under various circumstances. However, since we do have knowledge of the general likely direction and magnitude of response at any particular time, and since System policy actions can be, and often are, intended as "probing" actions, and can be intensified or reduced as their effects are observed, the lack of precise foreknowledge of effects under varying circumstances is not nearly as great a handicap as some critics contend. Meeting every three weeks, the Committee can keep a close check on developments, and can adjust the free reserve target as it deems necessary. As long as this is clearly understood by the Committee itself, as we believe it is, and since it undoubtedly will come to be understood by the public as a result of the directive format we are proposing, we see no valid reason for not using a free reserve target as a "first instruction" through which the views of the Committee are communicated to the Account Management with respect to the direction and magnitude of the change, if any, needed to achieve the intermediate-term objectives cited in the preceding paragraph.

Moreover, we believe that any specific alternative target variable for Element 4 would prove to have even greater shortcomings. For example, total required reserves show even more erratic short-run fluctuations than free reserves, and their link to interest rates is sufficiently loose to allow wide temporary fluctuations to develop in money market conditions. At the other extreme, the Treasury bill rate is heavily influenced by nonbank as distinct from bank liquidity pressures, and efforts by the Desk to hold the bill rate at some target level or range would almost inevitably be interpreted by the market as a "pegging" operation, with most of the short-run and long-run deleterious effects of an official "peg."

Attached is an illustrative directive of the type recommended in this memorandum that might have been issued at the May 5 meeting, ignoring the restraint then imposed by the Treasury refunding in order to illustrate the more usual -- and more difficult -- drafting problems. Presumably at times of Treasury financings the directive would still call for the maintenance of an "even keel," expressed in terms of relatively stable money market conditions or selective indicators thereof.

If a directive of this type were to be employed, some changes would be required in the format of the policy record entries. Either of two procedures might be followed. In one, the entry would include a fuller description of prevailing economic and financial conditions than that given in the more pointed and terse analysis embodied in the first two elements of the new directive. This would be followed by the customary description of the Committee's consensus, quotation of the directive adopted and the votes on it, and summary statements of the reasons for any dissents. Under an alternative procedure, which we would prefer, the directive would be quoted at the beginning of the entry and would be followed by a fuller exposition than is now given of the derivation of the consensus and the reasoning underlying majority and minority positions. In the course of this discussion, salient economic and financial facts would be cited quite naturally, in an analytical context. However, a decision as to how the policy record entry should be handled can be deferred pending a decision on a revised directive.

Also, it might be well to devote some effort to re-educating market participants away from the practice of looking primarily to money market indicators for signals reflecting current System policy.

B. Procedures

It is obvious that the Committee would have to make heavy demands on its staff if it were to issue a fresh directive of this length and complexity at each meeting. The staff is better equipped than the Committee to draft language for the analytical and descriptive parts of the proposed directive, but the Committee has the responsibility for evaluating, and amending as it deems necessary, any draft language the staff might prepare. It is the Committee's responsibility to formulate policy and decide on instructions to the Desk, but the staff can provide expert assistance in this connection. In view of these considerations, we would recommend that:

(1) Drafts of the first two elements of the directive should be prepared by the staff and distributed on the Friday evening before each meeting, along with the staff reserve memorandum and the supplement to the economic memorandum. At times when the staff's analysis suggests that significantly different interpretations might reasonably be placed on recent developments, alternative versions of these elements might be submitted. If the staff drafts are substantially acceptable to the Committee as interpretations of recent economic and financial circumstances, the deliberations at meetings would be concerned mainly with the third and fourth elements.

(2) With respect to the third element, the staff would be asked to advise the Committee of any developments foreseen during the weeks immediately ahead with respect to Treasury financing, substantial changes in Treasury balances from other causes, or other financial market changes that are expected to affect materially the movements in the key variables cited in this element. The staff could also be asked to submit tentative statements of the Committee's policy intent with respect to offsetting these expected changes, to be circulated in advance of the meeting. (It is likely that at a good many meetings little or nothing would be foreseeable in these connections.) The staff might also be asked on occasion to prepare alternative drafts of the summary appraisal with which this element begins, and the statement of expectations with which it ends, keyed to alternative rates of change in reserves required against private demand deposits that the Committee might reasonably wish to choose in stating its longer run policy intent. The Committee itself would select this rate, and it would also make the decisions with respect to the provision of reserves to support expansion in other types of deposits and in currency in circulation.

(3) With respect to the fourth element, the staff would be asked to report to the Committee on any developments foreseen that might affect the relation between levels of free reserves and Treasury bill rates, and between these on the one hand and the rate of growth in required reserves against private demand deposits on the other, in order to help the Committee arrive at those operating instructions

which would be most likely to produce the desired results for required reserves. Again, it is likely that there would often be little or nothing foreseeable in the way of major shifts in relationships between one meeting and the next.

The major difficulty with this directive procedure is the present lack of refined knowledge about the "linkages" in the system -- among the variables describing the Committee's ultimate economic objectives, its intermediate financial objectives, and the immediate operating targets it gives to the Desk. We recommend this procedure despite the difficulties for several reasons.

First, however deficient the state of the art, the Committee must and now does make judgments about these linkages. But the judgments, or elements of them, often are made obliquely or by default at present, because the policy alternatives are posed simply as "no change" or "greater ease or firmness." The Committee does not avoid responsibility for making decisions in the face of uncertainty when it takes this easy road of not specifying its intentions and its instructions in complete, clear, and consistent terms. It does, however, reduce its ability to make the best decisions of which it is capable.

Secondly, even if the Committee has great difficulty in deciding at any one meeting on the best longer run growth rate in required reserves, and on the ranges of free reserves and bill rates most likely to be consistent with this intent and with one another, it can still feel its way from meeting to meeting, modifying operating instructions over time if it becomes evident that past instructions have not produced the desired reserve growth, and modifying its intent with respect to reserves if it becomes evident that the results for the ultimate targets are less than desirable. In short, we consider the procedure feasible despite the lack of *a priori* knowledge about linkages.

Finally, we believe that the proposal goes about as far as is feasible at present. We think the basic framework established would be appropriate for the long run, but would expect to see continuing development and refinement of the component elements with experience and with advances in knowledge. It is in the spirit of innovation and experimentation that we offer this proposal. We recommend, as a first implementing step, that the Committee authorize preparation of a "shadow" directive in the revised form for each meeting, while continuing formally to adopt and operate with a directive of the existing type. Such a procedure should allow both proponents and skeptics to test their views.

Illustrative Directive
(as of May 5, 1964)

1. Economic expansion continues moderate and reasonably well-balanced. The index of industrial production rose further by about half of a percentage point in March, continuing the pattern of modest monthly increases that has characterized most of the period since September. With steel and auto output up, a further rise in the total index probably occurred in April. Retail sales were down a little in March and apparently still tended downward in the first half of April despite the reduction in personal income tax withholding rates early in March. The unemployment rate continued at 5.4 per cent of the labor force in March, and probably remained unchanged or perhaps increased slightly in April. Price stability has been generally maintained, with the wholesale price index only 1/2 per cent above its trough of a year earlier, despite rises in prices of nonferrous metals and some other materials and products in recent months.

The major new foreshadowing development was the estimate based on reports in a private survey that business expenditures for new plant and equipment in 1964 would be 12 per cent above their 1963 level. While this was a higher figure than reported in earlier canvasses of the same survey, its variation from the 10 per cent figure reported in the February Commerce-SEC Survey was not considered significant because of differences in methodology and coverage. The book value of inventories held by manufacturers increased $125 million in March and remained low relative to sales.

According to tentative figures, the U. S. balance of payments was in deficit again in April, apparently by an amount about offsetting the March surplus. Some part of this turnaround may have been due to a March inflow of short-term funds from Canada which was reversed in April. The payments deficit in the first four months of the year was at an annual rate of \$1 to \$1½ billion, compared with \$2 billion in the second half of 1963.

2. Free reserves in April averaged about \$130 million, up slightly from the levels of the two preceding months but below those of December and January. However, a reserve shift in favor of the central financial markets enabled money market banks to reduce their borrowings from the Reserve Banks considerably in April, while country banks held a substantially smaller volume of excess reserves.

Despite this climate of somewhat easier reserve availability in the central money markets, total credit growth at city banks moderated in April following a sharp first quarter rise. The private money supply, on the other hand, rose at a seasonally adjusted annual rate of 4.7 per cent in April and 3.9 per cent in the first four months as a whole. April developments in both bank credit and money reflected in large measure a sharp decline in Government balances following a March run-up. The Government used part of the high cash balances it held at the end of March to redeem debt and part for increased payments to the public. While privately-held demand deposits grew substantially in April as a result of the developments in Treasury balances, currency continued to show a steady rise after allowance for seasonal influences. Turnover of demand deposits rose slightly in March to near its late 1963 peak.

Reflecting the shifts in deposit ownership noted above, reserves required against private demand deposits rose at an annual rate of 6.8 per cent in April and 2.7 per cent in the first four months of the year. Meanwhile, expansion in time and savings deposits at commercial banks continued to moderate. Growth in savings balances at nonbank financial institutions also has fallen markedly this year. Most interest rates eased further in recent weeks following their advances in March, reflecting in the main changed expectations regarding likely future rate movements and monetary policy but also to some extent seasonal developments in the demands for and supply of short-term funds.

3. In light of the moderate pace of the business advance, the continued high level of unemployment, the general stability of wholesale prices, and the improvement in recent quarters in the U. S. payments balance, it is the Federal Open Market Committee's current policy to provide the reserves required to support about the same seasonally adjusted annual rate of increase in private demand deposits in the months ahead as has prevailed to date this year, namely, on average about 3 per cent. It also is the policy of the Committee to supply the reserves required to cover (1) the continuing gradual rise in currency in circulation over and above seasonal fluctuations, (2) the anticipated increases in U. S. Government balances, and (3) actual growth in private time and savings deposits. It is expected

that such provision of reserves will enable banks to meet likely credit demands from Government as well as private borrowers at substantially unchanged levels of interest rates.

4. To implement this policy, System open market operations over the next three weeks shall be conducted with a view to maintaining weekly average free reserves in the $50-150 million range; provided, however, that free reserves should be permitted to move above or below this range in order to moderate any movement in the Treasury bill rate outside the range of 3.40-3.55 per cent or any serious Constriction ~~contraction~~ or excess in the availability of Federal funds or dealer financing.