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June 16, 1964.

TO: Federal Open Market Committee

FROM: Messrs. Ellis, Mitchell, and Swan

SUBJECT: The Committee's current economic directive

CONFIDENTIAL (FR)

On May 5 the Committee postponed a scheduled general discussion of its current economic directive and asked us to outline some specific proposals to provide a better basis for such a discussion. This memorandum has been prepared in accordance with that request.

We believe that both the form and substance of the directive are in need of further basic revision. Applying the four criteria for a good directive that were given in the Secretariat's memorandum of April 8, 1964, we conclude that:

(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;

(3) It often 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.

Undoubtedly some members of the Committee like the present form of the directive, or like it well enough to live with it, and probably will not be persuaded out of their own considered judgments by arguments that already have been advanced in one form or another over the years.

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On the basis of recent Committee discussions, however, we believe (1) that a number of members share our feeling that improvements are needed, and (2) that the Committee as a whole might be prepared to introduce revisions if offered some reasonably clear-cut proposals that seemed both to be feasible and to represent progress. Accordingly, we are setting forth some proposals that we feel would improve the directive about as much as existing technology permits.

In recommending that the Committee adopt a directive of the type described below, we recognize that further modifications undoubtedly will appear desirable as experience is gained and expect 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. Summary and rationale of proposed directive

In general, we recommend moving toward a directive that is more comprehensive and more explicit. In the format proposed, the directive would begin with two elements dealing with the key economic and financial developments, respectively, leading up to the date of the meeting. These would be followed by a third element stating the Committee's policy intent in light of these developments, and by a fourth, containing its operating instructions to the Manager. More explicit language would be used throughout, including statements cast in quantitative terms to the extent feasible, and so written as to avoid internal inconsistency.

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The content proposed for each of the four elements is discussed in more detail below. But a preliminary word may be in order on the rationale of the proposal, particularly of elements 3-4.

The Committee's major concerns are how the economy is reacting to its monetary posture and whether and how monetary posture should be modified in light of developments in the economy. In recent years when the Committee has reached a consensus for "no change in policy" it has tended to leave the second paragraph of its directive unchanged. Thus, by "no change in policy" the Committee presumably has meant no change in money market conditions and in the general rate of growth in aggregate bank reserves, to both of which this paragraph typically has referred. But the several elements of money market conditions and the reserve growth rate do not always move in concert, particularly in the short run, and if one reads the directive literally the Committee at times has set an impossible task for the Manager.

The Manager has indicated that he gives priority to money market conditions when his instructions concerning them are in conflict with those relating to reserves. As a result, over periods during which the Committee has voted for no change in policy at successive meetings, there have been marked changes in the rate of growth of bank reserves -- and also in the rates of growth in deposits and the money supply, and in credit conditions other than those subsumed under the heading of money market conditions -- all stemming from developments in the economy at large against the background of the money market conditions the Manager has maintained.

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Under the proposed procedure, "no change in policy" would mean no change in the Committee's policy intent, as specified in the third element; it would not necessarily mean that the instructions to the Manager, as given in the fourth element, would be left unchanged. The financial analysis in the second element would encompass the variables in terms of which the Committee's policy intent and operating instructions are formulated. Its purpose would be to expose the recent working of the linkages between the policy and operating variables, and to clarify the financial situation that had been produced by the interaction of earlier monetary policy and market decisions.

We believe this general structure would make a substantial contribution not only to the public's understanding of the Committee's reasoning and goals, but also to the Committee's decision-making process itself.

B. Form and substance of the directive

Element 1 would consist of a broad description of those current economic conditions that bear directly 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 current developments of greatest significance for policy.

Element 2 would consist of an analytical statement of recent credit and monetary developments, discussing required reserves against

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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.

Element 3 would specify the Committee's longer run policy intent. It would indicate the seasonally adjusted annual rate of increase the Committee would like to achieve in reserves required to support private demand deposits over the intermediate-term period (not necessarily limited to three weeks but also not for so long a period as to be meaningless operationally), and the Committee's position with respect to the provision of reserves required to support changes in time and savings deposits, Government deposits, and currency in circulation.

Such a statement would avoid the ambiguity and potential inconsistency that exists in present statements of longer run policy intent ("to accommodate moderate growth in the reserve base, bank credit, and the money supply"). At the same time, since it would be a statement of 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.

Since the terms on which credit is made available to borrowers constitute one important channel through which the effects of monetary

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policy action are transmitted to the economy, the link between target levels of reserve availability and target credit conditions would be explicitly recognized. Thus, element 3 would include a statement of the Committee's expectations, in light of its described reserve posture, as to whether credit demands will be met at existing interest rate levels and structure, or whether the reserve expansion desired would change the rate level and/or structure.

Element 4 would consist of the short-run 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 credit conditions, as noted in element 3, in light of the economic and financial circumstances 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 necessary to allow for the margin of error in the preliminary figures available to the Desk on a current basis.

Subsidiary instructions would specify circumstances relating to Treasury bill rates and to one or more other key indicators of money market conditions under which departures from the instruction concerning free reserves would be called for. The purpose of these subsidiary instructions is to provide the flexibility the Manager needs to deal with unusual circumstances in the money market, such as might be produced by reserve maldistribution; and to prevent bill rates from moving to levels that the Committee considers undesirable in light of the balance

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of payments problem, because of possible impact on market psychology, or for other reasons. Except under the circumstances specified, the first instruction would control.

Other special instructions -- for example, relating to transactions in coupon issues -- could be included in this element from time to time, as the occasion requires.

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.

We recommend the use of free reserves in the first instruction at this time, despite the fact that they have been subject to extensive criticism as a target variable.[1/] Briefly, they will "work," in the sense that a change in the free reserve target would have quick and significant (if not always identical) consequences for other variables reflecting the Committee's intermediate and longer-range objectives; they are specific in a way that "money market conditions" is not; their use would involve

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1/ We agree 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 relations exist between the level of free reserves and rates of change in total or nonborrowed reserves, bank credit, or deposits. There also are operational shortcomings to free reserves: they are not known accurately until a few days after the event, and they are subject to fairly wide fluctuations that often make them hard to predict accurately.

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fewer problems of seasonal and transitory variations than would aggregates; and their use would avoid the implications of pegging that would be associated with a similar use of bill rates.

Moreover, 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 misunderstanding or misuse. The proposed directive is intentionally designed to cause the Committee to review every three weeks the free reserve target specified in the light of actual changes in required reserves behind demand deposits and in other variables. In any demand situation, there is some free reserve level -- however high or low it may be -- that is best calculated to achieve whatever objectives the Committee is seeking. Under the proposal the Committee, with the staff's assistance, would estimate that level and would modify it as necessary at three-week intervals.

Our endorsement of free reserves for the first instruction is limited to the time being because there may be other variables with a more stable relationship to the broader monetary goals. In particular, member bank borrowings may be superior to free reserves as a target variable in periods when they are not nominal, and excess reserves may work better than free reserves in periods of active ease. Or one of the measures -- free or excess reserves or borrowings -- limited to certain types of banks (for example, money market banks, weekly reporting member banks, or reserve city banks) may be better than any of the measures for all member banks. Moreover, the effectiveness with which any one of these can be used in a first instruction might be improved by adding a subsidiary

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yet to be explored in the depth necessary to justify the use of any of these possible alternatives to total free reserves for operating purposes. We believe that research along these lines is needed urgently, and that progress in this connection would be facilitated by the change in the directive proposed here.

Attached is an illustrative directive of the type recommended that might have been issued at the May 5 meeting. It ignores the restraint then imposed by the Treasury refunding in order to illustrate the more usual drafting problems. Also attached are draft materials for a directive that might have been circulated before the meeting on June 17, 1964, in accordance with the procedures outlined in the following section.

With a directive of this type, some changes would be required in the format of the policy record entries. One possibility would be to quote the directive at the beginning of the entry and to follow it with a fuller exposition than now usually is 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 naturally, in an analytical context.

C. Procedures

It is obvious that if the Committee is to issue a fresh directive of this length and complexity at each meeting it would have to depend heavily on its staff for working drafts. The staff is in a better position than the Committee would be in the course of the meeting 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

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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 recommend that:

(1) Drafts of the first two elements of the directive should be prepared by the staff and distributed before each meeting to be in the hands of Committee members by Monday morning. At times when the staff's analysis suggests that significantly different interpretations might reasonably be placed on recent developments, the alternatives would appear in the draft. 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 also could 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 also might be asked to prepare alternative drafts of the statement in this element of the Committee's expectations for credit conditions, keyed to several rates of change in

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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 the latter rate, and it also would 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 relations among levels of free reserves, Treasury bill rates, and any other money market indicators mentioned in this element; and between these on the one hand and the rate of growth in required reserves against private demand deposits on the other. Such reports would help the Committee arrive at the operating instructions most likely to be consistent with its expressed policy intent.

D. Concluding comments

In our opinion the procedure proposed above is feasible, would be a step toward a better directive, and would establish a framework under which further improvement could evolve.

It might be argued that our present knowledge about the "linkages" in the system is not sufficiently refined to support a directive of this type. Admittedly, we cannot now say what precise rate of growth in reserves required against private demand deposits or what precise credit conditions would contribute most to our ultimate objectives at any particular time, or, for that matter, precisely how given reserve growth rates would be related to particular levels of interest rates. Nor can we now forecast with complete assurance what money market conditions for three-week intervals would achieve the intermediate objectives selected, nor

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what relations among free reserves, three-month Treasury bill rates, and other money market indicators will prove consistent over the three-week period.

But we do have a great deal of knowledge of general directions and magnitudes of effect, and of probable patterns of relations, that usefully can be brought to bear in making decisions on these matters. And the Committee can reappraise its position from meeting to meeting, as it does now; it can modify its statements of intentions and expections and its operating instructions if it becomes evident that the results of past decisions were not those expected or were less than desirable. The proposed directive is constructed in a way that allows for present deficiencies in our knowledge of the monetary process; it avoids the kind of difficulty that would arise if, in the present state of the art, we attempted to pin down and quantify all relevant relationships. It also avoids the kind of internal inconsistency that exists in directives of the present type.

We believe the proposed procedure would be a step forward because the Committee's decisions cannot help but be improved when the issues are faced directly. However deficient the state of the art, the Committee must, and now does, make judgments of the sort that would be required under the proposal. But at present the judgments, or elements of them, often are made obliquely or by default because the policy alternatives are posed simply as "no change" or "greater ease or firmness." In short, the Committee does not avoid responsibility for these judgments

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when it takes the easy road and fails to specify its intentions and instructions in complete, clear, and consistent terms; it simply reduces its ability to make the best judgments of which it is capable and to learn from experience.

Finally, we believe the basic framework of the proposed directive would be appropriate for an extended period, but we would expect to see continuing development and refinement of the component elements with experience and with advances in knowledge. Adoption of the recommended procedure in itself probably would lead to more rapid progress in improving the basis of knowledge for the Committee's operations. In the effort to face the issues directly the Committee and its staff undoubtedly will come to have a sharper understanding of the problems, and this alone would be a long stride toward solutions.

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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.

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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

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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

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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 or excess in the availability of Federal funds or dealer financing.

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Illustrative Draft Material for Directive
(as of June 17, 1964)

1. Economic expansion is moving at a quicker pace than in the first quarter this year, but the advance remains orderly and price stability still prevails. Revised figures show the rise in industrial production in April to have been larger than originally estimated, and a further increase of about three-fourths of a percentage point in the index is estimated for May. April figures for retail sales also were revised upward and sales rose further in May to a new high. While employment increased only slightly in May, the unemployment rate dropped sharply to 5.1 per cent reflecting increasing job opportunities for adult men and a smaller than expected number of teen-agers and women seeking work. Unemployment among younger workers, however, particularly those unemployed for longer periods, remained at high levels.

Business spending also showed some quickening. The rate of inventory accumulation was substantially higher in April than during the first quarter, but additions to stocks were about in pace with increased business sales, and stock-sales ratios remained unusually low. According to a Department of Commerce survey, businessmen are still pursuing conservative inventory policies, with additions to stocks in coming months projected at a slower rate than sales increases. A new Commerce-SEC survey of capital spending shows recent capital outlays to have been somewhat larger than had been anticipated earlier and confirms that such spending will continue to rise throughout the year. In contrast to increased strength in private expenditures, Federal spending continues to run below and revenues slightly above earlier projections. It seems likely that the Treasury would end the

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fiscal year with an exceptionally high balance, with consequently smaller financing needs over the summer months than had been anticipated earlier.

The orderly nature of the expansion in domestic economic activity is reflected in continued price stability. Wholesale commodity prices remain essentially unchanged at about the levels reached at the 1961 recession low. Sensitive commodity prices, which had been rising since about mid-1963, changed little in recent weeks and foodstuff prices declined.

Recent international developments have been less favorable; the striking first quarter improvement in the balance of payments appears to have been reversed in April, with only a partial recovery in May. The deficit, which dropped to an annual rate of about $.7 billion in the first quarter, has since widened appreciably, with the trade surplus declining and increased private capital outflows on new security issues and liquid dollar deposits more than offsetting a reduction in bank lending abroad. The deficit over the full 5-month period is estimated to have averaged about $2 billion, slightly larger than in the second half of 1963.

2. Increased strength in economic demands is partly reflected in bank credit figures. Business loan demand has been appreciably stronger, particularly in the metals, miscellaneous manufacturing, and trade categories. Real estate and consumer loans of banks continued to show a seasonally adjusted rate of growth about the same as in recent months. A sharp rise in security credit during May helped raise total bank credit expansion from the end of April to the end of May

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well above the average for earlier months of 1964. Banks continued to draw down their Government security holdings to finance loan expansion despite the fact that time and savings deposit inflows supplied a somewhat larger volume of loan funds to banks last month than in March and April.

Member bank borrowings from the System in May and first half June moved back up from their lower April level to close to their $260 million average since the end of January. Excess reserves, meanwhile, held close to the relatively low April level. Free reserves, therefore, averaged lower in May than in April and still lower in the first two weeks of June.

Aggregate as well as marginal reserve measures declined in May. Reserves against private demand deposits dropped sharply, as the decline in private deposits more than offset the increase in Government deposits. Early June figures, however, suggest a more than seasonal rebound in private demand deposits, as Government deposits worked lower. On average from December through May, private demand deposits have grown at only a 1-1/2 per cent annual rate. Although turnover of demand deposits outside New York declined in May from the April peak, the average for the two months was 4.4 per cent above the July 1963-March 1964 plateau. Expansion in the private money supply--demand deposits plus currency--so far this year has been at a 2 per cent annual rate, compared with a 3.5 per cent rate in the last five months of 1963. Time deposit growth has also been slower this year, as has been bank credit expansion in total and in major components.

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Interest rates on most intermediate- and long-term securities stabilized following declines in the first part of May. Recently, distribution of new corporate and municipal securities offerings has been slowed by aggressive pricing. The three-month Treasury bill rate has fluctuated in a narrow 3.46-3.49 range since early May; at the same time the six-month bill rate has moved down to within 10 basis points of the three-month rate, reflecting some renewed investor confidence in the near-term stability of short-term rates.

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Background for Elements 3 and 4

In formulating its longer run policy intent and shorter term operating instructions, the Committee will want to take the following special factors into account:

1. If market conditions continue favorable, the Treasury may undertake a major financing operation involving coupon issues, possibly to be announced before the next FOMC meeting. Such an operation might reduce the floating supply of short-dated instruments and exert significant downward pressure on bill rates.

2. A rise in Government deposits larger than the usual seasonal increase is projected over the next three weeks.

3. Some relaxation from tax and dividend date pressures is anticipated in money markets over the next three weeks.

4. The target level for free reserves of about $100 million continues to be associated with a lower rate of expansion in aggregate reserves, in money supply, and in total bank credit than prevailed in the last five months of 1963, and no factors suggesting a departure from recent relationships are evident. The lower rate of expansion in reserves continues to be associated with stability in interest rates, however, reflecting in part the increased volume of saving flowing directly into financial markets.