CONFIDENTIAL (FR)

September 29, 1964

To: Federal Open Market Committee

From: Messrs. Ellis, Mitchell and Swan

Subject: Comments on criticisms of our proposal for the directive

At the Committee's request we advanced certain specific proposals for the form and content of the current economic policy directive in a memorandum dated June 16, 1964. Those proposals were discussed at the meeting held on July 28 and are scheduled for further discussion at the meeting on September 29. The purpose of this memorandum is to comment on the main criticisms of our proposals that were made in the course of the July 28 discussion.

The criticisms are considered below in three groups: those relating to the proposal as a whole, those specific to elements 1 and 2, and those specific to elements 3 and 4. For convenience, the outline of the discussion is given below.

I. Criticisms of proposal as a whole.

A. The proposal offers no advantages to the formulation of monetary policy.

B. The proposal would impose an undue burden on the Committee and staff.

C. The proposal would involve an undesirable shift of responsibility from Committee to staff.

D. The proposal is premature; more research is needed before it would be practical.

E. There are dangers in explicating the Committee's analysis in the manner proposed.

II. Criticism of elements 1 and 2.

Material of this type is more appropriately included in the policy record entry, as at present, than in the directive.

III. Criticisms of elements 3 and 4.

A. It is undesirable to specify policy intent and operating targets in terms of any single measures, for various reasons (even in the absence of quantification).

B. It is undesirable to specify policy intent and operating targets in terms of the particular measures recommended in the proposal.

C. It is undesirable to specify policy intent and operating instructions in numerical terms.

I. Criticisms of proposal as a whole.

A. The proposal offers no advantages to the formulation of monetary policy.

Comment:

Essentially, the Committee's task at each meeting is to reach agreement on three questions:

(1) the nature and interpretation of economic and financial developments,

(2) the policy objectives to be pursued in light of developments, and

(3) the instructions to be issued to the Desk for the next three weeks in light of policy objectives.

This task is not easy because the issues are complex, and it is made more difficult by the uncertainties attaching to facts and analysis as well as by the inevitable differences of view in a group as large as the Committee.

We believe that there would be real gains for policy if, as we recommended, the staff prepared and the Committee deliberated language dealing specifically and in logically structured fashion with the three essential questions facing the Committee at each meeting -- proceeding from developments to policy to instructions. First, this process would make any weaknesses or inconsistencies in analysis more apparent, and hence more readily remediable. Secondly, the Committee would consider language that was sufficiently clear and detailed to cover the questions at issue adequately. Nominal agreement may be possible when language is sufficiently cryptic, vague, and ambiguous to be susceptible to different interpretations or to no consistent interpretation at all. But meaningful agreement can be reached only on the basis of specific language.

B. The proposal would impose an undue burden on the Committee and staff. With a directive of this length and complexity, an undue amount of staff time would be required in advance of meetings to prepare draft material for Committee consideration, and an undue amount of Committee time would be required at meetings in deliberating on the specific language to be adopted.

Comment:

The procedure recommended would be more burdensome for the Committee and staff than the present procedure. But we believe it would be more efficient, mainly because the product--in terms of the quality of monetary policy decisions--could be progressively improved. Furthermore, in our judgment, it also would lead to a more effective use both of staff resources and the Committee's own time at meetings.

The function of the staff is to provide information and technical assistance to the Committee in reaching conclusions on the nature and interpretation of developments, on policy, and on operating instructions--that is, on the three essential questions. To ask the staff to prepare draft materials for a directive of the proposed type is, in effect, to ask it to supplement all of the detailed facts, interpretations, and judgments it provides to the Committee with a formal synthesis organized under these headings. Since this synthesis would follow the sequence and logical structure of the matters to be decided, its preparation would be as important a service to the Committee as any the staff could perform. If the task seems unduly burdensome to a staff of present size and responsibilities, it clearly would be desirable to reorganize staff assignments in view of the overriding importance of this service to the Committee.

We also think that the Committee's deliberations would be more efficient under the proposed procedure than at present. Each member would have before him draft language that was sufficiently clear and detailed to focus the three essential questions sharply, and he would be able to identify precisely his points of agreement and disagreement--not only with respect to the proposed language but also with respect to the conclusions expressed by other members. At present deliberations are handicapped by the lack of such a focus for discussion; there inevitably is some uncertainty with regard to the frames of reference within which individual members make their remarks and the nature of unexpressed assumptions. The tenor of discussions at the last few FOMC meetings, as members tried to agree on language communicating the kind of subtle shifts desired, demonstrates graphically the need to move toward more explicit statements of assumptions and desired results in order to make policy intentions clear.

If the proposal appears complex it is only because the Committee's job is complex. The Committee has an obligation to do its job as well as it can, and an interest--particularly because of the complexity of its task--in doing it as efficiently as possible.

C. Because the Committee is unable to edit a long and complex document around the table, there would be a tendency to adopt language proposed by staff without substantive change. This would amount to an undesirable shift in responsibility for policy formulation from the Committee to the staff.

Comment:

The Committee always has recognized the need for staff assistance in connection with information, analysis, and drafting; and it also always has recognized that responsibility for policy decisions rests on itself alone. The proposal calls for staff assistance of a particular but wholly conventional type. We believe it is safe to presume that the Committee would not abdicate its responsibility under the proposal procedure. In fact, with the draft directive making explicit the analytical judgments and expected results, the Committee should find it easier to recognize and alter any expressions that are at odds with its wishes. This would represent a greater degree of Committee control than results under the present directive, which often has been attacked as being so vague as to imply abdication of an important degree of Committee responsibility to its operating staff, most particularly to the Manager.

D. The proposal is premature; more research is needed before it would be practical.

Comment:

We agree that continuing and much more intensive research is essential to improve the basis for the formulation of monetary policy. At the same time, the Committee must make policy decisions now; and in our judgment the Committee is not making the best decisions of which it is capable because:

(1) it often does not come to grips with either the known or unknown consequences of its decisions, and

(2) it does not make its decisions on policy and instructions in clear, complete, and consistent terms.

Because of the lack of knowledge of linkages and market psychology the decisions may not always be good; but they will be better if maximum use is made of what is known now.

E. There are dangers in explicating the Committee's analysis in the manner proposed. Publication of the Committee's successive directives in the Board's annual report would expose the facts the Committee considered most relevant, the analysis employed, and the specific policy objectives sought. Detailed explication of these matters would invite criticism not only of the end product of the Committee's actions but also of its underlying reasoning. In effect, it would remove the opportunity for the Committee "to be right for the wrong reasons."

Comment:

Any additional criticism that might result from following the proposed procedure would depend on how astute the Committee was in its analysis and how well it understood the power of and limitations on its specific use of monetary tools. Surely as a public body it should not try to cover up its areas of uncertainty by silence. Moreover, some serious criticisms to which the Committee is now exposed would be overcome: that the directives are not intelligible to the informed observer, and that they do not transmit clear and consistent instructions to the Manager, thus giving him more freedom than warranted to make policy. Finally, much present criticism is not constructive simply because the Committee has not made clear how it formulates the problems facing it and how it reasons in arriving at conclusions. The more clearly the Committee exposes its thinking the more likely that criticism, internal and external, would be helpful to the Committee.

II. Criticisms of elements 1 and 2

> The main purpose of elements 1 and 2 evidently is to inform the public better, and the directive is not the appropriate instrument for that purpose. The proposed substance of these elements closely resembles that of the opening part of the policy record entries, and is more appropriately part of the entries, as at present, than of the directive. It is better to have such material drafted after the meeting so that it can reflect discussion at the meeting. Members now have an opportunity to comment on drafts.

Comment:

The intended purpose of elements 1 and 2 evidently was not made wholly clear in the June 16 memorandum, and this criticism reflects an understandable misconception. The main purpose was not to inform the public better--although that end would be served incidentally--but to sharpen the Committee's focus at meetings on the question of its assessment of economic and financial developments, with the expectation that this would lead to better policy decisions. A policy record entry prepared after the meeting obviously offers no advantages to the policy discussion itself. On the other hand, since the directive would be incorporated in the policy record entry, elements 1 and 2 could serve as a substitute for the equivalent material now included in the entry.

It can be argued that it is appropriate to include these elements in the directive for logical completeness, since they would set forth the key facts and analysis underlying the Committee's policy intent and instructions, as described in succeeding elements. The substance of elements 1 and 2 can be considered as an expanded and more analytical version of the statements in the first paragraphs of directives of the present type listing the factors that "this policy takes into account."

On the other hand, for the intended purpose it is not essential that these elements be included in the directive; what is important is that the Committee consider, and adopt by formal vote, language describing relevant developments and its interpretation of them. Such language might be separated from the directive itself--which would then consist of the statements of policy intent and instructions directly pertinent to the Desk's operations--and recorded in the minutes and policy record entry as "the Committee's consensus on economic and financial conditions." Any dissents from the language approved by the majority--which might or might not be associated with dissents on elements 3 and 4--could be noted and explained. Whatever the mechanics adopted, the Committee should have before it at each meeting a draft statement on the economic and financial situation to serve as a focal point for discussion and debate.

One final comment may be in order. The policy record entries are prepared in accordance with Section 10 (10) of the Federal Reserve Act, which reads in part, "The Board of Governors . . . shall keep a complete record of the action taken by the . . . Federal Open Market Committee upon all questions of policy relating to open-market operations and shall record therein the votes taken in connection with open-market operations and the reasons underlying the action of the . . . Committee in each instance." In short, while all members of the Committee and all Reserve Bank Presidents not currently serving have an opportunity to comment on drafts of the policy record entries, these entries are official documents of the Board, and final decisions on their language accordingly are taken by the Board rather than by the Committee. Under the terms of the Act, the Committee can issue and cause to be published its own official assessment of economic and financial conditions by formally voting on such language in connection with the determination of open market policies.

III. Criticisms of elements 3 and 4

A. It is undesirable to focus on any single measure for specifying the Committee's policy intent (even if not stated in numerical form) or on any measure more specific than "money market conditions" for operating target purposes, for a number of reasons. These include:

(1) The relevant linkages are too complex and changeable, and are not adequately understood.

Comment:

The overriding consideration is that the Committee must and now does reach conclusions on policy and operating targets, however complex, changeable, and uncertain the linkages. Moreover, in the two paragraphs of the present directives it now specifies its policy intentions and targets ("It is the . . . Committee's policy to accommodate moderate growth in the reserve base, bank credit, and the money supply. . ."; ". . . operations shall be conducted with a view to maintaining about the same conditions in the money market . . . while accommodating moderate expansion in bank reserves"). By using three measures in the first paragraph and two in the second (of which one--reserves--is included in both for reasons that are not wholly clear) the Committee does, indeed, avoid focusing on single measures. But this is only at the cost of ambiguity and potential inconsistency within each paragraph and between the two. The main purpose of the proposals for elements 3 and 4 was to enable the Committee to deliberate, and reach judgments on, policy intent and operating instructions in a more efficient manner. We believe that the Committee should acknowledge the fact that it cannot necessarily achieve all desired objectives simultaneously, and that it should face up to the hard choices often confronting it.

(2) It is probable that a measure which is appropriate at one time may be found inappropriate at another.

Comment:

There is no need for the Committee ever to feel "frozen in" by the fact that it has selected certain variables for citation in previous directives. Circumstances change, experience accumulates, knowledge grows, and the composition of the Committee is modified over time. At each meeting the Committee can formulate its statements of policy intent and operating targets in the manner which seems most appropriate to it then. It can choose to use a different variable on a continuing basis if its judgment so dictates; or it can modify the statements of intent and targets for a short interval if special temporary circumstances make the usual types of statements inappropriate.

(3) It is probable that the selection of a few measures would invite criticisms for "misses" that are not necessarily significant in light of movements of other, unmentioned, measures.

Comment:

The Committee is exposed to criticism of potentially greater severity under present procedures than any that seem likely to eventuate under the proposed procedure. In particular, it can be criticized for apparently failing to recognize that its various stated policy intentions and targets may be inconsistent (which would suggest that its knowledge of linkages is poorer than is in fact the case); and for "missing" the stated objectives of moderate growth in particular variables during periods when growth is not moderate by any standard. Moreover, since the controlling statement has in practice turned out to be that relating to money market conditions, the Committee can be criticized for specifying pious hopes without operational significance (relating to reserves, credit, and the money supply) in its official directive.

> (4) The Manager must consider more variables, in more complex interrelations, than it would be feasible to spell out in a statement of instructions; and an attempt to be more specific would result in undesirable constraints on operations.

Comment:

While the Manager (properly) considers diverse variables in making his day-to-day decisions, and while these variables can indeed occur in different combinations, it does not necessarily follow that the Committee is incapable of giving the Manager more specific instructions without having deleterious effects on his operations. As has been noted in various discussions on this subject, in the course of deliberations individual members often mention targets formulated in terms of specific variables, and the Manager takes account of such comments in his operations. However, as long as (1) the Committee as a whole does not vote on such instructions, (2) not all members make such comments, and (3) different members mention different sets of variables, the Committee simply is not making its intentions as clear as it might, and the Manager cannot be held as closely accountable for his operations as would be desirable.

The structure proposed for element 4, involving a "first" instruction qualified by a number of "subsidiary" instructions (possibly including one relating to "money market conditions"), would seem to allow for as much scope and flexibility for formulating instructions as is likely to be required under almost any circumstances. Under this structure the Committee could give the Manager whatever degree of discretion it believes appropriate. At the same time, any specific instructions it chooses to give would be transmitted formally, within the directive, by vote of the full Committee. The Committee as a whole is accountable for the Manager's operations, and the orderly procedure is for the Committee as a whole, rather than individual members speaking for themselves, to instruct the Manager.

B. It is undesirable to focus on the particular measures recommended for specifying the Committee's policy intent and operating instructions.

(1) In particular, it is not desirable to single out reserves required to support private demand deposits as the principal variable for expressing the Committee's policy intent. To do so is to commit the Committee to an overly simple and monolithic view of the mechanism through which policy influences nonfinancial developments. It also slides over such questions as the appropriate interpretation of changes in time deposits and in Government deposits.

Comment:

The proposed directive was drafted specifically to avoid a commitment to any particular theory of monetary causation. Both the views of those who feel the impact of policy runs from reserves to the money supply to economic activity, and the views of those who feel it runs from reserves to bank credit to credit conditions to economic activity, are accommodated within the framework of element 3.

Whatever one's analytic preference, there can be no argument with the proposition that the System's policy is effectuated by changes in the reserves made available to the banking system. Such changes influence both the money supply and the banking system's contributions to total credit flows. The common element in both theoretical structures is bank reserves. In the very short run, the System's own direct participation in financial markets can be a critical element in the supply of and demand for specific financial instruments and, of course, expectational effects engendered by System operations have influence in all credit markets. However, the full and longer lasting impact of policy is through changes in bank reserves resulting from open market operations.

Reserves, in turn, are but one stage in the linkage that extends to more ultimate financial objectives such as money supply, bank credit, and general credit conditions. (The structure of element 3 in the "trial run" directives distributed before the August 18 and September 8 meetings was modified to emphasize this "means vs. ends" relationship somewhat more than did the illustrative directive attached to the June 16 memorandum.) Since statements on these subjects also are included, no analytical commitment is implied by the proposed use of reserves for specifying policy intent

Nor is any commitment implied by the reference in element 3 to private demand deposits; statements on currency in circulation and time and Government deposits are called for as well. All that the proposed directive asks of those who prefer a money supply line of causation is that they be willing to specify the desired rate of expansion in each category of bank deposits and of currency. For those who prefer analytically the asset side of the ledger, the sum of the reserve growth specified for each type of bank liability determines the growth in total bank credit, enabling proponents of this point of view to compensate for those changes in bank credit which reflect diversions of credit flows from other instruments into time and savings deposits at commercial banks, thereby focusing on the expansion of bank credit attributable primarily to expansionary or contractive monetary policy.

We cannot avoid the fact that reserves are related by law to deposits rather than to some asset or group of assets--and that net reserve availability is therefore affected by changes in the Treasury balance, shifts of funds between time deposits and other liquid claims, and the absorption or release of reserves by the currency component of the money supply. The purpose, and advantage, of the approach suggested for element 3 is that it provides for the systematic treatment of the behavior of these various aspects of reserve utilization.

> (2) In the present state of knowledge it would be premature to attempt to specify expectations regarding the credit conditions that would be associated with a particular policy on reserves, as called for in the second part of element 3.

Comment:

Whether it is considered important to include a statement of expectations with regard to credit conditions would depend in part on whether one believes that such conditions are a key link in the chain of causation from reserves to economic developments. The purpose of including a statement on credit conditions as well as on reserves in element 3 was to accommodate those who held this view. And the statements were organized (one as an expression of intent, the other as an expectation) so that they would not be potentially inconsistent, *ex ante*, even though the expectation might well be disappointed.

To those who consider credit conditions to be a key variable in the causal chain, the fact that the relations between reserve changes and credit conditions are uncertain at any time is troublesome primarily because it makes uncertain the *appropriate reserve policy*. But if those who prefer this approach are to reach any conclusions on reserve policy now, they must be prepared to exercise judgment now regarding the probable relations in a particular period. The problem of uncertainty, of course, is not unique to this question; it affects the Committee's operations no matter what methods of analysis are used or what directive procedures are followed. Not only are judgments on uncertain issues likely to be better when the problems are faced directly, but progress in reducing the range of uncertainty also is apt to be made more rapidly.

> (3) It is not desirable to focus on free reserves in the first instruction of element 4 because (a) it would reinforce the position of those who exaggerate the importance of free reserves in monetary policy formulation, and it would give free reserves even more weight than many critics believe they have; and (b) free reserves are not an effective means of operational control.

Comment:

It is by no means clear that the use of free reserves in the proposed manner would reinforce criticism of the sort the Committee has experienced in the past. Much of this criticism was directed to the assumption imputed to the Committee that a particular level of free reserves always had the same implications for the economy. Under the proposed procedure the Committee probably would be adjusting the level of free reserves at frequent intervals in the effort to stay on course with respect to its longer run policy objectives, and this is a logically respectable undertaking. Indeed, by increasing the frequency of changes in the general level of free reserves, and by making it clear that the Committee considered the free reserve measure useful primarily for short-run operating target purposes, the proposed procedure might finally lay this issue to rest.

Whether free reserves are an effective operating variable ultimately is an empirical question, but an excellent *a priori* case can be made that they are. If the Committee's judgment is that some better variable is at hand now it should be used instead.

> (4) The subsidiary instruction relating to bill rates is undesirable because (a) knowledge by the market that the Committee was setting limits to such rates would have a rigidifying effect, and (b) it would be preferable to authorize the Manager to exercise judgment, not reacting to rate movements that seem to him clearly temporary, and reacting gradually to other movements rather than abruptly when certain limits are reached.

Comment:

This subsidiary instruction was proposed on the grounds that the Committee currently had an interest in limiting the range of bill rate fluctuations, among other reasons in order to minimize short-term capital outflows. If the Committee would prefer to have the Manager make gradual adjustments as the rate approached a limit, it could so instruct him. (The language used might follow that of alternative 6 (d) on page 3 of the appendix to the Secretariat's memorandum of April 8, which called for operations to "moderate any tendency of the rate of three-month Treasury bills to approach the limits of the range ___ to ___ per cent.") Similarly, appropriate instructions could be framed if the Committee wanted the Manager to avoid reacting to rate movements he deemed temporary. (However, at the meeting of March 3, 1964, the Manager indicated that it would be difficult to implement such an instruction. See pages 79-80 of the minutes for that meeting.) In any case, if the Committee wants the Manager to modify his operations in the event of certain bill rate developments, we believe (to repeat) that the Committee as a whole should decide on the appropriate instructions, and should include them in the directive.

As to whether knowledge by the market that the Committee had issued such instructions would have a rigidifying effect, it might be noted that instructing the Manager to moderate outsize bill rate fluctuations is not the same thing as setting a specific bill rate target. The limits would become relevant only if and when the market rate approached them, and there would be room for fluctuation between the limits of any amplitude the Committee might choose. This would leave a considerable amount of uncertainty as to the duration of any particular rate level, and would keep alive and active the private market's trading functions. Secondly, if the Committee believes that, say, the bill rate should not fall below 3.50 per cent for an extended period for balance of payments reasons, and the market should infer such a limit from the operations of the Desk, then that discovery would itself probably give rise to private expectational responses that would help to moderate any decline of the rate below the level the Committee desires.

C. It is not desirable to specify policy intent and operating instructions in specific, numerical terms.

(1) In particular, it is undesirable to specify policy intent in quantitative terms because it would be difficult to determine the appropriate numerical target in the present state of knowledge.

Comment:

Quantitative statements have a great advantage over purely verbal statements: of accuracy in communication, among Committee members in their deliberations, between the Committee and the Account Manager, and between the Committee and the public. That it may be difficult to determine the "appropriate" quantity does not gainsay the fact that some quantity will emerge from operations conducted on the Committee's behalf; the only question is whether the outcome is to be determined by chance or by the Committee. If the statement of policy intent relates to the measure or measures with which the Committee is primarily concerned, there is nothing to be gained by leaving the outcome to chance.

(2) It is undesirable to specify a numerical operating target in terms of a range of free reserves, even if the instruction is qualified, because:

(a) If the range was narrow enough to be meaningful, the Manager probably often would be unable to meet it because of errors in his data and projections. A high frequency of misses would imply that the Committee lacks control over the operations of the Desk, and might lead to much capricious and uninformed criticism of the Committee.

(b) Because of errors in data and shifts in reserve distribution, different indications often may be given by current free reserve estimates and by other indicators of money market conditions. Pursuit of a free reserve target may therefore result in operations that are contrary to the current market tone, and in wider short-run swings in money market conditions. It may also require operations that are larger and more frequent than at present. System actions would appear arbitrary and capricious to the market, tending to undermine the continuity of market atmosphere.

Comment:

A number of means could be used to ameliorate certain of these problems, and others could be found by experimentation. One approach would be through administrative changes, such as improving the current reporting of reserve factors (which would reduce the size of misses) and authorizing the Manager to enter into reverse repurchase agreements (which would allow the Manager to adjust the free reserve statistics and the tone and feel of the market more precisely in the closing days of the reserve weeks). Another would involve changes in the form of the instructions in element 4, such as specifying a central value rather than a range of free reserves (with the understanding, made clear in the record, that precise performance could not be expected) and specifying that the instruction applied to the central tendency over a three-week period and not separately to values for individual days or weeks.

A more quantitative wording of instructions does not necessarily mean more slavish attention to reserve statistics, in ignorance of other, quite quantifiable, indicators of the tone and feel of the market, or even of credit conditions more broadly viewed. The Manager can be directed to pay as much or as little attention to reserve statistics at any particular time as the Committee may wish. But generally, we believe that whatever the policy intent of the Committee, a more specific and quantitative instruction, appropriately qualified, would be clearer than the kind of instruction issued at present, and therefore preferable. Time and again the Manager has indicated that he has a quantitative interpretation of tone and feel instructions, and it is important for the record that these be specified by the Committee. In general, we believe that the Committee is capable of overcoming any difficulties of the kinds discussed above.