ARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 20, 1964

To

Subject: Directive

From Governor Robertson

Attached is a copy of the memorandum to which I referred at the Open Market meeting this morning with respect to the study of ways and means of improving our directive.

Attachment

Gov. Robertson sent copies to the 12 Reserve Bank Presidents, each Board Member, Messrs. Brill, Holland, Koch, Young, Noyes, Axilrod, & Sherman.

I distributed to Mr. Broida and Mr. Partee.
m.e.

October 19, 1964

Memorandum:

Re: Shadow Directive

The discussions on the directive have brought into the foreground a number of issues with which we ought to be grappling continuously. One has to do with the analytic basis as well as the format for conveying the judgments that we make about bank credit and money. A second has to do with whether our instructions should be conveyed in quantitative or qualitative terms.

However, in bringing these two issues into focus, I have a feeling that we have tended to tie together important elements that do not necessarily belong together. This has blurred some of the very useful contributions to our thinking that do or should underlie the directive discussion. To be specific, we have tended to confuse the kind of analysis that is appropriate to Committee judgments about bank credit and money with what is appropriate for inclusion in a directive that is eventually to be published and that is to reflect the views of a large deliberative body. Second, we have tended to stress the virtues of quantification without being clear as to what we should quantify.

Let me expand first on the question of analysis. The shadow directives have not, in my view, come to grips with our principal analytic problems with respect to bank credit and money. But even if they had, I would still be critical because I doubt that the directive is the place for such analysis.

What the Committee needs to have at hand in helping it formulate operating instructions and what the Account Management needs at hand to help it carry out these instructions is an analysis of the demand or market factors affecting bank credit and money in the immediate future. Such an analysis would enable us to judge whether movements in bank credit and money associated with a specified level of free reserves are likely to be inside or outside the bounds encompassed by our policy stance. It would also force us to define the bounds more carefully - to be more explicit in judging whether (say) a 9 per cent increase in money supply in the next three weeks or so is consistent with policy because it would represent a temporary response to loan demands or to a change in U. S. Government deposits or whether it is inconsistent because it would be unlikely to be reversed in the months ahead.

I realize that our knowledge is necessarily limited about the future and that the state of the economic art still leaves much to be desired in understanding the linkages between demand conditions in the economy and supplies of bank credit and money. The difficulties in prediction and the tentative nature of the conclusions make it clear that the directive is no place for such an analysis as I have in mind. But the analysis should be available - perhaps in memorandum form - as background for the Committee and the Account Management, to be used by both in full light of its experimental nature and of the very real possibilities that events may fool us all.

The shadow directive does not contain the analysis we need, and it should not. I am inclined to believe that as formulated the shadow directives are more likely to increase than to moderate public confusion. For instance, the September 29 shadow directive states that enough reserves should be supplied to permit private demand deposits to rise less rapidly than in the preceding three months. The trouble with that is indicated by the fact that such deposits in the three month July-September period rose more than twice as fast at an annual rate as in the January-August period, before policy became less easy. Demand deposits might increase more slowly than in

July-September and still be well above the January-August rate. To many observers that would be a strange result of a move toward less ease. If those who voted for the policy change are ready to accept such a result, more analysis is needed. If the behavior of private demand deposits is not relevant because (say) the July-September time period is too short, the reference should not be in the directive.

My remarks should not be interpreted as indicative of a lack of sympathy with quantification. But I am not at all sure what we should quantify - even in such vague terms as annual rates of increase over extended periods. As a matter of fact, I am not at all certain as to what time-spans the quantities should apply. When do trends begin and when do they end? What changes are temporary and what are permanent? How far ahead do today's actions have an impact? All these questions are crucial, and should be studied continuously.

We have the kind of directive we have now because we cannot be certain of our ground and because, after the fact, there are a number of unforeseen patterns of bank credit, money, liquidity and interest rates that may or may not turn out to have satisfied us. It would, I believe, be foolhardy to adopt a different kind of directive merely because it appears more precise and because it lists in somewhat more detail a number of variables that concern us, such as currency and private demand deposits, when we have neither worked out nor explained how private and governmental economic and financial activity will influence their behaviour in the light of our free reserve and interest rate objectives.

I would be the last person to claim that we now have a perfect directive. And I can see two reasons that would compel a change in its basic format - first, if we could clarify our intentions to the Desk; and second, if we could clarify our intentions to the public without at the same time confusing the Desk and ourselves.

A certain kind of clarity that would satisfy both criteria might be achieved by quantifying operating instructions such as for free reserves and bill rate ranges, as the shadow directives do in paragraph 4. But even here, I fear that unusual developments that might occur in a three-week period (as occurred in the week ending October 14), or revisions (as have plagued us for a long time now), would make the Desk and the FOMC appear to be either naive or willful, depending on who of the public is doing the interpreting.

As things are now, the Desk is reasonably clear about what we as a group want. The only thing a quantified set of operating instructions would do is to make it perfectly clear to the public that it is clear to the Desk what we want - but at the cost of a degree less of flexibility for the Committee, which might find it difficult to change its stance except overtly, and for the Desk, which might find it difficult to let the market have the kind of flexibility it should have if it is to communicate information to us.

To go beyond quantifying operating instructions to efforts to measure in quantitative or even general qualitative terms what these instructions will mean for bank credit and money is something we should do, as I have tried to make clear, but which should not be in the directive; that is, it should not be in the directive except as it is now - when we note that we want to "accommodate ('encourage' would be a better word) moderate growth in the reserve base, bank credit, and money." I do not think the shadow directive effectively goes beyond that statement, but for our policy-making purposes <u>we</u> need to. That is why I suggest the preparation by the staff of a memorandum analyzing market and other demand conditions that will influence bank credit, money, interest rates, et cetera, in the period ahead.

The ideal directive, in my view, should include only the first sentence of our current directive and the last paragraph; it would state the policy and what should be done to implement it. But the Committee should also agree on a statement for the policy record similar to what is included in the first two paragraphs of the shadow directive, but those paragraphs should be written more so that they look ahead - to the extent that we can. The paragraphs should reflect the Committee's evaluation of what the economic and financial facts mean and the Committee's judgment about the relative importance to be placed on such key items as price, output, employment, and balance of payments developments. When the policy record is published, it should be made clear that the condensed directive is issued on the basis of the general analysis and findings about the state of the economy and the end results the Committee is seeking to achieve.

As background material, we should have prior to each meeting a staff memorandum which discusses how credit and other financial developments are _likely_ to influence bank credit, money, and interest rates in the immediate period ahead if we do not change our operating instructions - _i.e._, do not change what we would like to see in free reserves, interest rates, or more generally, money market conditions.

Finally, let me say that I do not think that we should stop our efforts to obtain a better directive. More than that, we should not stop our efforts to clarify our understanding of the economy and how monetary policy impinges on it. Perhaps in light of our present economic knowledge, our current directive procedures are the best we can do. Or perhaps we can do somewhat better by including a few more forward looking statements in it, which has its risks. Or maybe we can do better by some further quantification of operating instructions, which, too, has its own risks.

Consequently, I think we should continue experimenting with new forms for the directive and accompanying statement for the record on which such directives are based, altering them from meeting to meeting as ideas are generated or found faulty, and requesting the staff to analyze each (including the old ones) in the light of a hindsight view of actions and results - all in the hope that we may improve our operations and at the same time bring about a better public understanding of the rationale of our policy judgments.

J. L. Robertson
Member, Board of Governors