BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

CONFIDENTIAL (FR) September 5, 1969.

To: Federal Open Market Committee

From: Mr. Holland

Enclosed is a memo from Governor Mitchell dated today and entitled "Proposed alternative to use of bank credit in proviso clause."

Robert C. Holland, Secretary,
Federal Open Market Committee.

Enclosure.

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To: Federal Open Market Committee

From: Governor Mitchell

Subject: Proposed alternative to use of bank credit in proviso clause.

The purpose of this memorandum is to elaborate on my remarks at the August 12 meeting concerning the use of bank credit in the second paragraph of the Committee's directive. At that time, I expressed the view that the single measure of bank credit was an inappropriate guide for operations, and I proposed an alternative directive[1/] whose primary instruction to the Manager would have involved a more collective target for operations stated in terms of "monetary aggregates." If the Committee prefers to retain the present style directive, incorporating "money and short-term credit market conditions" in the primary instruction, I believe the Committee should nonetheless relieve the proviso of its exclusive reference to bank credit.

As you know, a proviso clause geared to bank credit became feasible only with the development of the bank credit proxy, since the end-of-month bank credit series could not be employed as a guide to day-to-day operations. But--however useful the proxy series may have been originally--its usefulness has been greatly impaired, in

1/ "To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to moderating contractive tendencies in monetary aggregates while maintaining the position of firm over-all credit restraint; provided, however, that operations shall be modified if pressures arise in connection with foreign exchange developments."

my view, by the subsequent tendency of banks to develop and exploit various nondeposit sources of funds. Efforts can be, and have been, made to adjust the proxy series for funds from such sources, but data collection and analysis inevitably lag behind events and in some cases serious conceptual problems arise in the adjustment process. Moreover, although Committee members have continued to consider and comment on developments with respect to other monetary aggregates, the use of bank credit in the proviso clause undoubtedly has led to an overly sharp focus on this single measure in the staff's projection work and in the Committee's own deliberations. Another damaging consequence of our exclusive attachment to a bank credit proviso has been the impression left with the public that we ascribe even greater significance than is actually the case to a monetary aggregate which the rest of the world does not regard as having overriding importance as a target for System operations.

I submit that certain key monetary aggregates viewed collectively would provide a much better basis for the proviso clause. I have indicated my own views on the desirability of focusing at the moment principally on the money stock (M_1), or perhaps some aggregate reserve measure such as total reserves, and indeed I would be prepared to include such measures specifically in the proviso clause instead of a more general reference to "monetary aggregates." I recognize, however, that other Committee members might structure their emphasis among the monetary aggregates somewhat differently, and I see the wisdom of wording the aggregate reference in the directive in a way that would better encompass such differing preferences. Therefore, I would propose the use of the term "monetary aggregates" in the proviso clause, with that term understood to include such variables as (1) total and nonborrowed reserves; (2) total member bank deposits (the unadjusted proxy); (3) the proxy adjusted for Euro-dollars and other nondeposit sources of bank funds; and (4) the money stock (M_1).

I am convinced that inclusion of a reference to monetary aggregates in the proviso would be a feasible instruction to the Manager. Indeed, the Manager has long been given a primary instruction in the directive which is understood to refer to a "constellation" of money and short-term credit market conditions rather than to any single measure. At the present time, such measures as reported in the blue book include the marginal reserve measures--free/net borrowed reserves, excess reserves, and member bank borrowings--the Federal funds rate, dealer borrowing costs, and short-term interest rates, principally Treasury bill rates. Obviously, the relative importance which Committee members have attached to individual measures within the over-all constellation has varied over time as circumstances have changed, but the Manager has been able to operate effectively with this "constellation" instruction.

I can conceive of a similar approach with respect to the proviso clause instruction. The staff would furnish in the blue book projections of the various monetary aggregates considered to be significant by the Committee. Assuming the projections are accepted and made the basis of the proviso clause, the Manager would act to implement the proviso if significant deviations from the projections occurred in several of the aggregates. The chief adjustment needed in the blue book drafting might be a little fuller elaboration of foreseen relationships among the monetary aggregates.

A possible objection to the approach outlined above is that the aggregates may deviate from the projections in both directions, leaving the interpretation of the proviso ambiguous. In my opinion, we have a strictly analogous situation now with respect to the current primary instruction to the Manager. In resolving such a dilemma--which he very frequently confronts--the Manager must necessarily weigh the size and significance of the varying deviations, referring back to and interpreting the statements which Committee members make about their priorities during the course of the Committee's deliberations. In the same way, the Manager would depend upon expressions of Committee members' views before reaching a decision on the possible implementation of a "monetary aggregates" proviso.

In the latter connection, a major advantage which I believe would stem from the adoption of such a proviso would be the fuller accommodation of the disparate views among Committee members concerning the relative current importance of the various monetary aggregates. Individual Committee members would thus be better served; their respective views would be likely to have a greater impact on operations; and, not to be overlooked, there would also be a positive dividend in terms of the Committee's public posture.

To conclude, while I do not hold to the specific language, the following might serve as an example of the type of proviso I have in mind:

"...provided, however, that operations shall be modified if monetary aggregates appear to be deviating significantly from projections."