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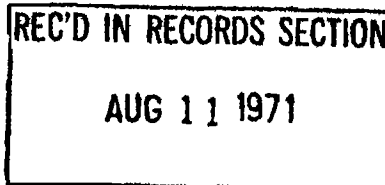
BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551



August 10, 1971

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Broida

There is enclosed a copy of a document dated today and entitled "Interim Report of the Committee on the Directive." As you know, the Directive Committee consists of Messrs. Maisel, Morris, and Swan.

It is contemplated that the subject of this document will be discussed at the meeting of the Open Market Committee to be held on August 24, 1971. For background purposes you may wish also to consult the earlier report of the Directive Committee dated March 2, 1970.

Arthur L. Broida,
Deputy Secretary,
Federal Open Market Committee.

Enclosure

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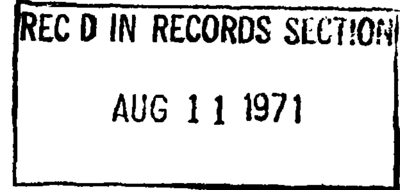

August 10, 1971

CONFIDENTIAL (FR)

TO: The Federal Open Market Committee

FROM: Messrs. Maisel, Morris, and Swan

INTERIM REPORT OF THE COMMITTEE ON THE DIRECTIVE

Background

When we filed our initial report 18 months ago, we stated that ". . . *the specification of what monetary policy the Committee desires* and the relating of such a policy to the Manager's operations and the Committee's goals remain critical problems." We recommended

> ". . . a directive under which the FOMC would determine at each monthly meeting a desired monetary policy for the following three months. For operating purposes, this policy would be translated into a total reserves target covering this same period. In attempting to achieve this target, the Manager would be instructed to avoid extreme (although we recognize that only actual experience will produce a definition of extreme) strains or slacks as money markets fluctuate."

In the interim, important progress has been made in achieving these goals. The Committee has broadened its horizon to three months or more. The staff has attempted to relate alternative monetary strategies to the projections of income, employment, and prices. Committee members have more frequently expressed their views on the current directive in the light of their intermediate goals and strategies.

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We may characterize the current directive as one in which: (a) While it continues to constrain its actions in accordance with events in credit markets, particularly as it believes expectations will be affected, the FOMC gives significant emphasis, in considering its goals and decisions, to desired and projected movements in the intermediate monetary variables--primarily aggregates and especially M_1. (b) In contrast, operating instructions to the Manager have been primarily couched in terms of movements in the federal funds rate and other money market conditions with, in most cases, a proviso based on movements in the aggregates.

The staff analysis presented in the Blue Book has typically spelled out expected relationships between money market conditions and the monetary aggregates for more than one possible policy alternative. One of the policy options presented has been a no-change alternative; the others have specified the adjustments in money market conditions that would be needed to achieve a shift in growth of the monetary aggregates to more or less rapid rates than those recently prevailing.

The Blue Book alternatives presented primarily have been those related to operations which for any given directive would limit changes in the federal funds rate to about a 25-50 basis points range between meetings, with additional leeway to change the rate if reported deposit data appeared to be deviating significantly from projections.

The FOMC has debated the expected effect of these alternative movements in money market conditions on the growth rate of the aggregates and after selecting the desired alternative has issued the necessary

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operating instructions to the Manager. As a result of this procedure, the Committee has been far more explicit and also more flexible in its directives. The FOMC has achieved a better view of the direction in which it wanted policy to move and of the operating instructions needed to accomplish its desires.

Nevertheless, a major problem has remained with respect to magnitudes of movements in the aggregates. The staff has had to project how much effect a movement in money market conditions would have on the aggregates, taking into account the exogenous forces in the economy and the banking and credit system. While these projections have usually predicted directions of change correctly, they have sometimes missed seriously the degree of change both in monthly movements (which we do not believe to be too important because of noise in the data), but more importantly in the three-month figures. At the same time, by adhering to an operating approach which in practice has meant only relatively small incremental changes in the funds' rate, the FOMC has prevented itself from moving more rapidly toward its desired intermediate financial objectives.

Because the structure of our directive still emphasizes money market conditions as an operating variable, the market has naturally continued to focus its attention on the federal funds rate. But, in addition, it now watches behavior in money supply very closely, and when growth in money begins to appear excessively large or excessively small, the market comes to anticipate movements in the federal funds rate. Both actual money supply behavior and actual federal funds rate behavior have come to have strong expectational influences on market interest rates and conditions

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generally. This has often led to situations requiring perhaps excessively cautious movements in the federal funds rate for fear of setting off sharp, unwarranted changes in interest rates more broadly.

Recommendation for a New Operating Guide

We believe that it would improve the FOMC's ability to achieve a policy posture conducive to stable economic growth if money market conditions were de-emphasized further. The increased use of reserves as a week-to-week operating target seems likely to encourage somewhat more effective System control over the behavior of intermediate monetary variables.

For operating purposes, our basic recommendation is that the FOMC instruct the Manager to attain a particular level of reserves on a week-by-week basis altering these levels in accordance with two provisos: (a) one would depend on comparisons of actual reserves to the path that the Committee had selected as consistent with its moving three-month objective for intermediate monetary variables, and (b) the second would state the maximum acceptable movements in short-term interest rates. The path would be designed to take into account reserves required for normal seasonal and random forces as well as Treasury changes so as to minimize expected short-term interest rate fluctuations.

There are, of course, a number of issues to be considered in determining whether or not to adopt this recommendation. The first and basic one, and that primarily discussed in this memorandum, is whether or not monetary policy would likely be improved by expressing these

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recommended operating instructions in terms of reserves, while relegating money market conditions to two other roles: acting as a proviso and as an intermediate variable along with the nonreserve aggregates. A second issue is the appropriate width of the limits of the money market conditions proviso to be used in the early trials of the new system, if it is decided to move in this direction (a condition also applicable to the other issues mentioned below). A third issue is what form the week-to-week operating target or control system should take. A fourth issue--again no different basically than our current problem--is the relative weight to place on various money market conditions and nonreserve aggregates in deciding the general position of the FOMC regarding the pursuit of policy tightness or ease. A fifth issue is whether, when, and how to publicize the new approach. This brief report is directed only to the first of these issues, since it is the key to all the others and since a decision in principle concerning it is not dependent on the prior resolution of the rest.

Reasons

Developments since our last report have made the introduction of a reserve target the next logical step in the evolution of monetary policy. Policy questions in selecting among the possible levels of the monetary aggregates and interest rates will always remain, no matter what the operating variable through which the Committee instructs the Manager. But once the Committee comes to a decision with respect to its policy stance on the monetary aggregates and interest rates, we feel that it is technically preferable to express the operating instructions in terms of a reserve aggregate.

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We believe that there are a number of advantages to be obtained by shifting the focus and language of the operating instructions to the Manager from money market conditions to reserves.

(1) Bank reserves represent a magnitude that the central bank can control over time with a rather high degree of accuracy, while its control over particular types of deposits is more limited. Public acknowledgement that the FOMC was working with a reserve target on an operational basis might help make it clear to the public what the Committee can and cannot accomplish and, therefore, for what it should and should not be held responsible.

(2) Experience has shown that the structural relationships between money market conditions and movements in the aggregates are difficult to predict with existing knowledge. As a result, the FOMC is subject to constant surprises and criticisms when the current operating procedure fails to achieve a desired target. A week-to-week reserve operating target would seem likely, in practice, to result in an improved degree of control over the monetary aggregates.

The question whether it would be more efficient to control the monetary aggregates through reserves or through money market conditions is, of course, still subject to considerable debate, since empirical work in this area has been under way for only a few years and the results thus far cannot be said to be conclusive. Our staff has analyzed this point--among others--in some detail, however. Its conclusion is that use of a reserve target with a wider range of federal funds rate movements will tend to keep the System from adjusting reserves automatically through open market operations as a result of unexpected and undesired shifts in credit demands.

It should be noted that a reserve target will not solve the problems which arise from changes in the deposit mix that tend to throw off the original multiplier relationship assumed between reserves and deposits. However, movements in and out of the discount window can work as a safety-valve cushioning the money market in the face of erratic short-run movements in the demand for money and in the mix of deposits.

(3) Under current procedures, debates over operating procedures take place in terms of small incremental moves in the federal funds rate. As a result, the FOMC does not consider the full range of possible operations on reserves or the aggregates. In view of the limited knowledge about relationships

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between operations and targets, the cautious character of existing procedures may be advisable. But it would seem more logical to consider the full range of possible targets, to select the Desk operations expected to achieve the desired target, and then to constrain these operations only if they seem to imply disturbingly large interest rate fluctuations that might exceed an agreed-upon range.

(4) Under current procedures, the market reacts, at times sharply, to small changes in the federal funds rate. Expectational forces are built up because the market recognizes correctly that rates have been altered by the Desk in order to influence reserves and aggregates in a certain direction. It has little knowledge of the size of move that is under way.

Shifting to a reserve weekly operating target and a longer run total reserve path should reduce the focus on the money market and over time the expectational impacts of changes in the federal funds rate. The rate would be able to move more in accordance with market demand and supply forces, in contrast to the present system where its movements primarily reflect the execution of Committee decisions.

Limitations

It must be emphasized that moving toward a reserve operating path will not eliminate many inherent difficulties in achieving goals for monetary aggregates or in making policy decisions that inevitably involve choices among monetary aggregates and desired interest rate behavior. Use of reserve paths should, however, represent at least a modest improvement over current procedures. The success with which an intermediate monetary target can be hit by using reserves as a week-to-week operating target rather than money market conditions will, of course, still depend heavily on the staff's ability to anticipate correctly the multiplier relationships between reserves and deposits. Recent experience has shown

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this can be a very difficult task. Nevertheless--where misses occur--it should prove possible to make adjustments in the reserve path to attain more nearly the desired aggregates, just as it has been necessary to make such adjustments in the federal funds target.

A second limitation on the proposed approach is that it depends critically on the FOMC's willingness to allow for larger short-run variations in money market conditions. If, in practice, the Committee placed too narrow a constraint on the federal funds rate, then a reserve target would be hardly distinguishable from a money market conditions target.

* * *

Upon the acceptance of these recommendations by the FOMC, the staff is prepared to provide a description of the control system and related procedures in more detail. The possible sets of reserve, deposit, and money market relationships will be presented in the Blue Book.