Authorized for public release by the FOMC Secretariat on 5/10/2021

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

December 14, 1977

STRICTLY CONFIDENTIAL (FR)
CLASS I FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida

Attached is a copy of a memorandum from the Subcommittee on the Directive dated today, and entitled "Implications for Directive of Immediate Publication on Adoption."

It is contemplated that this memorandum will be discussed at the forthcoming meeting, under agenda item 1.

Attachment

Authorized for public release by the FOMC Secretariat on 5/10/2021

STRICTLY CONFIDENTIAL (FR)
CLASS I - FOMC

TO: Federal Open Market Committee

DATE: December 14, 1977

FROM: Subcommittee on the Directive (Messrs. Eastburn, Gardner, Partee (Chairman), and Volcker)

SUBJECT: Implications for Directive of Immediate Publication on Adoption

The Subcommittee on the Directive was asked to investigate what changes, if any, should be made in the FOMC's directive in the event that the Court's order requiring immediate publication becomes effective. We have considered possible adaptations only for the operating paragraphs of the directive--that is, those which contain shorter-run specifications for the funds rate and the monetary aggregates and longer-run ranges for the aggregates. The court's order does not seem to raise any significant problems in connection with the "background" paragraphs of the directive.

The first part of this report consists of the arguments for and against various possible changes in the directive paragraph containing the shorter-run specifications for operations in the interval before the next FOMC meeting. Our recommendation in this respect is presented in the body of the report. It is, essentially, to retain the present procedure for the time being. The subcommittee recommends, however, that an instruction to take account of financial market conditions be added to the penultimate paragraph of the directive to provide the flexibility the Manager may need in the new environment created by immediate publication. Also, the subcommittee suggests that, at least initially, the width of the funds rate range ordinarily be held to about ½ of a percentage point, recognizing this could increase

Authorized for public release by the FOMC Secretariat on 5/10/2021

the likelihood of inter-meeting telephone or telegraphic modification. (The funds rate range has in practice been ½ percentage point wide in recent directives). Other modifications in the directive may, of course, prove to be desirable on the basis of actual experience.

In our deliberations, we recognized that the present form of the FOMC's directive reflects an approach--in which day-to-day open market operations are aimed at some specific weekly average Federal funds rate, with adjustments in that rate dependent for the most part on behavior of the monetary aggregates--that is the result of a long evolution and of well considered FOMC debate. We also recognized that the Court order would change the environment in which the FOMC operates and, therefore, might well call for some change in operating methods on substantive grounds. We do not feel, however, that the Court order itself should be taken as the reason for adopting a basically new approach to operations unless such an approach has clear economic advantages. Accordingly, the subcommittee did not believe it desirable at this point to consider such alternatives as shifting to a reserve target--a course which the FOMC has debated, experimented with, and decided against in recent years.

The second section of this report discusses the paragraph of the directive that cites the longer-run ranges for the monetary aggregates and proposes a modification in procedures. A brief final section considers how the release of information concerning members' votes may be handled.

Authorized for public release by the FOMC Secretariat on 5/10/2021

I. ALTERNATIVES FOR SHORT-RUN OPERATING GUIDELINES

1. Continue current procedures with respect to directive--choosing between monetary aggregates and money market directive and varying the width of numerical ranges as circumstances may require.[1/]

Pro:

(a) Committee would not be subject to charge that it was attempting to mask its decisions in order to evade intent of court order.

(b) Since market is familiar with current directive, and actions taken under it, probability of misinterpretation of System intentions may be lower and market adaptations to immediate publication may be smoother than would occur under some other proposals that involve modifications in current practice. (For example, use of the current directive probably would not lead the market to move rates quickly to the levels consistent with upper or lower limits of published funds rate range, since many market participants are aware that Desk has often not had to use the full range specified).

(c) Committee's present procedures permit valuable degree of flexibility in choosing between monetary aggregate and money market directives, in employing ranges of varying width for aggregates and funds rate, and in modifying instructions between meetings.

1/ The Trading Desk has sought the views of key market participants about the effects of prompt publication of the directive. These views are summarized in Appendix A.

Authorized for public release by the FOMC Secretariat on 5/10/2021

(d) In deciding on degree of movement in funds rate, the Desk, under current procedures, has the flexibility to "test the water" and can let the funds rate settle at particular levels depending on market circumstances.

(e) Publication of ranges in advance would increase market knowledge and thereby tend to limit the risk of erratic interest rate movements generated by misinterpretation of weekly aggregates data and of Desk actions.

Con:

(a) By disclosing System policy intentions in advance would encourage speculative movements of interest rates, stock prices, and exchange rates. Speculative movements would occur in part because the market would not have knowledge of such key matters as the width of the "zone of indifference" and week-to-week changes in staff projections of the two-month growth rates of the aggregates but also in consequence of a natural market tendency to attempt to minimize the risk of loss. Thus, the System may tend to lose control of reserves, and/or of its ability to effect gradual changes in the Federal funds rate, as it has to adapt open market operations to offsetting speculative market movements rather than to attaining monetary policy objectives.

(b) Focus on weekly figures for monetary aggregates would be increased since market would have precise knowledge of Committee's two-month target ranges for the policy period.

Authorized for public release by the FOMC Secretariat on 5/10/2021

(c) Increased volatility of interest rates could damage financial markets and could increase the average level of interest rates as market participants seek compensation for additional risk.

(d) The Federal funds rate would lose almost all of its value as a source of information about the demand for, and supply of, reserves if a particular funds rate objective were published in advance.

(e) The intense publicity focused on the Committee's directive--the monthly release of which would be a major news event, awaited eagerly here and abroad--would inevitably become an element in the FOMC's decision-making process and might distort it. For example, the risk of producing severe market disturbances could argue for a directive that envisages less potential variability in the funds rate than the Committee would otherwise find desirable, thereby impairing the FOMC's ability to attain its longer-run objectives for the economy and the monetary aggregates. Under the present schedule, which calls for release of the directive after the period to which it applies has passed, the announcement is anti-climactic, not highly publicized, and has little or no market impact, though it does provide the public with a basis for assessing the Committee's policies and procedures.

Authorized for public release by the FOMC Secretariat on 5/10/2021

The next several alternatives all involve some changes in present Committee practice with respect to the directive. Many of the "pro and con" arguments developed in the analysis above of present practice are also relevant to particular alternatives, especially those with numerical specifications, but are not restated. The arguments presented represent additional points of special relevance to the particular proposal.

2. Numerical specifications for funds rate and aggregates, but with a very narrow funds rate range ordinarily set at monthly FOMC meeting.

Pro:

(a) Very narrow funds rate range reduces potential announcement effects.

Con:

(a) If the very narrow funds rate range led to less movement in the rate over time, control over the aggregates would be reduced.

(b) The need for frequent inter-meeting revisions of the directive would probably be increased. Each revision would have to be published immediately, with attendant announcement effects.

3. Numerical specifications for funds rate and aggregates, but with funds rate range always very wide.

Pro:

(a) If the market interprets range as wider than apt to be used, would minimize "announcement" effects.

Authorized for public release by the FOMC Secretariat on 5/10/2021

(b) Would reduce need for inter-meeting revisions of directive.

(c) To the extent range is used, could lead to closer control over aggregates.

Con:

(a) If market comes to expect range to be used, would increase probability of harmful "announcement" effects.

(b) If the Committee published a very wide funds rate range, and if it appeared that it did not intend to use the full range, it could be charged that the change was made simply to evade intent of the court order.

4. Numerical specifications of ranges for funds rate and aggregates but with initial funds rate objective ordinarily set at about prevailing level. (If Committee in fact prefers higher or lower funds rate, ranges for the aggregates could be adjusted to make such an outcome highly probable).

Pro:

(a) Because initial objective for funds rate ordinarily would not be different from prevailing rate, immediate announcement effects would be minimized.

(b) Approach would emphasize role of aggregates in determining the funds rate.

Con:

(a) Might be interpreted as misleading the market.

Authorized for public release by the FOMC Secretariat on 5/10/2021

(b) Might reduce the Committee's ability to attain a change in the funds rate that is desired more or less independently of current behavior in the aggregates.

5. Express specifications for Federal funds rate qualitatively (e.g. tell Manager to attain somewhat easier/somewhat tighter/ about unchanged money market conditions) and for aggregates numerically--with Manager relying on sense of discussion during meeting for notion of permissible degree of fluctuation in funds rate.

Pro:

(a) Uncertainty about full extent to which Manager may adjust funds rate might moderate announcement effects.

(b) Would make it easier for Desk to undertake "probing" operations.

Con:

(a) It is assumed that the Committee as a whole would not establish an unpublished numerical range for the funds rate by informal poll in order to avoid any suggestion that it was attempting to evade the court order.[1/] Accordingly, there could be problems of communication both among Committee members and between Committee members and the Manager.

(b) Because the Manager would have less precise guidelines than at present to interpret the Committee's decision,

1/ The Blue Book could, of course, continue to contain numerical specifications.

Authorized for public release by the FOMC Secretariat on 5/10/2021

this alternative could lead to the charge that the Committee had shifted an undue amount of authority to the Manager.

(c) While the procedure followed might in fact not be inconsistent with the Court's order, it would be denounced in Congress and in the press as an evasion of that order.

(d) The vagueness of the funds rate objective could lead to intense market efforts to determine exactly how far the Fed was prepared to go and to speculation on the basis of guesses.

6. <u>Express both funds rate and aggregates qualitatively [e.g. objectives for aggregates could be expressed as somewhat/substantially faster (or slower) than in the recent past (or longer-run ranges)]</u>.

Since the effect of this alternative would be similar to that of the preceding one--in that it involves substitution of qualitative for quantitative information--the pro's and con's would also be similar.

7. <u>Limit directive issued at monthly meeting to a funds rate for forthcoming week or so and hold telephone conferences weekly to review funds rate objective</u>.

<u>Pro</u>:

(a) Would avoid need for Committee to select explicit aggregate target ranges.

(b) Might reduce attention to weekly figures on the aggregates.

Authorized for public release by the FOMC Secretariat on 5/10/2021

(c) Might tend to restrain market reaction to announcement of the funds rate objective, because of uncertainty about the extent of future movements in the funds rate and about the relation between the funds rate and the aggregates.

Con:

(a) Committee decisions would get excessive publicity; there would be 52 reports a year instead of 12.

(b) Procedure would suggest that interest rates are determined by fiat of the FOMC rather than on the basis of behavior of the aggregates, credit demands, and the economy.

(c) Manager's ability to probe in the market and adjust funds rate in light of developing conditions may be reduced.

(d) Weekly meetings may prove burdensome and could impair the efficiency of the decision-making process through excessive focus on very short-run financial and economic developments.

(e) Market activity might tend to dry up just prior to the announcement of result of the weekly Committee meeting, thereby limiting the Treasury's flexibility in the timing with which they can offer new issues.

(f) Suppression of information on Committee's expectations for aggregates would be interpreted as an evasion of the FOMC's responsibilities to the public, if not of its obligations under the court order.

Authorized for public release by the FOMC Secretariat on 5/10/2021

8. Issue directive along lines of present directive at monthly meeting, but include a specific funds rate target only for first week or so. Basic directive would be addressed to a subcommittee, which would meet weekly and establish subsequent funds rate targets. (Subcommittee's decisions, which would also have to be published, would replace Manager's decisions about weekly funds rate targets, which are not).

Pro:

(a) Uncertainty about each week's funds rate target would be eliminated.

(b) Would be less burdensome to full Committee than option 7 above.

Con:

(a) See first five negative arguments under option 7.

9. Assuming directive is announced in late afternoon of meeting day, shift meeting day from Tuesday to Friday.

Pro:

(a) May moderate announcement effects by giving market more time to study implications of directive.

Con:

(a) If account is to be taken of latest data available on monetary aggregates, an updated blue book could not be available to Committee members until late Thursday night.

(b) Friday afternoon announcement would engender market uncertainty on the day when banks and dealers are positioning for a 3-day weekend.

Authorized for public release by the FOMC Secretariat on 5/10/2021

Recommendation

If the FOMC in the end is required to publish the directive immediately on adoption, the Subcommittee would recommend continuation of the paragraph containing the shorter-run specifications in its present form, with two modifications:

First, we would add the following sentence at the end of this paragraph: "In the conduct of day-to-day operations, account shall be taken of emerging financial market conditions." This would provide the Manager with flexibility that may be needed to take account of, among other things, the increased likelihood of undesired financial market developments in the new environment created by prompt publication of the directive. It also would serve to loosen the market's perception of the linkage between the aggregates and movements in the funds rate.

Second, we would suggest that the Committee ordinarily employ a range for the funds rate of about ½ point, at least in the first few months while experience is being gained with prompt release of the directive. This should help limit "announcement" effects. We recognize that such an approach to the funds rate range probably would require more frequent consideration of inter-meeting adjustments to deal with inconsistencies in the Committee's instructions. Such adjustments, whether decided on in special meetings or through telegrams, would also have to be published promptly. This approach may help to limit sizable market reactions to the times when they would relate to actual changes in the funds rate rather than to speculation on potential changes.

Authorized for public release by the FOMC Secretariat on 5/10/2021

Other approaches considered by the subcommittee seemed less satisfactory for a number of reasons. We view a return to qualitative instructions as a step backwards and one that would make the decision-making process more difficult and its implementation more uncertain. Options that would require very frequent meetings by the FOMC (or a subcommittee) to set a current funds rate would have the disadvantage of giving undue publicity to the policy process and of making interest rates appear to be the principal concern of--and closely under the control of--the FOMC.

The subcommittee did recognize that there could be some advantage to Friday publication of the directive, since this would provide an automatic "cooling off" period in market evaluation. We believe that the best practice, however, would be to release the directive promptly after the market close on the day of adoption. A Friday release date would, therefore, require that the regular monthly meeting be shifted to Friday. On balance, since the advantage to the market of a Friday release date is not clear-cut and probably not substantial, we are not prepared to recommend a change from the present meeting schedule.

II. LONGER-RUN RANGES

The foregoing analysis and conclusions relate to the short-run operating specifications for the Federal funds rate and the aggregates pertaining to the period between Committee meetings. But a problem will also arise four times a year when new specifications

Authorized for public release by the FOMC Secretariat on 5/10/2021

for longer-run monetary aggregate ranges are determined. If present procedures are maintained after the court's mandate became effective, the new ranges would be published well before the Chairman's appearance before the Banking Committees of Congress. Since the subcommittee believes that there is an advantage to having decisions with regard to the longer-run ranges presented in the context of the broad analysis of current economic and financial developments contained in the Chairman's testimony, we believe it important to avoid that result.

Avoidance of premature release of longer-run ranges would involve a more complex decision-making procedure, under which the FOMC would delay its final decision on these ranges until just prior to the Chairman's testimony. A preliminary discussion could be held at the regular FOMC meeting, and the final decision made in the course of a telephone conference the day before the Chairman testifies. The decision would be made public on the following morning coincident with the Chairman's testimony. In the Subcommittee's judgment this procedure would be feasible and appropriate.

Under such a procedure, the directive adopted at the regular meeting might (a) contain no reference to longer-run ranges, (b) include a sentence to the effect that the Committee has not concluded its discussion of longer-run ranges, or (c) continue previous longer-run ranges for the interim period prior to the Chairman's testimony. Whichever of these alternatives is adopted--and we prefer

Authorized for public release by the FOMC Secretariat on 5/10/2021

(c)[1/]--the published short-run ranges for the aggregates and the funds rate might lead the market to speculate on the potential change, if any, in longer-run ranges. But we doubt that this will be a significant additional development affecting market behavior.

Counsel for the Committee has noted, however, that while it can be aruged that the procedure proposed in this section appears to comply with the Freedom of Information Act, it offers the potential for a charge of circumvention of the FOIA's requirement for prompt publication.

III. HANDLING INFORMATION ON VOTES

The subcommittee considered the procedure that might be following for revealing votes of individual Committee members if prompt publication of the directive is mandated. Counsel for the Committee has advised that an affirmative response would be required for any request for identification of individual votes on the directive properly submitted under the Freedom of Information Act (Section 552 (a)(5)). While the FOIA grants a maximum period of 10 days within which to respond to a request for agency records, there would appear to be no logical reason to defer for 10 days the identification of votes on the Committee's directive when the directive itself was released on the day of its adoption. There is little doubt that there would be immediate requests for the votes.

1/ Stated perhaps as follows in the directive: "The Committee decided to retain for the time being the longer-run growth ranges agreed upon at its meeting of October 18, 1977. These ranges, which apply to the period from the third quarter of 1977 to the third quarter of 1978, are 4 to 6½ per cent, 6½ to 9 per cent, and 8 to 10½ per cent for M-1, M-2, and M-3 respectively."

Authorized for public release by the FOMC Secretariat on 5/10/2021

We believe that it would be far preferable for the votes to be made public when the policy record is released--not when the Directive is released--since the record provides the explanation necessary to adequate public understanding of the reasons for favorable votes on the directive as well as those for the dissents, if any. If such a position cannot be sustained, as appears to be the case, it may be desirable for Committee members to agree that they will not publicly discuss the substance of their positions until the policy record appears, on the grounds that individual discussion may be misleading when the public does not have the opportunity to review the full report of the Committee's deliberations.

Authorized for public release by the FOMC Secretariat on 5/10/2021

Appendix A

The following notes summarize several conversations with market observers and participants in regard to the possible effects of immediate disclosure of FOMC directives.

1. Nonbank dealer specializing in Government securities.

The market will "go dead" while awaiting news of the directive. As soon as it is out, the market will make a "snap adjustment" rather than a diffused reaction, as it would move swiftly in response to an indicated new objective.

Whereas the Fed now has an opportunity to be flexible in response to new developments, this would be diminished. The Fed has a number of diverse instruments at its disposal and can operate, when it wishes, with finesse and refinement which enables it to keep various factors in proper perspective. Immediate disclosure would limit the Fed's ability to exercise finesse.

There is too much attention these days to the monetary aggregates. The stock market as well as bond markets ride on the weekly M numbers. Not enough attention is given to information on, or forces shaping, the real economy. Unfortunately, immediate disclosure would be likely to focus more attention on the M's.

2. Large securities firm

Given the way the Desk has operated in recent months the Fed may have less trouble from immediate publication than might have been the case earlier. There might even be some gains from immediate disclosure. Perhaps the October 31 "flap" would have been avoided or at least not made so much of.

He would not expect immediate disclosure to help the sophisticated dealer, though. Such dealers are better off in the current set-up, where they may be able to figure out shifts in policy before the rest of the market and position themselves accordingly.

If the Desk followed a "more relaxed" policy vis-a-vis the funds rate--as he believes we did some six months ago, rather than "cooking the thermometer" as he feels we now do--then immediate disclosure could be more of a problem, as it could cause some loss of flexibility.

Immediate disclosure could interfere with gradual moves, such as 1/8 per cent per week moves in the funds rate, but gradualism of this type is pointless anyway. If the Fed knows where it wants to get to in a few weeks, it might as well go right there rather than make small

Authorized for public release by the FOMC Secretariat on 5/10/2021

weekly steps. Successive steps would have some point in the case of large moves, however; he would not advocate moving the funds rate as much as ½ per cent, for example.

3. Bank dealer

He noted that they make guesses now about the probable ranges for aggregates and Fed funds. Their estimate on funds usually come quite close, and on the aggregates not so close--even though he feels their analysts are as good as others. Under immediate disclosure they would know the aggregate ranges with certainty, as well as the latest weekly M data, and thus they could have a pretty good idea what the Desk would be shooting for. This would mean there is more of a preconceived notion as to what the funds rate should be, and hence it would not be as good a guide to reserve availability as it is now.

On the whole, however, he does not feel that immediate disclosure would have tremendous effects. There would be some stronger reactions at times to the publication of directives, and perhaps they would be overreacting, but there could also be some avoidance of misinterpretations.

The Fed has made the funds rate like the discount rate, but without all the announcement effects. This means there is some greater opportunity for flexibility, and opportunity for errors without incurring undue embarassment. But there are also opportunities to mislead the market under current procedures. Immediate disclosure could curb the Fed's flexibility but might also limit the opportunities to mislead.

Immediate disclosure could perhaps be helpful to the less sophisticated market participants, as they would get "the word" as soon as the sophisticates. There could still be opportunities for the sophisticates to reap speculative gains, however, if they are able to anticipate what the next decision of the FOMC would be.

4. Large securities firm

He does not believe that immediate release of the directive would put the professionals in a relatively better position, and indeed self-interest leads him to favor the present set-up, as he feels he can take better advantage of the existing uncertainties than others. On the other hand, the public might be better served by a change to immediate disclosure.

Immediate disclosure, of course, merely provides a "framework" --it does not tell everything that is to come. It would, however, permit the market to adjust its sights more realistically with some assurance that if M-1 rose a certain amount it would most likely produce a change in the funds rate. Even so, he feels the Fed would still keep

Authorized for public release by the FOMC Secretariat on 5/10/2021

its prerogatives and its flexibility to operate would not be curbed. He sees little danger that trigger points would be actuated in an overly mechanical fashion.

5. Large securities firm

He sees some danger of strong reactions to immediate disclosure, but is not sure that the reactions would all be uniform. There will still be some diversity of opinion. On the whole, though, some delay in publication is preferable in the interest of maintaining orderly markets.

6. Mutual fund

He believes immediate disclosure could change the way the Fed operations. If the Fed announced a specific funds rate target and it was changed from what had prevailed, then there could be a large market impact--as with discount rate changes. Anticipating this, the Fed may feel it cannot make such sizable discrete changes. If it were possible to announce wide ranges, though, with no specific centering within them, then the impact might not be so great. He thinks the Federal Reserve is well advised to seek to resist the change.

With immediate disclosure, professionals probably would have less of an edge over less sophisticated market participants than is now the case. This can make an appealing argument to the Congress in favor of immediate disclosure. Indeed, short-term self-interest of someone in his position would argue in favor of immediate disclosure. Even so, he favors the present lagged disclosure as it can make the over-all "system" work better--in that it permits more flexible execution of monetary policy.

7. Large Bank Dealer

Immediate disclosure would heighten what is already excessive market attention to Fed decisions. He would anticipate strong market reactions and market dislocations. The Fed should have sufficient flexibility to be able to act without market knowledge of the decision. The Fed's operational flexibility would be limited.

8. Nondealer Bank

Initially, he commented that he did not see much impact on the Government securities market from immediate disclosure. They already project the ranges of the aggregates they believe the Committee has adopted and they have been fairly successful with this. On the Federal funds range, they are less certain, but he assumes the published range would be quite broad. Thus immediate publication would take out some of the uncertainty but not all of it. In further comment, however, he noted that if the Fed pin-pointed a Federal funds rate, then this might be rather disruptive to the market.