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STRICTLY CONFIDENTIAL (FR)  
CLASS I - FOMC

TO: Federal Open Market Committee

FROM: Murray Altmann *M.A.*

President Black has asked me to distribute the attached memorandum entitled "Further Recommendations on FOMC Procedures to Implement the "Humphrey-Hawkins" Act."

## Office Correspondence

To Subcommittee on the Directive  
Federal Open Market Committee

Date January 26, 1979

From Robert P. Black *R.P.B.*  
Alternate Member  
Federal Open Market Committee

Subject Further Recommendations on  
FOMC Procedures to Implement  
the "Humphrey-Hawkins" Act

The purpose of this memorandum is to extend the dialogue on FOMC procedures initiated by the Subcommittee's December 13 report on the implications of the Humphrey-Hawkins legislation for FOMC procedures. The new law does not appear to require radical changes in the way the FOMC formulates and implements policy. It presents, however, an excellent opportunity to improve some of the FOMC's current procedures, particularly those procedures related to controlling the growth of the aggregates.

In our view the existing FOMC procedures for controlling the aggregates have two principal defects. First, they allow procyclical base drift. Second, they fail to provide an adequate linkage between the long-run targets for the aggregates and the short-run tolerance ranges.<sup>1</sup> We believe that the new law, together with the Subcommittee's recommendations, goes a long way toward removing these defects. Although the potential for base drift would not be eliminated under the new target-setting procedure, it seems likely to be reduced since the base for the targets will shift forward annually rather than quarterly. Also, the Subcommittee's recom-

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1. It can be argued, of course, that the short-run ranges and the long-run targets are linked under present procedures, since each Bluebook relates a set of short-run ranges to quarter-by-quarter growth paths of the aggregates covering the entire long-run target period. We believe this linkage has been of limited practical value in recent years, however. The short-run ranges presented in the Bluebook have frequently borne little apparent relation to the long-run targets. Substantial differences between the short-run ranges and the long-run targets have often been simply offset arithmetically by unrealistic growth rate specifications for the later quarters of the long-run target period.

mendation that the short-run tolerance ranges be expressed in terms of moving one-quarter growth rates would eliminate some of the confusion that surrounds the present practice of setting these tolerance ranges in terms of annualized two-month growth rates that are highly variable and often differ markedly from the announced long-run targets.

Nonetheless, we are not entirely satisfied with the specific recommendations regarding the relation of the short-run tolerance ranges to the long-run targets. As we understand the Subcommittee proposal, it has two main features. First, as noted above, the short-run tolerance ranges would be expressed as moving one-quarter growth rates. Second, each month the Bluebook would compare the actual growth of the aggregates with their respective target paths and recommend alternative strategies for returning to the target paths when deviations occur. The weakness in the Subcommittee's proposals, as we see it, is that there is no specific guideline for relating the tolerance ranges to either the long-run target path itself or any interim path leading back to the target path from a point of deviation. As indicated in the report, the omission was deliberate because the Subcommittee felt that a rigidly mechanical linkage between the tolerance ranges and the long-run targets would be inappropriate. We have some sympathy with the Subcommittee's concern in this respect since any such mechanical linkage might require unnecessary responses by the Desk to clearly temporary deviations of the aggregates from their long-run target paths.

#### An Alternative Proposal

We would like to propose an alternative procedure that might better satisfy those members of the Committee who would prefer a somewhat more explicit linkage between the tolerance ranges and the long-run targets but

which we believe meets the Subcommittee's major objections to a formal linkage.<sup>2</sup> The proposal has two basic elements. First, it would express the short-run tolerance ranges in terms of dollar levels that could be directly related to the long-run target. Second, while the procedure would not require the Desk to alter the Federal funds rate in reaction to a current-period deviation of an aggregate from its long-run path, it would require the staff to include such a reaction as one Bluebook alternative for the Committee's consideration. The procedure would not limit the alternatives that the Committee might consider. On the contrary, it is designed to ensure that a meaningful alternative is available in the Bluebook to those Committee members who want to give greater weight to current deviations of the aggregates from their long-run target paths.

The next few paragraphs describe our recommended procedure with the aid of Chart 1. The chart is intended to illustrate, hypothetically, the situation the Committee will be facing with respect to any one of the monetary aggregates at its next several monthly meetings. At its February meeting, the Committee will set a long-run target for the aggregate from the fourth quarter of 1978 to the fourth quarter of 1979. Hence the base level for the target can be represented by point A, the midpoint of 1978 IV, and the end level by point Z, the midpoint of 1979 IV. A steady target path would then be the line AZ. The parallel bands above and below AZ, which are discussed in greater detail below, would represent the range of maximum current-period deviations from the long-run path believed to be consistent with hitting the long-run target.

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2. There is nothing especially new or original about our proposal. A similar proposal was made by Paul Meek as early as 1973. See in particular his paper "Restructuring FOMC Procedures--Further Proposals," dated December 26, 1973.

The Dimension of the Tolerance Range

Consider now the situation faced by the Committee at the time of the March meeting. Under the Subcommittee's proposal, the short-run tolerance range would be expressed in terms of the growth rate of the three-month average level of the aggregate for the months of February, March, and April over the average level for the months of November, December, and January. At each subsequent FOMC meeting the period covered by this growth rate would be shifted forward one month.

An important problem with this approach, as with the current procedure, is that it involves the use of short-run growth rates that have (1) a different base and (2) a different time frame from the long-run target growth rates. The Subcommittee's recommendation would be a distinct improvement over the current practice, since its moving one-quarter growth rates would probably be less volatile than the present two-month growth rates. But it would probably retain some degree of unnecessary confusion because it requires the Committee to consider two sets of growth rates (short- and long-term) having different dimensions.<sup>3</sup> A second difficulty with the Subcommittee's approach is that if the base level of the short-run range is significantly off the long-run target path, the Committee might have to set and publish short-run growth rates that differ rather significantly from the long-run targets. Such differences might prove troublesome in explaining policy objectives to the Congress and the public.

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3. Although the Subcommittee's short-run growth rates would very likely be less volatile than the currently used two-month growth rates, one should not expect actual short-run growth rates calculated in this manner to coincide closely with actual long-term growth rates. The behavior of  $M_1$  in 1976 illustrates this point. The short-run growth rates over that year calculated using the Subcommittee's recommended procedure ranged from 3 percent to almost 8 percent. Throughout the year, however, the moving quarterly average level of  $M_1$  was always less than 0.6 of a percentage point away from the midpoint of the long-run target path set by the Committee for the period 1975 IV to 1976 IV.

We suggest that the tolerance range be expressed not as a growth rate but as a simple three-month average level spanning the month of the meeting and the two following months. At the March meeting, for example, the range would be expressed in terms of the average level for March, April, and May, that is, a three-month average centered on April. In terms of Chart 1, this three-month average would be shown as a point such as B, C, D, or E on the vertical line drawn at the month of April.

At the March meeting the range would be set as follows. In the Bluebook for the meeting the staff would provide an initial projection of the March-April-May average, that is, a projection of the position of the point on the vertical line centered on April. Suppose the projected point were point B, which happens to represent a sizable deviation above the target path. If the Committee wanted to trigger relatively prompt corrective action, it might set the upper limit of the tolerance range at the upper limit of the long-run target band (point B'). In these circumstances the Desk would adjust the Federal funds rate upward within its range as long as the projected March-April-May level remained above the upper band. Alternatively, if the Committee wanted to approach the long-run target path more gradually, it might establish an upper limit for the tolerance range between points B and B' or, for that matter, at or even above point B. An opposite set of choices would exist if the initial projection of the three-month average were at a point like E.<sup>4</sup> If the initial projection were within the long-term band (such as at point C or D), the tolerance range might or might not be set to coincide with the upper and lower boundaries of the long-run band. There would be no

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4. It might not be unusual for the Committee to set only an upper limit for the tolerance range when the initial projection is at a point like B and only a lower limit when it is at a point like E.

requirement, in general, that the limits of the short-run tolerance range coincide with the boundaries of the long-run band.

During the March to April intermeeting period the staff would provide a weekly updated projection of the three-month average level. The Desk would then be guided by the emerging relationship between these projections and the tolerance range in a manner similar to existing operating procedures. At the April meeting the time frame would shift one month forward to the April-May-June period.

The advantage of the approach we are recommending is that without limiting the choice of policy alternatives, it would permit the Committee to relate the short-run tolerance range to the long-run target path by means of simple graphs like Chart 1. This feature of the procedure would facilitate Committee consideration of alternative short-run ranges.

One might object to this procedure on the grounds that the use of the three-month average level of an aggregate centered on the month following an FOMC meeting would make the projection available at the time of the meeting too uncertain. We do not feel that this uncertainty would be a serious problem in practice, especially since the projection would be based increasingly on preliminary actual data as the intermeeting period progressed. If this feature of the proposal troubled the Committee, however, it might consider substituting the three-month average centered on the month of the meeting.

#### Required Options and the Role of the Band

The second element of our proposal deals with the menu of alternative specifications presented to the Committee in the Bluebook. As suggested

above,<sup>5</sup> in recent years the Bluebook has not always offered an acceptable alternative short-run specification to Committee members who preferred a relatively prompt reaction to deviations of the aggregates from their long-run target paths. Therefore, we recommend that the Bluebook routinely include as one of its short-run alternatives a specification that sets the limits of the tolerance ranges for the aggregates at the boundaries of their respective long-run target bands. Further, we recommend that the Federal funds rate range associated with this alternative be centered at least 25 basis points above the current level of the funds rate if, at the time of the meeting, the projection of the relevant three-month average level of an aggregate is above its long-run band. Similarly, if the projected three-month average is below the band, the Federal funds rate range for this alternative would be centered at least 25 basis points below its current level. In short, this alternative would (1) instruct the Desk to adjust the funds rate immediately if the short-run projection of an aggregate were outside the long-run band at the time of a meeting and (2) instruct the Desk to adjust the rate if the projection were within the band at the time of the meeting but moved out of the band during the subsequent intermeeting period.

In the context of this recommendation, the widths of the long-run bands are obviously a matter of considerable importance. Ideally, the widths of the bands should reflect the ranges around the long-run target paths beyond which short-run deviations of the projected three-month moving average levels of the aggregates tend to signal permanent deviations from the long-run paths. Our own analysis, summarized in an appendix, suggests that using a three-month average level would make a relatively narrow band of one-half of a percentage

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5. See footnote 1.



point on either side of the long-run target path feasible in the case of  $M_1$ . In any case these bands would be operational bands designed to assist the Committee and the Desk in implementing policy. They should not be confused with any range of acceptable long-run growth rates around the central long-run target growth rate that the Committee might want to announce in Congressional testimony.

We think this proposal meets the Subcommittee's objections in Section G of its report to other recommendations of this general nature. Specifically, while our procedure would require the Bluebook to present one alternative along the lines suggested above, it would in no way limit the other alternatives that the Bluebook might contain. Presumably, some of the other alternatives would permit the Committee to (1) discount a current-period deviation if it believed the deviation resulted from seasonal or other temporary disturbances or (2) reapproach the target path over a period of several months, if it thought the deviation was more permanent in nature.<sup>6</sup> The procedure would in no way restrict the ability of the Committee to change the long-run target at any time. Since the Committee would be free to choose from what would in practice probably be a rather varied set of alternatives at each of its monthly meetings, we do not believe the procedure would establish an excessively mechanical linkage between short-run operating instructions to the Desk and the long-run targets.

### Conclusion

The framework for setting long-run targets for the aggregates established in the Humphrey-Hawkins legislation together with the Subcommittee's

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6. Moreover, supplemental instructions comparable to the current distinction between the "monetary aggregates" and "money market" forms of the directive could be retained, further enlarging the Committee's options.

recommendations constitute a major improvement in FOMC operating procedures in our opinion. Nonetheless, we feel that the two additional recommendations presented in this memorandum would enhance the Committee's policy deliberations within this new framework. These recommendations are:

- (1) to express the short-run tolerance ranges in terms of dollar levels and
- (2) to require the staff to provide one alternative short-run specification in the Bluebook that would instruct the Desk to adjust the Federal funds rate promptly whenever an aggregate deviates significantly from its long-run target path. We hope that the Subcommittee will give these suggestions careful consideration.

$M_x$   
(\$ Levels)

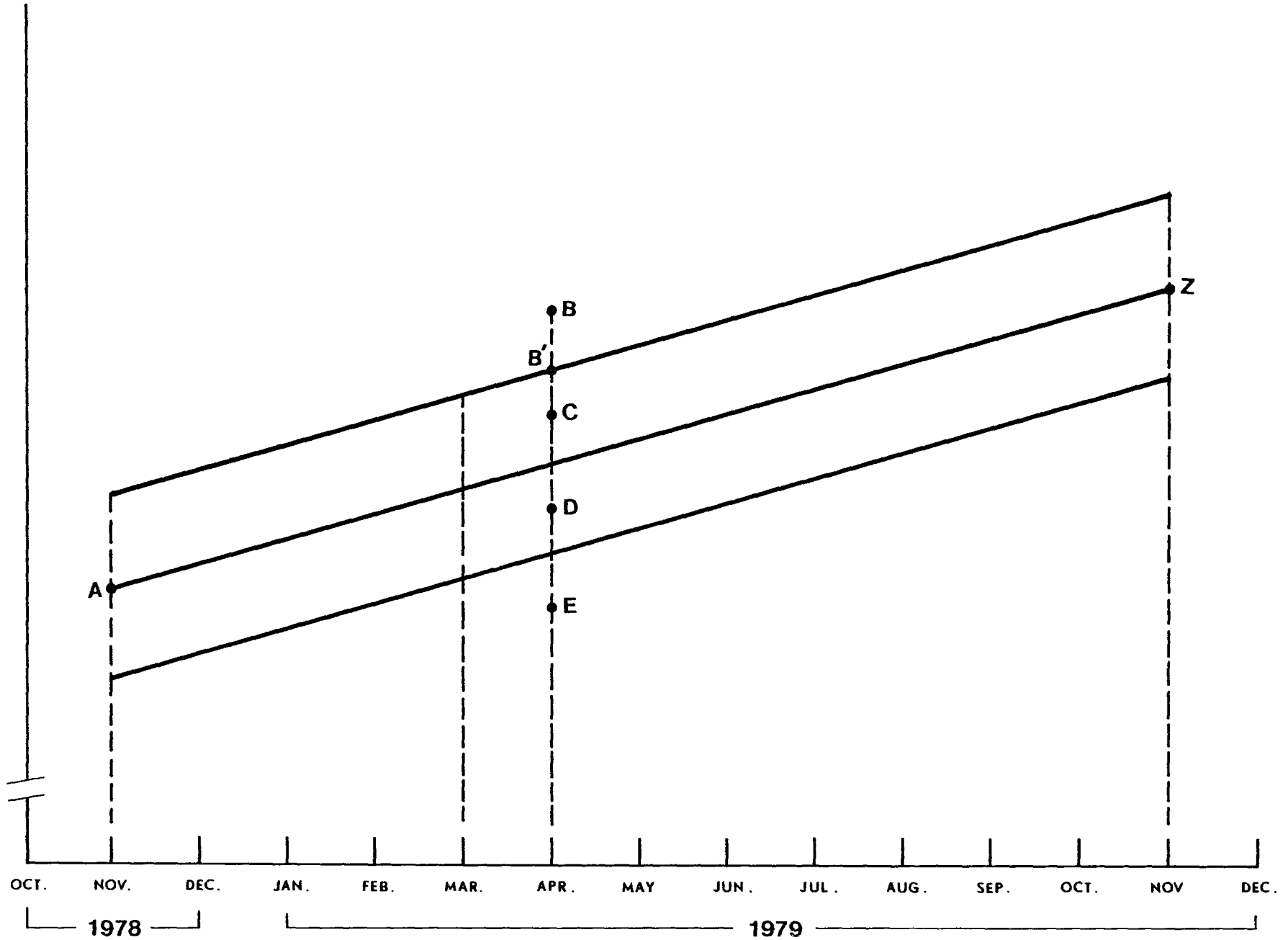


Chart 1

Appendix

Appropriate Width of the Recommended  
 $M_1$  Band Using Quarterly Average Levels

If the Committee were to express its short-run tolerance ranges in terms of three-month average levels as opposed to, say, monthly levels, the band signaling lasting deviations from the long-run target path in the case of  $M_1$  would appear to be relatively narrow. Tables A-1, A-2, and A-3 examine three periods in the 1970's that exhibited fairly constant trend rates of growth of  $M_1$ . During the first period, from late 1976 through the third quarter of 1978, the trend rate of growth of  $M_1$  was 8.1 percent. Table A-1 compares the deviations of the monthly  $M_1$  levels from this 8.1 percent trend to the deviations of the moving centered three-month average levels from the trend. The maximum deviation of the monthly level was \$3.0 billion or .87 percent of the trend level. In contrast, the maximum deviation of the moving three-month average level was \$1.5 billion or .44 percent of the trend level.

Table A-2 provides similar data for the period from early 1975 to the third quarter of 1976, when the trend rate of  $M_1$  growth was 5.2 percent. During this period, the maximum monthly level deviation was .93 of a percentage point, while the maximum deviation of the moving three-month average level was .69 of a percentage point.<sup>1</sup> Finally, Table A-3 indicates that the corresponding maximums were .54 and .37 of a percentage point during the period from early 1973 to the third quarter of 1974. During this period the trend rate of  $M_1$  growth was 5.4 percent.

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1. This relatively large deviation of the moving three-month average level reflects the impact of the 1975 tax rebate. If the months affected by the rebate are excluded, the maximum deviation is .41 of a percentage point.

These tables suggest, in an admittedly rough way, that short-run deviations of the monthly levels of  $M_1$  of up to one percentage point on either side of a specific long-run target path are consistent with that path. For moving three-month average levels, however, the tables suggest that deviations exceeding one-half of a percentage point may well signal lasting movements away from the path. Consequently, if the Committee decided to express its short-run specifications in terms of moving three-month average levels, we feel that an operational band of one-half of a percentage point on either side of the long-run path would be adequate for  $M_1$ . At the current level of  $M_1$ , this percentage point range is equivalent to a band of about  $\pm$  \$2 billion around the long-run path.

TABLE A-1

Monthly and Quarterly Average M<sub>1</sub> Levels Compared to 8.1% Path

	<u>8.1% Path</u>	<u>Actual Monthly Level</u>	<u>Difference from 8.1% Path</u>	<u>Difference as a Percent of Path</u>	<u>Actual Quarterly Average Centered Level</u>	<u>Difference from 8.1% Path</u>	<u>Difference as a Percent of Path</u>
December 76	313.7				313.7		
January 77	315.8	315.9	.1	.03	315.6	-.2	-.06
February	317.9	317.3	-.6	-.19	317.6	-.3	-.09
March	320.0	319.5	-.5	-.16	320.0	0	0
April	322.1	323.2	1.1	.34	322.1	0	0
May	324.2	323.7	-.5	-.15	324.2	0	0
June	326.3	325.6	-.7	-.21	326.0	-.3	-.09
July	328.4	328.7	.3	.09	328.3	-.1	-.03
August	330.5	330.5	0	0	330.7	.2	.06
September	332.6	333.0	.4	.12	333.1	.5	.15
October	334.7	335.9	1.2	.36	335.0	.3	.09
November	336.9	336.2	-.7	-.21	336.9	0	0
December	339.1	338.5	-.6	-.18	338.8	-.3	-.09
January 78	341.3	341.7	.4	.12	340.7	-.6	-.18
February	343.6	341.8	-1.8	-.52	342.1	-1.5	-.44
March	345.9	342.9	-3.0	-.87	344.4	-1.5	-.43
April	348.2	348.5	.3	.09	347.3	-.9	-.26
May	350.5	350.6	.1	.03	350.6	.1	.03
June	352.8	352.8	0	0	352.6	-.2	-.06
July	355.1	354.2	-.9	-.25	354.6	-.5	-.14
August	357.4	356.7	-.7	-.20	357.3	-.1	-.03
September	359.7	360.9	1.2	.33	359.9	.2	.06

TABLE A-2

Monthly and Quarterly Average M<sub>1</sub> Levels Compared to 5.2% Path

	<u>5.2% Path</u>	<u>Actual Monthly Level</u>	<u>Difference from 5.2% Path</u>	<u>Difference as a Percent of Path</u>	<u>Actual Quarterly Average Centered Level</u>	<u>Difference from 5.2% Path</u>	<u>Difference as a Percent of Path</u>
January 1975	282.8				282.8		
February	284.0	282.8	-1.2	-.42	283.5	-.5	-.18
March	285.2	285.0	-.2	-.07	284.2	-1.0	-.35
April	286.4	284.8	-1.6	-.56	285.8	-.6	-.21
May	287.6	287.6	0	0	288.0	.4	.14
June	288.8	291.5	2.7	.93	290.2	1.4	.48
July	290.0	291.5	1.5	.52	292.0	2.0	.69
August	291.2	293.0	1.8	.62	292.9	1.7	.58
September	292.4	294.1	1.7	.58	293.6	1.2	.41
October	293.6	293.6	0	0	294.6	1.0	.34
November	294.9	296.1	1.2	.41	295.0	.1	.03
December	296.2	295.2	-1.0	-.34	295.9	-.3	-.10
January 1976	297.5	296.5	-1.0	-.34	296.8	-.7	-.24
February	298.7	298.7	0	0	298.4	-.3	-.10
March	300.0	300.0	0	0	300.3	.3	.10
April	301.3	302.2	.9	.30	302.1	.8	.27
May	302.6	304.1	1.5	.50	303.5	.9	.30
June	303.9	304.3	.4	.13	304.4	.5	.16
July	305.2	304.9	-.3	-.10	305.3	.1	.03
August	306.5	306.6	.1	.03	306.4	-.1	-.03

TABLE A-3

Monthly and Quarterly Average M<sub>1</sub> Levels Compared to 5.4% Path

	<u>5.4% Path</u>	<u>Actual Monthly Level</u>	<u>Difference from 5.4% Path</u>	<u>Difference as a Percent of Path</u>	<u>Actual Quarterly Average Centered Level</u>	<u>Difference from 5.4% Path</u>	<u>Difference as a Percent of Path</u>
January 1973	257.1				257.1		
February	258.2	258.2	0	0	258.0	- .2	-.08
March	259.3	258.2	-1.1	-.42	258.5	- .8	-.31
April	260.4	259.0	-1.4	-.54	259.7	- .7	-.27
May	261.5	261.9	.4	.15	261.6	.1	.04
June	262.6	264.0	1.4	.53	263.5	.9	.34
July	263.8	264.7	.9	.34	264.6	.8	.30
August	265.0	265.2	.2	.08	265.0	0	0
September	266.2	265.1	-1.1	-.41	265.5	- .7	-.26
October	267.4	266.2	-1.2	-.45	266.6	- .8	-.30
November	268.6	268.6	0	0	268.4	- .2	-.07
December	269.8	270.5	.7	.26	270.3	.5	.19
January 1974	271.0	271.8	.8	.30	271.8	.8	.30
February	272.2	273.1	.9	.33	273.2	1.0	.37
March	273.4	274.8	1.4	.51	274.4	1.0	.37
April	274.6	275.4	.8	.29	275.5	.9	.33
May	275.8	276.2	.4	.15	276.5	.7	.25
June	277.0	277.8	.8	.29	277.4	.4	.14
July	278.3	278.3	0	0	278.4	.1	.04