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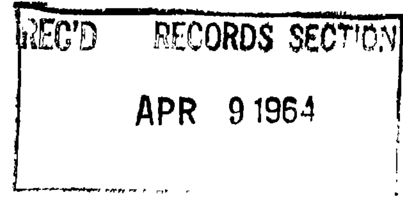

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

April 8, 1964.

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Young

Transmitted herewith is the memorandum on the current economic policy directive requested by the Committee at its meeting of March 3, 1964. Its general conclusions are summarized briefly below.

The first paragraph of the directive should be looked to for a statement of the Committee's general policy posture and the main underlying considerations. As experience has been gained with directives of the present type, the formulation of this paragraph has improved. Further improvement is obviously possible, and the staff would expect to assist the Committee in developing better formulations over time.

The problems of the first paragraph and those of the second are interrelated. However, in the March 3 discussions, the Committee was primarily concerned with improving the formulation of the second paragraph conveying instructions to the Manager. The general conclusion reached is that these instructions should be formulated primarily in terms of "money market" variables. Thus, Committee references to such aggregates as bank reserves, bank credit, and the money supply would ordinarily be contained in the first paragraph.

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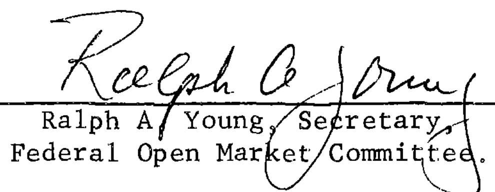
It is in the light of this paragraph that the operating instructions to the Manager should be read.

This conclusion still leaves open a range of alternative formulations for the second paragraph, which are discussed in the text and illustrated in Appendix A.

Mr. Broida carried main responsibility for drafting the memorandum. The coverage and content of the final product reflects many of the comments on an earlier draft made by members of the Board's and New York Bank's staffs concerned with open market matters. Account could not be taken of all suggestions received, however, and the Secretariat is responsible for the final text.

Apologies probably are in order for the length and complexity of the memorandum. While these, to some extent, are a consequence of the complexity of the subject, there is little doubt that with additional time a simpler, shorter, and clearer analysis could have been developed. Because the issues are pressing, however, it seemed preferable to circulate the present version rather than to hold it back for further compression and polishing.



Ralph A. Young, Secretary,
Federal Open Market Committee.

Attachment

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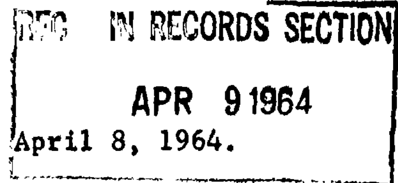

CONFIDENTIAL (FR)

April 8, 1964.

TO: Federal Open Market Committee

FROM: The Secretariat

SUBJECT: The Committee's current economic policy directive.

This memorandum has been prepared in accordance with the Committee's instruction to the Secretariat at the March 3 meeting to consider ways of improving the Committee's current economic policy directive. It treats the following matters:

I. Criteria for a "good" directive.

II. Problems in improving the directive.

III. Possible means for meeting certain problems of the second paragraph. Appendix A includes sample paragraphs illustrating some suggestions with specific language.

In light of experience, the current economic directive can be said to serve two purposes. It provides:

(1) Instructions to the Manager of the System Open Market Account regarding the open market operations in which he is to engage until the next meeting of the Committee.

(2) Information to the Congress, academic economists, market professionals, and the interested public with respect to the policy actions of the Committee at each meeting. This information is made available when the directives issued over the course of a year are published as part of the Policy Record in the Board's Annual Report.

The directive also plays an important role in the deliberative process itself, by providing a vehicle for the Committee to reach common ground on policy after the individual views of members have been expressed. The directives issued at the March 3 and March 24 meetings are quoted in Appendix B.

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The directive has typically been formulated in two paragraphs and both are relevant in conveying instructions to the Manager and information to public readers.

The first paragraph has usually begun with a broad statement of the Committee's longer term policy objectives with regard to key banking and monetary aggregates. This statement has been followed by reference to the main domestic and international circumstances and developments taken into account by the Committee in arriving at its policy objectives.

The second paragraph contains the operating instructions to the Manager for the interval until the next meeting. It is intended to be implemented in accordance with the basic authorizations and directions set forth in the Committee's continuing authority directive.

The current directive is not the only source of information on Committee policies. The Manager relies mainly on the directive as a source of current policy and operating instructions, but for confirmation and supplementation of his interpretation he also draws on his understanding of the oral discussions at meetings. He is provided with additional assistance by the synopses of policy views supplied to him by the Secretariat on the day following; by the minutes of the meetings, which he receives in preliminary form about a week later; and by the views that may be expressed by the members of the Committee and staff participating in the daily conference calls.

Readers of the Annual Report likewise do not rely wholly on the directives for information about the Committee's policies. The

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Policy Record itself, as well as the Annual Report's introductory review of monetary policy and economic conditions, provide additional background information, and further understanding can be gained by following closely Board and Bank publications and releases, and speeches and testimony of System officials. The Congress, academic economists, market professionals, and the interested public, however, have no way of knowing the content of all policy discussions that serve to supplement the Manager's reading of the directive. Therefore, they may regard the directive as the sole instrument for communicating instructions and for reflecting the complex background to the Committee's economic policy judgment, and assess the Committee's operations accordingly.

I. Criteria for a good directive.

Effective communication to the Manager of the Committee's policy objectives and of its operating instructions is important not only so that he can achieve the results the Committee intends, but also so that the Committee can determine, after the fact, whether the results were in accordance with its intent. Effective communication to the public of the Committee's policy objectives, its operating instructions, and their interrelation is important not only to instill public confidence in the Committee's actions but also to encourage the public understanding and acceptance on which continued successful administration of open market policy so heavily depends.

For all these ends, the content and phrasing of a directive should meet four partly overlapping criteria:

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A. Completeness;
B. Reasonableness;
C. Clarity; and
D. Informativeness.

The first three criteria relate most immediately to effective communication with the Manager, but they also affect the informativeness of the directive to the public. Informativeness is listed as a separate criterion because a directive that effectively instructs the Manager may still need amplification to inform the public adequately.

The directive, of course, can be no better than the underlying policy judgment it reflects and is intended to communicate. With the best of drafting, the directive can appear incomplete, unclear, or unreasonable because the economic situation may be exceedingly complex and require at best tentative, and even hesitant, judgments; or because the policy decision itself contains conflicting elements. As will be seen later, some of the problems in improving the directive stem from the more fundamental problems the Committee faces in arriving at a policy consensus.

A. Completeness. A good directive should both communicate the Committee's objectives to the public as fully as feasible and express its judgments and instructions to the Manager as explicitly as practicable, given limitations of time at meetings. The first paragraph of the directive would state the intermediate-term objectives of Committee policy for major financial variables--aggregate reserves, bank credit and money supply--in the light of:

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(a) The current growth momentum and cyclical stage of the economy;

(b) The balance of inflationary-deflationary forces;

(c) Credit availability as reflected in the balance of supply and demand in credit markets; and

(d) The country's international payments position.

Against this background, the second paragraph would:

(a) Identify the short-run operating target variables that are expected to be consistent with the longer run objectives noted in paragraph one;

(b) Specify the results desired for these operating target variables in quantitative or qualitative terms; and

(c) Indicate circumstances in which departure of operations from these targets would be authorized.

This criterion implies that the reliance placed by the Manager on oral statements at meetings to supplement the instructions contained in the directive would be reduced to a minimum. One reason for this is that those readers most interested in the Policy Record cannot know the full content of the discussions which have given rise to the substance of a particular directive. More important, however, is the fact that even the minute record of the Committee does not at each point of discussion spell out the implications intended for the Manager's operations.

For example, it has been suggested at recent meetings that free reserves should be kept positive and in the neighborhood of $100 million; that there should be more fluctuation in the bill rate than occurred during, say, December and January; and that the bill should remain within certain bounds--perhaps 3.45-3.65 per cent. But comments

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in these connections were made by individual members of the Committee. It is far from clear that the Committee as a whole intended instructions along such lines and, if it did, whether the figures mentioned here are those that the Committee intended.

The criterion of completeness does not require that the Committee give formal instructions to the Manager in the current directive or elsewhere with respect to operations under every conceivable contingency. The Committee may choose to leave decisions under various possible circumstances to the Manager's discretion, and at times may want him to "play it by ear." But the criterion does imply that the number of occasions on which the Manager is left in some doubt as to the Committee's intent should be minimized.

The existing directive is not completely satisfactory in this respect. In a memorandum on the second paragraph dated March 18, 1964, the Manager reports that he has understood the phrase "money market conditions" to encompass "a number of indicators . . . frequently cited by members . . . for example, the Federal funds rate, <u>a range</u> (italics added) of average free reserves and of average member bank borrowing, and Treasury bill rates." This list is illustrative; a fuller list probably also would include the volume and direction of Federal funds flows, rates on dealer loans, other short-term rates, the degree of difficulty experienced by dealers in obtaining financing, and perhaps additional factors. Thus, the simple phrase "maintaining about the same conditions in the money market" subsumes a number of variables and particular ranges for these variables. On occasion, therefore, the Manager

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has had to advise the Committee that different indications had been given by different variables encompassed by the phrase, and that he had acted in accordance with his interpretation of the Committee's intent.[1/]

Even though the Manager and the Committee probably attach about the same interpretation to the phrase, "money market conditions," and the Manager probably understands the Committee's intent when he must make judgments in the light of various indications, this is not completely and clearly communicated from the Committee to the Manager, and certainly not to the public, by the phrase itself. In addition, there are also elements of ambiguity in the words "in recent weeks" and "moderate," which in the past seem to have been interpreted differently by various members of the Committee, and have given rise to discussions between the Manager, various Committee members, and the staff.

B. Reasonableness. In a good directive, the Manager should not be instructed to make judgments that properly should be made by the Committee. Nor should he be asked to perform beyond his capacities because of:

(1) Potentially inconsistent multiple targets;

(2) Inadequate availability of data on a day-to-day basis pertaining to variables he is instructed to consider; or

(3) Ends unattainable through open market operations, or through operations over the specified interval.

1/ See, for example, pp. 11 ff. of the minutes of the meeting held on February 11, 1964.

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If the Manager is asked to make judgments on highly uncertain matters--e.g., to distinguish between "temporary" and other changes in variables for which such distinctions are difficult--the Committee must be prepared to accept the results of his judgments. Members would, of course, retain freedom to comment on these results in light of their responsibilities and of the lessons learned that might have a bearing on future operations.

The current directive at times has appeared unreasonable because it has not specifically dealt with potential conflicting tendencies among the elements of "money market conditions" or between instructions relating to market conditions and to aggregate bank reserves. The Manager finds that he has not encountered any significant difficulty because of the latter potential conflict, although he feels that judgments might differ on the closeness with which results have been in conformance with the second instruction. In a further comment, the Manager considers one possible response the Desk might have made had it seemed that such a conflict was emerging:

> The Desk could, of course, have sought to modify money market conditions, including short rates, free reserves and borrowings, in a way which might be expected to affect the pace, or perhaps even the direction, of change in one of the measures of aggregate reserves--such as total reserves, non-borrowed reserves or required reserves. Such action, however, would produce effects that have hitherto been regarded by the Committee, the market, and indeed nearly all observers as constituting a shift in monetary policy. I have not considered it within the Manager's province to undertake action to bring about such a change in market conditions.

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The Manager also discusses an alternative possible response, which would involve leaning "a little (italics added) in the direction indicated by the behavior of aggregate reserve measures within the context of the money market conditions specified by the Committee." He notes that "While such an approach might be worth trying experimentally, one should probably not expect more than modest results from it at best" because of various difficulties, which he cites, in using the short-run behavior of aggregate reserve measures as policy targets.

Thus, the role of the aggregate reserve clause in the second paragraph is not clear; it has apparently influenced the Manager's operations little, if at all. Its inclusion, however, implies to the reader of the Policy Record that it does convey a significant operating instruction.

C. Clarity. Some ambiguity in the language of the directive may be unavoidable, particularly if instructions are given in non-quantitative terms, because qualitative expressions often have different meanings to different people. Also, language which is well understood within the System may be obscure to outside readers who are not familiar with the jargon of monetary policy. In a good directive, the language in both paragraphs would express the Committee's intent as clearly as possible.

D. Informativeness. A good directive would be informative to sophisticated readers of the Policy Record. Any directive whose two paragraphs meet the tests of completeness, reasonableness, and clarity would go a long way toward meeting this test also. But what

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may be informative inside the System is not necessarily understood outside the System, as past experience has well demonstrated. To a certain extent, this is always going to be the case (since people have different interests and ways of viewing the world), but a more careful articulation of the Committee's intent and instructions may avoid confusing a large portion of our outside readers, misleading them, or stimulating them to mistaken criticism. For example, the relation between the first and second paragraphs might be more clearly expressed since some recent criticism has alleged that the Committee pays too much attention to money market conditions and too little to such factors as money supply or bank credit.

An informative first paragraph would be one that is sensitive to change in the economic or credit situation, whether or not a policy change seems to be required. Readers of the Policy Record must at times have been mystified as to why a first paragraph has been carried unchanged for long periods when the situation as reported in the Record made clear that significant economic and financial changes had in fact occurred.

II. Problems in improving the directive.

Progress towards a more satisfactory directive has been made in the past and further progress should be possible in the future. One continuing problem is that it is inherently difficult for any group of people to reach agreement on specific language dealing with a complex subject in the course of a relatively short meeting. Other sources of difficulty are:

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A. The facts that the Committee has multiple objectives, some of which may be conflicting at any particular time, and that members differ in their views concerning these objectives and of the nature of their conflict, if any;

B. The facts that monetary economics, like other parts of economics, continues to be an uncertain science, and that members employ different theoretical and empirical frames of reference;

C. The fact that the two paragraphs of the directive are necessarily interrelated and that the second is to be read in the light of the first; and

D. The fact that there are a number of advantages to avoiding highly precise instructions to the Manager.

A. Objectives. The Committee's broad policy goals are to contribute to high, sustainable rates of domestic growth and resource utilization, reasonable price stability, and balance in the country's international payments through influence exerted on the supply, availability,and cost of money and credit. In achieving these goals, the Committee is interested in fostering security markets having "depth, breadth and resiliency"; improving the efficiency of other domestic credit markets and of the international payments mechanism; promoting public understanding of its problems and policies; avoiding creation of problems for the Treasury in the latter's debt management operations; avoiding transmission of false signals to the market; preserving the quality of the signals it receives from the market; and so forth.

The possibility of conflict among goals and aims of these various types has often been discussed, and need not be elaborated here. However, Committee members differ in their views on the extent to which there may in fact be conflicts among particular objectives

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under given circumstances; on the relative importance of each; and on the nature of the "trade-offs" among any that are thought to conflict.

Such differences in views may often pose fundamental problems in the Committee's effort to arrive at a consensus on policy. With respect to the directive, they obviously may produce difficulties in formulating the first paragraph statement of broad policy objectives. But they also lead to difficulties in the effort to formulate good second-paragraph instructions to the Manager because they can result in use of language so general that a majority of the members are able to interpret the directive consistently with their different views, or in instructions to the Manager to achieve simultaneously several targets that may be inconsistent under existing circumstances.

It would be easier to improve the directive if the Committee as a whole were able to reach a closer meeting of minds on these matters, and to formulate its preferences more fully and more explicitly in the course of its deliberations. The choices often would be hard, partly because of difference of judgment as to whether there in fact is conflict among particular objectives at particular times, and partly because of uncertainty as to the nature of "trade-offs"--in terms of cost and desirability--between conflicting objectives under given circumstances. Basically, such problems are aspects of the larger uncertainty about the appropriate analytical framework, discussed below.

B. Analysis. Committee members receive a continuing flow of economic intelligence, relating in part to past, current, and possible future positions of variables indicative of the over-all course of the

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economy through time--GNP, industrial production, employment and unemployment, prices, international payments flows, and so forth--and in part to a variety of financial variables whose movements are relevant to that course--bank reserves, bank credit, the money supply, measures of money and capital market conditions, interest rates, and other financial magnitudes. In arriving at views on appropriate policy, the members must decide what types of open market operations would influence the financial variables in the manner best calculated to move the structure of the "real" variables in the desired direction.

In the process of reaching such a conclusion, some broad frame of reference is inevitably employed. Any views held with respect to the desirability of particular kinds of operations, in light of given longer range objectives and of current and prospective economic circumstances, necessarily arise out of a process of deciding which financial variables are most relevant, how these variables would be affected (in terms of magnitude and timing of changes) by open market operations of particular types, and how and with what time lag particular changes in financial variables would influence the real variables. (Conclusions on the existence of conflict among objectives, and on the nature of "trade-offs," would be part of the outcome of this process.) It is important to emphasize that some framework theory--whether explicit or tacit, good or bad, internally consistent or inconsistent--underlies every judgment on the desirability of a particular program of operations.

One problem the Committee faces in composing its directive--and, of course, in formulating policy--is that the individual members

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employ different analytical frameworks. They emphasize different financial variables, and reach different conclusions on the specific effects that particular policy actions would have on particular financial variables and, through them, on the real variables. A related problem is that individual members may at times be uncertain as to what hypothesis is most defensible in terms of theory and empirical research. These problems, like those deriving from divergent views about objectives, can lead to use of general language or of potentially inconsistent multiple instructions in the directive.

One way of highlighting the implications of differences in analytical approaches and uncertainties regarding different approaches is to pose the question: was monetary policy "tighter" or "easier" in the second half of the year 1963 than in the first half? Briefly, in the second half, interest rates were generally higher and the level of free reserves was lower than in the first half. These facts might be read by some to indicate that policy was tighter in the second half.

On the other hand, the seasonally adjusted money supply (both including and excluding time deposits), total reserves, and reserves required to support private deposits all increased at an accelerated rate in the second half. These facts might lead others to conclude that policy eased after mid-year.

The question of whether or not to change "policy" is debated at each meeting of the Committee, but it was far from clear last fall what no change in policy meant. This is not to say that there is any

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simple answer to the question awaiting discovery; the problem is extraordinarily complex, and an answer under the circumstances of any particular time may be far from simple.

The Committee has shown an understandable tendency to associate "no change in policy" with no change in the operating instructions to the Manager. Because the Manager has referred mainly to the instruction regarding money market conditions in deciding on his operations, the effect of decisions against policy change has been to keep these conditions unchanged. But the fact that the Committee included an instruction relating to bank reserves in the second paragraph of almost every directive of the past two years implies that this did not express its whole intent.

The analytical problems that Committee members encounter are, of course, reflections of the fact that existing monetary theory is not as yet fully developed and rests in part on hypotheses that have not been adequately tested. This is not to deny, of course, the value of existing theory concerning the relationships among open market operations and changes in financial and real variables, or of the large stock of systematic knowledge about these relationships that the System itself has acquired through experience over the 50 years of its existence. But much more needs to be learned.

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The problems of composing a good directive--and the more fundamental problems of improving the efficacy of monetary policy for achieving whatever structure of objectives the Committee desires--will obviously be alleviated as further advances are gradually made in testing received monetary theories and developing and testing better ones. In the meantime, however, the Committee is obliged to reach decisions and issue directives.

C. Interrelationship between the directive's paragraphs. Within the Committee and on the part of the Manager, there has been an understandable tendency to regard the first paragraph of the directive primarily as a public relations paragraph, having only a general relationship to or bearing on the instructions given to the Manager in the second paragraph. At the same time, there has been a disposition to avoid updating the first paragraph, lest a change, especially if material, suggest to outside readers that a change in policy posture, even though minor, was in fact the Committee's intent.

This difficulty is a real one and will continue to plague the Committee's endeavor to attain a directive that fully meets the criteria of goodness. But if it is accepted that the purpose of the first paragraph is to convey the Committee's policy posture for a time period longer than its meeting interval in the light of its judgment as to the balance of growth, cyclical, inflation-deflation, and international payments forces, then both the public and the Manager should read the second paragraph in the light of the first. Clarification of the connection between the two paragraphs is thus part of the problem

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of formulating the second paragraph, but it is also quite obviously relevant to the way the first paragraph comes to be expressed. Hence, the following discussion, which relates mainly to the second or instruction paragraph, needs to be read with the problem of interrelationship between the paragraphs in mind.

D. The advantages of avoiding highly precise instructions. The Committee conceivably could give the Manager complete (if not altogether informative) instructions in the second paragraph of the directive issued at each meeting by specifying a rigid schedule of transactions to be executed on each business day until the next meeting. Such instructions could be developed on the basis of the Committee's forecasts, or those of its staff, of daily developments for the three-week period. But such forecasts inevitably would be imperfect, and actual events would differ from those forecast. Meeting every three weeks, the Committee must leave the Manager free to deal from day to day with unexpected developments and, more generally, to take advantage of the new information continually becoming available to him. Accordingly, it is necessary to so formulate instructions as to give the Manager flexibility with respect to his daily transactions.

If the instructions are formulated in terms other than a schedule of transactions, the language of the directive should not imply that precise performance is expected from week to week. There are two main limitations on the Manager's ability to produce any results the Committee might desire in connection with some variable or variables,

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apart from errors in judgment: the influence of factors other than his own operations on the variable or variables in question, and inadequacies in the data available to him.

With respect to the first limitation, all potential target variables other than the composition of the System portfolio are affected to some extent by factors other than Account transactions. If, as seems clear, it is not desirable to formulate instructions in terms of a schedule of transactions, the Manager must be expected to make allowance in his operations for the effects of market factors on the variable(s) he is instructed to consider. His ability to offset the net effect of all other factors on a target variable would differ a great deal, depending on the variable.

With respect to data problems for the target variable(s), these are of several sorts, and also would differ considerably in intensity among variables. If information on a variable is available only periodically--monthly, bi-weekly, or weekly--use of that variable as a day-to-day target would require the Manager to operate without full information much of the time, although information on its recent trend might still be employed in his daily judgments. If information on a variable used as a target is available daily, but with a lag, or if early figures are subject to substantial later revision, or if there are problems with seasonal adjustments, the Manager's operations each day would have to be based on projections or estimates and would be characterized by considerable uncertainty. Of course, the quality and currency of any set of data can be improved with sufficient effort and outlay.

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Thus, the precision of the performance that reasonably can be expected of the Manager, and the precision with which the instructions might reasonably be written, depend on whether the variable(s) in terms of which the instructions are formulated pose few or many difficulties for the Manager. Or, to approach the question from the opposite direction, the choice of target variables is affected by the importance attached to making relatively precise performance possible.

For some variables the attainment of certain targets, while perhaps technically feasible, might involve side effects that the Committee would consider undesirable. For example, assuming a target specified in terms of one aggregate or marginal reserve measure, efforts to stay close on the target may be undesirable if reserves are maldistributed, if they change because of the effects of temporary market factors, or if they change substantially in a short period so that abrupt, large-scale open market operations would be required to offset the change. Again, the attainment of some aggregate or marginal reserve figure may produce a Treasury bill rate with undesired effect on attitudes domestically or abroad, or on capital outflows; and attainment of some specific bill rate target may require publication of a net borrowed reserve figure, with undesired effects on domestic market attitudes. The latter situation, of course, is an aspect of the problem of conflicting objectives, discussed above.

The Committee presumably would want to leave the Manager sufficient flexibility to deal with such circumstances. With respect to some, such as maldistribution of reserves, the Committee might

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prefer to authorize the Manager to depart from the primary target specified in his instructions, at his discretion. With respect to others, such as those involving undesired levels of bill rates or net reserves, the Committee might prefer to instruct the Manager to depart from the primary target.

Finally, the Committee may have no interest in attaining some narrowly specified figure for a target variable; its intent may be to achieve a figure in some general neighborhood, leaving the precise outcome to circumstances. In fact, it may seek, as a positive goal, some range of fluctuation in a particular variable, such as free reserves or the bill rate. These considerations obviously would militate against formulating targets in terms of levels (as distinct from ranges) of such variables.

In sum, even if members were of one mind with respect to objectives as specified in the first paragraph and as regards analytical methods, the Committee would be faced with serious problems in the effort to compose a good directive. The instructions to be transmitted to the Manager are inherently complex, and it is not likely to prove feasible to spell them out so fully and clearly that the Manager could, for example, be excused from attendance at meetings and be expected to operate on the basis of the directive alone. The problem is to find means for reaching a satisfactory middle ground.

The Committee might relax the precision of the instruction to the Manager by any one of several devices:

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1. By specifying a numerical range rather than a numerical level for the target variable;

2. By specifying a numerical target--either level or range--but qualifying it with an adjective such as "about";

3. By implying rather than explicitly mentioning numerical targets--for example, referring to actual averages over some past period; or

4. By avoiding explicit or implicit numerical targets entirely, relying instead on such adjectives as "slight," "moderate," "substantial," "higher," "lower," etc., as in the present instruction calling for "moderate expansion in aggregate bank reserves."

III. Meeting certain problems in the second paragraph.

Section A below focuses on a problem to which the Committee devoted particular attention at the March 3 meeting: that of avoiding potential inconsistency in the instructions given the Manager in paragraph two. Section B is concerned with a number of other problems, relating to the selection and formulation of target variables.

A. Avoiding potential inconsistency in instructions. Instructions in paragraph two are potentially inconsistent when they are multiple; the simplest and most obvious way of avoiding conflict within the second paragraph, therefore, is to give the Manager a single instruction--that is, a single target variable. It may be worth repeating that a nominally single target variable, such as "money market conditions" (or the degree of monetary "ease" or "firmness") may in fact involve a number of potentially conflicting component variables.

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Such a procedure is not inconsistent with the existence of multiple objectives on the part of the Committee; it would imply that the Committee has decided that operations over a three-week period conducted in conformance with the single instruction would attain the desired compromise among its various objectives. Three weeks is a very small time slice relative to the larger span to which paragraph one relates.

The use of a single target variable might mislead the reader of the Policy Record with respect to the Committee's longer term objectives or methods of analysis, although this depends in part on how closely the second paragraph is linked with the first. In any event, for the sake of increasing informativeness, it might be desirable to add language indicating the Committee's expectations for other variable(s) if the single instruction is followed. This variant was used in alternatives A and B distributed by the staff at the March 3 meeting, the last sentence of which read: "The Committee expects that operations so conducted will be consistent with resumption of an upward trend in aggregate bank reserves." The expectation expressed may, of course, be disappointed, in which case the Committee presumably would consider modifying the nature of its single instruction at subsequent meetings.

To formulate instructions in terms of a single variable is, of course, to sacrifice the opportunity to indicate in the directive itself any possible concerns the Committee might have with effects of operations on other variables. This might be justified on the grounds

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that three weeks is a relatively short period, and that the next meeting would occur soon enough for the Committee to change its instructions if the outcome is not in accordance with its intent--particularly since the Manager or members can request a special meeting if circumstances change radically. On the other hand, multiple instructions might be justified on the grounds that the Committee knows in advance that it does not want certain outcomes even within the interval before its next meeting, such as bill rates in excess of some level, or three consecutive weeks of net borrowed reserves.

If the Committee chooses to specify more than one operating target variable in paragraph two--call them targets X and Y--one way in which it can avoid potential inconsistency is by calling for operations "with a view to achieving X, and, <u>to the extent consistent with this objective</u>, also achieving Y." However, the Manager can give no consideration at all to Y unless different states of X are satisfactory. Accordingly, this can be a meaningful formulation only if target X is specified and/or understood by the Manager with a sufficient degree of flexibility so that the instruction can be considered to have been fulfilled under various results for X. To illustrate, if X refers to free reserves and Y to the bill rate, a meaningful instruction would call for free reserves within some range. The Manager then could attempt to reach that point within the range indicated for free reserves that brings the bill rate as close as possible to the target level or range specified for it.

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Another means for avoiding potential inconsistency with multiple targets is to specify one target variable, and at the same time to authorize (or direct) departures from this target under named circumstances with respect to other variables. For example, the instruction might take the following form: "Operations shall be conducted with a view to achieving X. However, this objective may (should) be modified if necessary to prevent such-and-such a condition from developing with respect to Y."

If deemed necessary, more than one circumstance can be included under which departures from the operating target are indicated. To illustrate this procedure, the target variable might relate to a level or range of free reserves, and the basis for departure from the target given might involve certain developments with respect to bill rates and/or rates of growth in some aggregate reserve measure.

Still another means for avoiding potential inconsistency would be to call for maintenance of some relation between two target variables. In a sense, this procedure is implicit when a free reserve target is used. An instruction calling for a given level or range of free reserves in effect calls for a given relation between excess reserves and borrowings, which could be satisfied at either high or low levels of both. If the two targets are expressed in the same dimensions--for example, rates of interest on different types of instruments--the relation specified might be an average.

In many cases, however, this means for avoiding inconsistency would involve greater difficulties than the others mentioned. It would

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not be easy, for example, to specify precisely a target expressed in terms of a relation between, say, an interest rate variable and a dollar level or a rate of growth variable. However, such a relation is in fact specified loosely when the target variable is, as at present, "money market conditions." As noted earlier, this term is interpreted to involve a complex of component variables expressed in different ways.

B. Selecting and formulating targets. If the Committee should choose to formulate its broad policy goal in paragraph one in terms of the growth rate in some variable such as aggregate reserves, bank credit or the money supply, it could formulate its operating instructions in the second paragraph directly in terms of that policy variable. Alternatively, it could formulate them in terms of any other variable or set of variables for which changes will have effects on the rate of growth of the aggregate first mentioned. The latter would include such variables as nonborrowed reserves, free reserves, interest rates, and "money market conditions." In short, the Committee can seek the same results for a particular financial variable through instructions formulated in terms of any of several different operating target variables.

This fact implies that a decision at a meeting to make no change in "policy" may require a change in the directive. For example, if it was desired to maintain some given average growth rate in bank credit or money over the longer run, and the operating target was

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specified in terms of free reserves, it probably would be necessary to revise the target level for free reserves from time to time, as market conditions changed.[1/]

The full set of potential operating target variables for paragraph two might be thought of as falling into two broad groups. One group consists of "money market conditions" and its components--free reserves, short-term interest rates, and so forth, in most cases specified in terms of levels. The second group consists of the various aggregate reserve measures, bank credit, bank deposits, the money supply, and so forth, specified in terms of rates of growth.

In recent years the Committee has tended to refer to variables from both groups in the second paragraph of its directive. Usually money market conditions and bank reserves have both been mentioned, but not invariably.[2/] References to short-term interest rates were frequent in the first five months of 1962 and again in the first three months of 1963; and references to credit expansion and monetary expansion, particularly the former, were frequent in the first half of 1962.

For reasons set forth below, it probably would be desirable in the future to formulate the second-paragraph instructions to the

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1/ The changing relation between free reserves levels and rates of growth in aggregates is pointed out in the latest edition of the System's "Purposes and Functions" booklet.

2/ There were no second-paragraph references to bank reserves in the directives issued on January 9, 1962 and July 9, 1963, and none to money market conditions (as such) in those issued from March 6 through May 29, 1962.

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Manager primarily, if not necessarily entirely, in terms of money market variables. References to rates of change in aggregates, including aggregate reserves, would be used primarily in the first paragraph statement of the context in which the Manager was expected to carry out his instructions.

1. Defensive open market operations focus on money market conditions, with the objects of cushioning the effects of random and seasonal changes in the short run, and of accommodating smooth transitions in periods of change. A substantial part of the Manager's day-to-day operations are defensive in nature, and it seems reasonable to authorize them in the instructions.

2. On the whole, the Manager probably can be expected to perform better from day to day during the three-week interval if his operating target is specified in terms of money market variables than if it is specified in terms of growth rates in aggregates. This is because better data are available to him on money market variables than on aggregates, and because it is easier for him to offset the effects of other factors on money market variables than on aggregates. Of course, circumstances vary considerably among the different money market and aggregate variables, so these generalizations are not necessarily absolute.

With respect to the quality of data, the best information undoubtedly is on short-term market rates--on Federal funds, Treasury bills, and other short-term instruments. With respect to the various elements of the bank reserve complex, figures are available on the

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same time schedule for the aggregate measures--total, required, and nonborrowed--as for the marginal measures--excess, borrowed, and free. All are subject to a short lag, and all but borrowings involve large elements of estimation on a current basis, so that they are subject to later, sometimes large, revisions. However, the situation as between aggregate and marginal reserve measures is not quite a standoff; seasonal adjustment problems are often serious for the aggregates but are largely irrelevant for the marginal figures. Data for the aggregates other than reserves, such as total bank credit and its components, time and demand deposits, and the money supply, all involve longer time lags, serious estimation problems (particularly in the preliminary figures), and, in most cases, serious seasonal adjustment problems. Of course, better figures on all aggregates could be obtained with some effort and outlay; but the same would hold for the marginal reserve measures (other than borrowings).

With respect to the Manager's ability to offset the influence of other factors, there is little doubt that in the short run he can influence marginal reserve measures, short-term rates, and other elements of money market conditions more closely than he can influence most aggregate measures, even apart from data problems. If successive short-run instructions concerning money market conditions lead to continued undesired growth rates in aggregates, the instructions presumably would be modified.

3. In most circumstances, the problems that might result from a sharp short-run departure from a preferred time path for a

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variable would be greater in the case of money market variables than in the case of aggregates. If the Manager's only instruction was to do his best to maintain a particular growth rate in some aggregate over a three-week interval, net reserves or bill rates might reach levels that had adverse consequences for attitudes in domestic or international markets. In the present environment, for example, two or three successive weeks of net borrowed reserve figures or of bill rates 10 or 15 basis points above present levels undoubtedly would be read by the market as a signal of a policy change. But if, in this environment, the Manager were instructed to maintain some specified money market conditions, the consequences of a resulting sharp, short-run fluctuation in any aggregate would be less adverse. To put this point another way, the Committee's objectives for growth rates in aggregates apply to averages over an interval longer than three weeks, and short-run fluctuations about a longer trend are not particularly disturbing; whereas from several points of view under present conditions its objectives with respect to money market conditions focus on the short run.

4. If the growth rate in an aggregate is to be used as a short-run operating target, some one (or combination) must be selected. The choice is crucial; for, given the circumstances of the moment, a particular growth rate for one aggregate may imply diverse rates of change in all others, and the set of rates of change would vary with the circumstances. To select one aggregate for operating target purposes might be taken to imply a commitment to a particular

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analytical approach, and in view of the differences of opinion on analysis among Committee members and of the uncertainties attaching to the kinds of analyses made, it probably would be well to avoid such a commitment at present. By formulating targets in terms of money market variables the Committee can feel its way for the time being, keeping its collective eye on the rates of change in many aggregates at once. The problem would not be eliminated; nor should it be, considering the System responsibilities. But it is apt to be much less serious in connection with statements of broad policy intent than in connection with specific operating instructions.

While these various considerations would seem to add up to a strong case in favor of using money market variables for operating target purposes, some disadvantages of this procedure might be noted. For one, the Committee has been concerned about the lack of fluctuation in Treasury bill rates and free reserves. To use such variables in operating instructions may--depending on how the instruction is formulated--lead to continued stability. In other words, the greater fluctuation in money market conditions that would result from use of the rate of growth in an aggregate as an operating target would have some advantage, and any desired limits to the range of fluctuation could be set by supplementary instructions.

Moreover, the fact that the market reads money market variables as signals of policy change is unfortunate because it tends to tie the Committee's hands. The Committee might choose at some time to seek firmer or easier money market conditions in order to maintain a

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particular average growth rate in some key aggregate or combination of aggregates over the longer run, but be inhibited from doing so because of the impact on expectations that would result from changes in levels of free reserves or bill rates.

But the market's attitude undoubtedly is a consequence of the fact that the Committee has used such variables in the past for specifying its operating targets--"money market conditions" in the directive itself, and component elements more or less vaguely in oral statements of individual members. The problem has become circular; the Committee feels constrained to maintain these variables in certain ranges because figures outside the ranges might be read by the market as signals of a policy change, but as long as the Committee continues to use such variables as operating targets it feeds the market's conviction that their levels transmit meaningful signals.

Breaking this circle would be highly desirable, and one means of doing so might be to begin specifying targets in terms of rates of change in aggregates. There are, however, other alternatives, including the use of ranges rather than levels in instructions relating to money market variables. The ranges might be widened gradually over time as the market became accustomed to larger fluctuations. On the other hand, in periods of "even keel," they would presumably continue to be quite narrow.

If the Committee concurs in the conclusion that the weight of the argument favors placing primary reliance on money market variables for purposes of short-run operating targets, it would still be necessary

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to select the specific target variable or variables from this group. There would seem to be three main possibilities: "money market conditions"--as at present; marginal reserve measures, such as free reserves and/or its components, excess reserves and borrowings; and bill rates. All three have serious disadvantages.

The first, as noted earlier, involves a set of variables whose several indications may at times be conflicting. To use either free reserves or bill rates might further harden the market's conviction that figures for these variables constituted good signals of policy, and might mislead the Policy Record reader with respect to the Committee's ultimate policy intentions and methods of analysis. Free reserves also have the disadvantage of having been subject to academic criticism as an operating target variable, despite efforts by the System and others to specify how they can be used appropriately for this purpose in the short run. To use the bill rate as the target variable could amount to pegging, even though fluctuations could be induced by specifying a range rather than a level, and by changing the range as occasion demanded.

On the whole, the continued use of "money market conditions" as the operating target variable seems to have fewer disadvantages than the other alternatives mentioned. The difficulties with this variable could be overcome in good part by spelling out, in the directive itself, the Committee's intent with respect to particular elements, such as free reserves, the bill rate, and the relation between the Federal funds rate and the discount rate. This would be desirable not only for

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the sake of informativeness, but also to provide an opportunity for all members to vote on the type of supplementary instructions that in the past have tended to be conveyed by separate comments of individual members. Such instructions might be further amplified by stating the Committee's expectation with respect to the approximate average growth rate in some aggregate that would be associated with the named target; by specifying conditions under which the Manager should or may depart from the specified objective; or in both ways.

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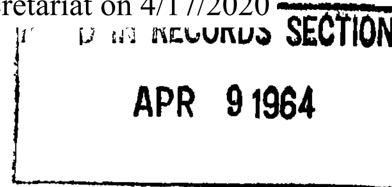

APPENDIX A

This appendix illustrates with specific language a number of possible alternative formats for the second paragraph of the current economic directive, based on the text discussion of means for dealing with particular problems. The instructions are in a form that might be appropriate for adoption at the April 14 meeting.

No attempt is made to exhaust the possibilities that are created by putting together in different combinations all of the alternatives noted in the text on such matters as choice of target variables, the degree of precision with which targets are expressed, means of avoiding inconsistency, and so forth, although many combinations are indicated. The reader can, of course, readily develop additional alternatives by making recombinations of the elements of those illustrated below. Within each numbered alternative, possible variants in clauses are indicated by lettered subheadings in order to avoid excessive repetition of language.

Each of the variants is assumed to be preceded by some one of the following phrases:

(a) To implement this policy, ...

(b) In the context of this general policy . . . .

(c) In light of this general policy and these underlying considerations . . . .

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Group A

"Money market conditions" as the first target mentioned.

System open market operations shall be conducted with a view to

1. maintaining about the same conditions[1/] in the money market as have prevailed

   (a) in recent weeks.

   (b) on average since the first of the year.

2. Add to 1: with weekly average free reserves[2/]

   (a) in the general neighborhood of $100 million.

   (b) generally in the range $50 - $150 million (or some other range).

3. Add to 2: and, to the extent consistent with this,

   (a) the rate on Federal funds at or close to the discount rate much (or most) of the time.

   (b) the bill rate in the general range 3.50 - 3.60 per cent (or some other range; or in the general neighborhood of _______ per cent; or near the average level prevailing since some date.)

   (c) both (a) and (b).

4. Add to 1, 2, or 3: The Committee expects (believes, anticipates, assumes) that operations so conducted will be consistent with a (continued) moderate upward trend in

   (a) aggregate bank reserves.

   (b) (some other aggregate or combination).

1/ This language would, of course, need to be modified if the Committee decides at the April 14 meeting to seek a change in money market conditions.

2/ Alternatively, the reference here could be to member bank borrowings.

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5. Add to 1: However, money market conditions shall be permitted to ease or tighten, as necessary, to moderate any substantial and persistent

(a) change in the rate of growth of aggregate bank reserves (or some other aggregate) from that obtaining on average since (add date).

(b) change in the level of free reserves from that obtaining on average since (add date).

(c) change in the level of member bank borrowings from that obtaining on average since (add date).

(d) departure of the rate on Federal funds from the discount rate.

(e) change in the rate on three-month Treasury bills from that obtaining on average since (add date).

(f) some combination of above.

6. Add to 1: However, money market conditions shall be permitted to ease or tighten, as appropriate, to moderate any tendency of

(a) the weekly average level of free reserves to approach the limits of the range $0 - $200 million (or some other range).

(b) the weekly average level of member bank borrowings to approach the limits of (some range).

(c) the rate on Federal funds to deviate substantially and persistently from the discount rate.

(d) the rate on three-month Treasury bills to approach the limits of the range 3.45 - 3.65 per cent (or some other range).

(e) some combination of above.

Group B

Money market conditions not the first target mentioned.

System open market operations shall be conducted with a view to

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1. maintaining the weekly average level of free reserves

   (a) in the general neighborhood of $100 million (or some other figure).

   (b) in the general range $50 - $150 million (or some other range).

2. maintaining the bill rate

   (a) in the range 3.50 - 3.60 per cent (or some other range).

   (b) in the general neighborhood of_______per cent.

   (c) some other specification for the bill rate.

3. maintaining the average rate of growth in aggregate bank reserves (or some other aggregate) in the neighborhood of______per cent, insofar as this is feasible given the margins of error in currently available data estimates.

4. Add to 1, 2, or 3: However, this objective should be modified in the appropriate direction if in the judgment of the Account Manager pursuit of the objective would result in

   (a) a substantial and persistent change in money market conditions.

   (b) (if 2 or 3 is used) weekly average free reserves outside the range $0 - $200 million (or some other range).

   (c) member bank borrowings outside the range_________.

   (d) a substantial and persistent departure of the rate on Federal funds from the discount rate.

   (e) (if 1 or 3 is used) a rate on three-month Treasury bills outside the range 3.45 - 3.65 per cent (or some other range).

   (f) some combination of above.

5. maintaining (some condition with respect to free reserves or the bill rate)

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(a) and to the extent consistent with this (maintaining some condition with respect to the bill rate if free reserves are used, with respect to free reserves or member bank borrowings if the bill rate is used, with respect to money market conditions, the Federal funds rate, the average growth rate in some aggregate, etc.)

(b) However, this objective shall be modified, as appropriate, to moderate any substantial or persistent (etc., as in A-5).

(c) The Committee expects (believes, anticipates, assumes) that operations so conducted will be consistent with (etc., as in A-4).

(d) some combination of above.

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...CORDS SECTION
APR 9 1964

APPENDIX B

A. Directive issued at meeting held on March 3, 1964:

It is the Federal Open Market Committee's current policy to accommodate moderate growth in bank credit, while maintaining conditions in the money market that would contribute to continued improvement in the capital account of the U. S. balance of payments. This policy takes into consideration the fact that domestic economic activity is expanding further, although with a margin of underutilized resources, and that it is likely to receive additional stimulus from the recently enacted reduction in Federal income tax rates. This policy also takes into account the fact that the balance of payments position is still adverse, despite a tendency to reduced deficits, and that the effects of increases in money rates in important European countries are as yet uncertain. In addition, it recognizes the increases in bank credit, money supply, and the reserve base of recent months.

To implement this policy, System Open Market operations shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks, while accommodating moderate expansion in aggregate bank reserves.

B. Directive issued at meeting held on March 24, 1964:

It is the Federal Open Market Committee's current policy to accommodate moderate growth in bank credit, money supply, and the reserve base, while maintaining conditions in the money market that would contribute to continued improvement in the capital account of the U. S. balance of payments. This policy takes into consideration the fact that domestic economic activity is expanding further, although with a margin of underutilized resources, and that it is likely to receive additional stimulus from the recently enacted reduction in Federal income tax rates. This policy also takes into account the facts that the balance of payments position, while improved, may still be adverse, and that the effects of increases in money rates in important countries abroad are as yet uncertain. In addition, it recognizes the imminence of new cash borrowing by the Treasury.

To implement this policy, Sys tem open market operations shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks, while accommodating moderate expansion in aggregate bank reserves.