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RECORDS SECTION
APR 23 1969

FORM 99-198

MEMORANDUM

FEDERAL RESERVE BANK OF CHICAGO

TO: Mr. C. J. Scanlon, President

DATE: April 29, 1964

FROM: Research Department

SUBJECT: Economic Policy Directive of the F.O.M.C.

This memorandum consists of four parts: (A) the major reasons why, in our opinion, the statement of monetary objectives and/or instructions to the Manager should be stated in quantitative terms; (B) a summary of System efforts to move toward quantification and views expressed by System personnel as to appropriate targets of policy; (C) a summary of proposals made by critics and outside academic observers with respect to measuring the System's performance in relation to its objectives; and (D) a translation of the present directive into quantitative terms and three alternative proposals, based in part on the versions proposed by the Secretariat prior to a recent F.O.M.C. meeting. The present state of our knowledge of the relationships between the various guides and objectives is, of course, limited but would be expected to improve as experience was gained with a directive stated in quantitative terms.

A. The need for a more specific statement of monetary objectives and instructions to the Manager

Obviously, the Committee's real interest is in the long-run objectives of the economy--growth and employment, price stability and international equilibrium. The only way the System can influence these long-run goals is through its effects on bank reserves, money and credit. Furthermore, the immediate areas of the impact of System operations are the money and securities markets. Within this structural framework, the Committee could pursue its objectives from either of two general approaches. First, it would be possible for the directive to simply specify the amounts or rates of growth

FOR FILES
George W. Mitchell

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in one or more of the intermediate goals--reserves, money, credit--that it wishes to achieve in the period ahead in view of its expectations that such a rate of growth would contribute best to the achievement of desired economic developments. It would leave to the Manager the task of achieving this result within the limitations imposed by his standing authorizations. If a second objective (such as interest rates) were also desired, it would be necessary to state which should be subordinated in case it were not reasonably possible to achieve both concurrently.

Basic to a directive of this nature would be the assumption that the Committee is not really concerned about short-run developments in the money market except as they affect the Manager's ability to achieve longer run goals, and that it is these longer-run effects on money aggregates that are closely linked to desired trends in real economic variables. Evaluation of the Manager's performance would, of course, have to be in terms of his achievement of the goals specified. It is quite possible that the precise targets specified for intermediate goals would not be achieved within so short a period as three weeks, and that these targets should reasonably apply to averages over a somewhat longer period. The essential element of this approach is, however, that the Committee sets a specific desired rate of change in an aggregate monetary variable with maximum freedom for the Manager as to the methods employed in reaching it. It would be reasonable within this framework to schedule meetings of the F.O.M.C. on a monthly basis which, incidentally, would also have the merit of making available statistics more easily adaptable to the Committee's needs.

An alternative approach is for the Committee to specify the kind of conditions in the money market the Committee believes to be consistent with its intermediate and/or final objectives and instruct the Manager to achieve these short-run conditions, altering those instructions when they appear not

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to be producing the desired effects on bank reserves, money and credit, or economic growth and prices. This approach is more closely related to the present framework of policy. The alternative wordings suggested in the Broida memorandum and in the proposed alternatives distributed for consideration at the April 14 F.O.M.C. meeting are examples of this approach. In any case, the present form of the directive is not sufficiently specific to make the intent of the Committee clear to the public, and possibly to the Account Manager or to all members of the Committee. Its shortcomings become apparent when put to the tests for a "good" directive suggested in the recent Broida memorandum. These shortcomings may be summarized as follows:

1. The terms used in the present directive are ambiguous. Phrases like "the same money market conditions" and "moderate expansion" do not mean the same thing to all members of the Committee and this would be true of most qualitative descriptions. While the determination of policy is the responsibility of the Committee, such vague language leaves a substantial responsibility for interpretation to the Manager. His interpretation may reflect stated views of certain members of the Committee as to quantitative goals, but it is far from certain that it would be consistent with a consensus if the directive were stated in quantitative terms. Thus the Manager is in a position where he must decide in what way the various views held by individual Committee members will be merged into an operating policy. This "merging" of views should be done by the Committee if the immediate goals (and criteria for evaluating policy) are money market variables.

2. The present directive contains elements of potential conflict in its use of dual targets with no indication of which is to have priority if these turn out to be inconsistent. Likewise, there is no specific indication as to the tolerable limits that would be acceptable with respect to either stated targets or other possible developments. In practice, the Manager has

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used the "color, tone and feel" of the money market as the primary guide and this has been accompanied by an uneven rate of growth in reserves, money and credit.

3. The present directive does not inform the reader as to why and how the short-run targets are expected to have the desired effect on the Committee's ultimate goals. (Presumably it is not necessary that this be outlined in each directive but the Committee should have available a statement which provides such a rationale, i.e., evidence of linkages.)

4. The lack of precision in the instructions leaves the Committee without a basis for making an objective judgment of either the Manager's performance or the relation of its own policy decisions to economic developments.

How can the statement of guides in quantitative terms reduce these shortcomings?

The necessity to attach numerical values to targets would bring into focus the wide differences which may exist in the views of various members as to what should be done to accomplish current objectives. The major aim would be to clarify cummunication within the Committee, from Committee to Manager, and from the Committee to the public. The Committee, rather than the Manager, would have the responsibility for deciding just what magnitudes of reserves or money market variables are likely to produce the results it desires. There is little question that the Manager does in fact interpret the instructions in terms of specific magnitudes as targets, and it is more appropriate that the Committee agree in advance that these specific numbers are desirable goals and write the instructions accordingly. Allowance should be made, of course, for some margin of error, and qualifications could be included to take account of any other developments that are considered relevant. Where multiple guides or goals are stated, it would be necessary

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for the Committee to come to grips with possible conflicts and to set forth priorities and the conditions under which modifications in the primary guide would be required.

We recognize that the problems of giving the instructions in quantitative terms are both numerous and severe. In general they are of two kinds. One is analytical; the other is organizational. As to the first, we do not now have sufficient knowledge of the linkages between the variables which the F.O.M.C. can influence directly and economic effects flowing therefrom to enable us to select the best objective or specific target magnitudes with confidence at this time. For example, is bank credit or money supply the more significant element through which the System influences the economy? What rate of reserve growth is consistent with optimum credit flows? What is the effect on the economy of short-run fluctuations in money market variables? (Fluctuations in these variables probably would be greater if an aggregative rather than a marginal measure were used as a policy objective.)

These analytical problems will not be solved in the immediate future. Extensive research is necessary to improve our knowledge of how monetary policy works and with what lags. There are a number of conflicting theories, none of which has been sufficiently substantiated to be immediately useful. Until there is better evidence of the relationships between money market elements, bank reserves, money supply and credit and their impact on economic activity, we do not know even which items should be quantified and how these should be varied with changing conditions.

The second kind of problem is organizational--even assuming an improved state of technical knowledge, a majority of the Committee may not agree that any specific set of numbers provides an appropriate short-run target.

It is undoubtedly because of the magnitude of these problems that the directive has never been cast in quantitative terms and that many F.O.M.C.

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members and staff are unwilling to attempt to do so now. We would urge, however, that this step be taken despite the limited state of technical knowledge for two reasons: (1) Some assumed relationships are implicit in any policy action that is taken. Even the present instructions are associated with certain quantities or combinations of quantities in the Manager's mind. Someone's best judgment as to what specific conditions are consistent with ultimate policy objectives is a necessary part of current operations; such a judgment is the Committee's responsibility and should be stated in specific terms. (2) In attempting to achieve a consensus of this type the necessity for better understanding of the relationship between monetary factors and real activity will be so apparent that it will give rise to strong pressure for research activities that can be expected to produce a better framework for policy than we now have. In the meantime the use of numerical targets, even in a limited or qualified way, and careful analysis of the results should help to build up experience that will eventually enable the Committee to formulate a more effective and defensible policy.

B. System efforts toward quantification of guides

The tendency for free reserves and other money market indicators to be used as guides to current policy stems largely from the view that the System is a marginal supplier in the market for short-term funds. In this view any increase in credit supply in relation to credit demand would be considered a move toward monetary ease. Both a rise in free reserves and a fall in interest rates would describe such a condition. But an "easy" posture in this sense is not necessarily an "expansionary" one. In a situation where credit demand declines sharply, rising free reserves and falling rates can be accompanied by a reduction in aggregate reserves and bank credit.

The shortcomings of free reserves as a guide have been widely recognized

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both within the System and by others, but a major difficulty in focusing on changes in aggregate reserves for short-term policy purposes has always been the strong seasonal element in credit demand. In recent years, the development of seasonally adjusted reserves has made it possible to use aggregate reserve measures in judging the current impact of policy. Although instructions have continued to be in terms of money market conditions (and this is at least in part attributable to the objective during recent years of maintaining short-term rates), at the same time the Committee has been able to watch trends in the rate of change in total reserves and other aggregate reserve measures.

The required reserves guideline. The development of the Board's "guideline" reflected the recognition of the need for some quantitative guide with respect to the intermediate objectives of policy--the reserve base, bank credit, and money supply. The guideline was experimental and induced varying reactions among users, but the ensuing discussions and experience with the guideline exposed differences of interpretation and provided evidence as to the probable results of any policy that would call for strict adherence to any one guide or objective. Although nobody insisted on strict adherence to the guideline, it has provided a kind of norm against which the actual reserve growth could be judged. For example, at the September 11, 1963, F.O.M.C. meeting, Mr. Koch voiced some dissatisfaction with the then-current rate of growth in money supply, and called attention to the fact that actual required reserves were $200 million below the guideline.

At this meeting and through subsequent memoranda prepared by Messrs. Stone and Sternlight, attention was focused on some of the problems associated with use of the guideline and interpretation of departures from it. These may be summarized briefly as follows:

1. The question of whether full allowance should be made for changes in the Treasury's deposits, and under what conditions.

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(Mr. Koch felt full allowance should be made while Sternlight argued that under certain circumstances only a partial offset should be made.)

2. The question of whether money supply or bank credit is the appropriate factor influencing spending in the private economy.

(Koch was concerned with money supply while Sternlight felt that "as a guide to the probably course of spending, money supply does not mean much in itself but is one convenient measure of the credit creating activities that have brought it into being.")

3. The question of whether a total reserve measure, such as the guideline, could be used by the Desk as a guide for day to day operations.

(Mr. Stone indicates that he has not actually used aggregate reserve measures as a short-run guide and implies that to do so would not only be difficult but would cause changes in money market conditions which "observers" would interpret as a change in policy.)

With respect to this last question, a further point could be made and is perhaps implicit in the Manager's reluctance to work with the aggregates. This is the matter of whether the data are good enough--mainly with respect to seasonal adjustment--to provide a reliable guide over a relatively short period of say three to six weeks. Another relevant question is whether the use of money market guides provide a better indication of actual reserve growth in relation to goals than the required reserve estimates (except, of course, where a money market rate is itself an objective).

It might also be noted that the Manager's difficulties in working with a measure of aggregate reserves is in part related to the day-to-day nature of his operations in the money market. Current operations are based on the assumption that the Desk's operations will be geared to offsetting short-run changes in money market pressures. Use of a total reserves guide would probably be feasible only if the Committee is willing to permit considerably greater variation in free reserves and short-term rates on a day-to-day and week-to-week basis.

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The Knipe proposal. In the fall of 1962 James Knipe submitted to the Chairman a proposed format for the directive suggesting instructions in quantitative terms. This proposal consisted of (1) a paragraph of instructions in which free reserves were given as the immediate target (a specified $50 million range) and bill rate limits were included as a qualification, (2) a paragraph stating the over-all objectives of policy and the belief that the designated level of free reserves is consistent with these objectives, and (3) several paragraphs of background facts representing the major considerations behind the policy decision.

While Knipe used free reserves as the basic guide to the Desk, his proposal assumed that the Committee would determine the appropriate level of free reserves by reference to other developments. He measured F.O.M.C. actions in terms of free reserves, bill rates and nonborrowed reserves. Implicit in this approach, of course, is the assumption that there is some linkage between free reserves and longer-run goals and that this can be predicted under various circumstances.

The Broida Alternatives. The Broida paper, including suggested language for a number of alternative formats, distributed for review early in April also recognized the need for more specific instructions and, in particular, the resolution of certain potential conflicts in the use of multiple targets. The suggested language provides mainly for the quantification of money market variables either as direct targets of action or as modifications of the primary target. But the general framework permits the use of numerical values for aggregate measures, as suggested in connection with the first approach discussed on pages 1 and 2 above, if these are desired. The conclusion reached is that although the Committee is concerned with growth rates in broad monetary aggregates it can seek results through any of several operating target variables if these are appropriately changed as conditions change.

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Broida feels, on grounds of both the superior quality of the money market data and the greater ability of the Manager to influence money market conditions, that "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."

Both the Knipe and Broida proposals assume the continuation of day to day "defensive" operations and cushioning effects on the money market.

C. Summary of criticisms made by "academic" economists

Although the current Patman hearings are directed primarily at legislation which would alter the structure of the Federal Reserve System, some of the questions put by committee members to witnesses concern the operation and evaluation of monetary policy. The views of 16 academic economists who appeared before the Subcommittee on Domestic Finance of the House Committee on Banking and Currency between February 11 and March 12, 1964 are summarized here with respect to the appropriate role of monetary policy. The consensus of these economists was that open market operations should be undertaken to attain some designated rate of change in some agreed upon definition of the money supply and that operations undertaken to influence short-run money market developments should be discontinued or greatly curtailed. By a narrow majority, the group also proposed that policy should be formulated at the discretion of the monetary authorities rather than according to a once-and-for-all rule. General dissatisfaction was expressed with the recent conduct of policy. (It should be recognized that the dissatisfaction may reflect primarily the view that policy should have been more expansionary. It is not clear that the proposed changes in policy targets and organization of the System would have resulted in a more expansionary policy in recent years.)

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Money Market Objective

The economists expressed widespread agreement that policy operations directed at short-run stabilization of the money market are undesirable. The main reasons cited were:

1. The private money markets are sufficiently viable to withstand most shocks.

2. Money market events are not as important to the achievement of the ultimate objectives of monetary policy as changes in money supply and distract attention from the more important variables.

3. Because the impact of monetary policy actions on "real" economic activity lag the actions by an estimated 3 to 9 months, focusing on daily money market events, which reflect current economic happenings, causes the System to overreact to emerging economic trends and consequently make abrupt and destabilizing policy changes when the impact of their policies is observed.

The following quotes are representative of the arguments presented.

Professor G. L. Bach of Carnegie Institute of Technology testified:

> Federal Reserve officials appear to have generally been overly concerned with short-run, "feel of the market," considerations, relative to longer run goals. The operating practices of the open market committee, which largely determines policy three weeks at a time, plus the great concern felt for the day-to-day, and even hour-to-hour, "tone" of the government securities markets, inescapably focus a large amount of Federal Reserve attention on these issues.
>
> The Fed's major job is to make the largest possible contribution to stable economic growth, including reasonable price stability and a viable balance of payments condition; not to look out for the day-to-day behavior of government security markets. To be sure, Fed actions have their immediate impact through bank reserves and the money markets, but this does not change the major goal.
>
> In my judgment, the Fed could properly place much more reliance on banks and other financial intermediaries to carry out their own short-run, hour-to-hour and day-to-day position adjustments, especially if it established an always open discount window with a penalty rate.
>
> It should focus its own attention more on three months, six months, and years ahead--on counter-cyclical and stable growth considerations. The private financial markets are far more capable of making their own

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adjustments than many of us give them credit for, if they are properly warned that they are expected to do so. Perhaps the Fed always has a carefully balanced view of the short and long run considerations. But when any organization becomes heavily concerned with day-to-day operating details, it runs the risk that more basic but less pressing issues will be slighted. The Fed is no exception.

Professor Harry Johnson of the University of Chicago stated:

Because it concentrates on money market and banking phenomena, rather than the effects of its policies on the quantity of money and economic activity, and because the effect of monetary policy on the economy operates with a substantial lag, the central bank is extremely likely to push its policy too far and too fast before it realizes that the policy has taken effect and begins to consider moderating it; and because the realization of effectiveness comes late, it is likely to reverse its policy too sharply."

Money Supply as the Target

With only one dissent, the economists were united in their view that policy should be directed to obtain some rate of growth of money supply. Only Professor Gurley of Stanford University argued for an interest rate target. Opinion differed as to the appropriate definition of money supply but one senses that the group would be amenable to using any of several definitions as long as the measure accepted is not altered frequently and then only with good reason. The group was not in agreement as to whether policy should be formulated at the discretion of the monetary authorities or according to an unalterable rule specifying a constant rate of increase in the money supply. Six of the 15 economists favored discretionary policy, four favored the rule technique, one favored interest rates and the other five did not express an opinion on the matter, possibly because they were not asked to do so.

Those favoring the fixed rule approach generally based their arguments on their belief that while the results of policy actions based on such a guide may not produce the best of all worlds, they would produce better economic performance than has been achieved under discretionary policy. In response to a question on whether a continual 4 per cent expansion in the money supply would ensure a stable economy, Professor O. H. Brownlee of the

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University of Minnesota replied,

> Well, we cannot be sure of a stable economy. But we probably get more stability this way than we do under existing rates, whereby we try to guess what is going to happen in the future, miss frequently on such guesses, adopt anti-inflationary policies in anticipation of inflation, when deflation actually is the outcome, or adopt anti-deflationary policies in anticipation of deflation when inflation is the outcome. We cannot expect perfect stability. But it is my guess that we get more stability this way than with any other procedure that I can think of.

Likewise, Professor Robert Strotz of Northwestern University, himself not an advocate of a fixed rule, pointed out that:

> It should be understood that his (Professor Milton Friedman's) main reason for advocating it (the fixed rule) is not that it would work perfectly, but that it would work possibly better than more arbitrary measures often based on improper forecasts have worked in the past.

Dissatisfaction with the recent conduct of monetary policy was not limited to the proponents of a fixed rule alone. With the exception of Professor Friedman, it was generally believed that policy had been too restrictive since 1958. Professor Friedman expressed particular displeasure that the money supply declined from mid-1959 to mid-1960. An ever-expanding money supply with only the rate of change altered in response to economic conditions seems to be envisioned by the advocates of discretionary policy.

There was wide agreement that too little is known about the linkages between the monetary and real sectors of the economy and that the Federal Reserve should accelerate its efforts to identify and measure these linkages. Only with a precise knowledge of these relations could a truly effective policy be formulated.

D. The directive

The inadequacy of the present directive becomes immediately apparent when numbers are substituted for qualitative words or phrases wherever possible. This could be illustrated as follows:

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It is the Federal Open Market Committee's current policy to accomodate seasonally adjusted annual rates of growth of about 7 per cent in total bank credit, 3-1/2 per cent in money supply and 4 per cent in aggregate bank reserves while maintaining the short-term Treasury bill yield within a range of plus or minus 30 basis points of the covered yields on comparable issues of U. K. and Canadian securities. This policy takes into consideration the fact that a more rapid expansion of domestic economic activity is desired in order to reduce further the margin of underutilized resources and that additional stimulus is likely to be provided as a result of the recently enacted reduction in Federal income tax rates. This policy also takes into account the improvement in the balance of payments position during recent months and the possible adverse effects on international money flows of recent increases in money rates in important countries abroad.

To implement this policy System open market operations shall be conducted with a view to maintaining free reserves at an average of between zero and 200 million dollars, depending on their distribution, and rates on Treasury bills, Federal funds, and dealer loans within the range that has prevailed in the past six weeks.

The assignment of values to all of the variables mentioned as policy goals and immediate operating targets clearly exposes the problem of potential inconsistency. Yet if the instructions are to be meaningful, it must be assumed that some combinations would be acceptable to the Committee and some would not.

The use of quantitative terms in the first paragraph points up the probable undesirability of including three broad measures--bank credit, money supply and aggregate reserves--since these typically do not move in fixed relation to each other. Probably it would be better to focus on "reserves supporting private deposits," or a similar measure. This would make clear to the Treasury that the monetary effects of large and sustained changes in Treasury balances would be offset by F.R. policy. Possibly it would be desirable to narrow the reserve target further and set as a policy objective the "reserves supporting private demand deposits." The decision would rest largely upon how closely the Committee desired its reserve target to approximate a money supply concept.

In line with our view that the directive should be quantified, we have suggested below three alternative formats. Each would begin with a

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statement about current economic conditions in relation to goals such as that suggested in "Alternative B" with respect to the first paragraph of the staff proposal offered for consideration prior to the April 14 F.O.M.C. meeting, as follows:

The Federal Open Market Committee notes that domestic economic activity continues to expand at a moderate pace with relative stability in average prices, and that the existing margin of unutilized resources will permit further expansion. It also notes that progressive stimulus to activity will be exerted over coming months by the recent reduction in Federal income tax rates and by the increases projected for the year in business capital expenditures. In addition, the Committee has taken account of the slower growth in aggregate bank reserves and the money supply in the first quarter of this year as compared with the fourth quarter of last year; the further improvement in the economy's payments balance internationally; and the possibly adverse effects on the capital account of the payments balance arising from interest rate advances over past months in important markets abroad.

1. Following this statement, the simplest way to complete the directive in our view would be as follows:

...In the light of these developments, it is the Committee's current policy to increase reserves against private deposits over the month ahead at a 3-1/2 per cent annual rate after allowance for seasonal changes, and policy operations shall be conducted with a view to achieving this growth rate. The Committee expects that this policy will result in a moderate expansion in the money supply and credit flows sufficient to finance further expansion in the economy without causing a deterioration in the capital account of the payments balance or stimulating inflationary pressures. However, in order to protect against capital outflow and excessive strain in the money market, the reserve goal should be modified in the appropriate direction if it results in a rate on three-month Treasury bills outside the range of 3.45 - 3.65 per cent for more than a two-day period.

Instructions of this type would focus on a single intermediate objective (one of the aggregate reserve measures) and give the Manager complete freedom in achieving it. This sample directive states the expectation that the achievement of the primary target will be accompanied by certain trends in other variables, but does not risk potential inconsistency by specifying more than one target. It suggests that the pursuit of its designated target is not expected to cause major disturbances in the money market, and provides for some modification in that target in case such ex-

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pectations turn out to be wrong. It would meet the tests of completeness, reasonableness, clarity and informativeness.

One could argue, of course, with the specific target chosen and the specific rate of growth recommended. It may be noted that the Committee's target in this case (contrary to the recommendations of the Secretariat) is in terms of the growth rate of an aggregate rather than money market variables, except for the limitations imposed by the bill rate. Assuming one does not want to aim directly at specific interest rates, the choice narrows to some aggregate variable or free reserves. It is difficult for us to understand why it is easier for the Desk to achieve a free reserves target than one in terms of total reserves since both measures depend on the same estimating procedure. (Computation of free reserves involves the estimation of both vault cash and required reserves.) The Broida paper states that "seasonal adjustment problems are often serious for the aggregates but are largely irrelevant for the marginal figures." We submit that the seasonal adjustment problem is indeed a source of concern in arriving at the target dollar volume of reserves that would represent the growth rate called for. But use of a free reserves guide avoids this problem only by assuming, in effect, that all changes in required reserves are seasonal. It seems to us that money market guides are appropriate if the Committee desires to affect money market conditions. But aiming at money market conditions only as a means of achieving some desired change in the aggregates is likely to end in frustration since historical evidence has not revealed a stable relationship between free reserves and total reserves even in the very short-run.

Our preference would be for this type of instruction as an ultimate resolution of the directive problem, and we would be willing to experiment with it now. However, in view of the unresolved theoretical and technical problems, the reluctance of the majority of Committee members to place the

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entire responsibility for carrying out policy on the Manager is understandable.

2. As an alternative, the Committee could state a reserve growth rate as a goal, but give instructions to the Manager in terms of the money market guides which the Committee believes consistent with the achievement of this goal. If this were done, the phrase "and policy operations shall be conducted with a view to achieving this growth rate" would be deleted from (1) above, and the following would be added:

> ...To implement this policy, open market operations shall be conducted with a view to maintaining free reserves in the 0 to 200 million dollar range, the three-month bill rate at an average within the 3.45 to 3.65 per cent range, and the Federal funds rate near the discount rate most of the time--conditions that have been accompanied by an appropriate rate of reserve growth in recent weeks.[1]

If in maintaining these money market conditions the desired growth rate is not achieved, after allowing for some reasonable margin of error, the Manager cannot be held responsible. Rather, it would mean that the money market guides specified turned out to be inconsistent with a 3-1/2 per cent rate of growth in reserves, and an adjustment of either the intermediate guide or the money market targets would be necessary.

3. A third possibility is to omit a specific reserve growth rate in the directive but give money market targets in quantitative terms. Under this alternative, the introductory statement of economic and monetary developments would be followed by a policy statement, preferably in terms of only one intermediate guide, such as:

> ...In the light of these developments, it is the Committee's current policy to achieve moderate growth in the reserve base in order to facilitate the financing of further expansion of the economy while sustaining the improved position for the capital account of the U. S. balance of payments and avoiding the emergence of inflationary pressures.

This would be followed by the same paragraph of instructions as in (2) above.

In this case, as in the previous one, the achievement of money market targets may not turn out to be consistent with the Committee's intermediate

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[1] See attached sample proposed directives.

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objectives and would have to be changed if the latter did not respond in the desired way. But if the Committee is really aiming for intermediate objectives, it would seem desirable to state these in terms everyone understands, as in alternative (2) above. On the other hand, if the Committee should decide that money market conditions are themselves an objective of policy, then this third type of instruction is appropriate. The reference to achieving growth in the reserve base as a policy objective, however, would then have to be qualified.

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Sample Proposed Directives Calling
for No Change in Policy

The first paragraph to be a statement of economic conditions taken into consideration, as follows:

The Federal Open Market Committee notes that domestic economic activity continues to expand at a moderate pace with relative stability in average prices, and that the existing margin of unutilized resources will permit further expansion. It also notes that progressive stimulus to activity will be exerted over coming months by the recent reduction in Federal income tax rates and by the increases projected for the year in business capital expenditures. In addition, the Committee has taken account of the slower growth in aggregate bank reserves and the money supply in the first quarter of this year as compared with the fourth quarter of last year; the further improvement in the economy's payments balance internationally; and the possibly adverse effects on the capital account of the payments balance arising from interest rate advances over past months in important markets abroad.[1]

The policy statement and instructions to the Manager to be along the lines of one of the following statements:

1. ...In the light of these developments, it is the Committee's current policy to increase reserves against private deposits over the month ahead at a 3-1/2 per cent annual rate after allowance for seasonal changes, and policy operations shall be conducted with a view to achieving this growth rate. The Committee expects that this policy will result in a moderate expansion in the money supply and credit flows sufficient to finance further expansion in the economy without causing a deterioration in the capital account of the payments balance or stimulating inflationary pressures. However, in order to protect against capital outflow and excessive strain in the money market, the reserve goal should be modified in the appropriate direction if it results in a rate on three-month Treasury bills outside the range of 3.45 - 3.65 per cent for more than a two-day period.

2. ...In the light of these developments, it is the Committee's current policy to increase reserves against private deposits over the month ahead at a 3-1/2 per cent annual rate after allowance for seasonal changes. The Committee expects that this policy will result in a moderate expansion in the money supply and credit flows sufficient to finance further expansion in the economy without causing a deterioration in the capital account of the payments balance or stimulating inflationary pressures. However, in order to protect against capital outflow and excessive strain in the money market, the reserve goal should be modified if it results in a rate on three-month Treasury bills outside the range of 3.45 - 3.65 per cent for more than a two-day period.

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[1] Quoted from "Alternative B" with respect to the first paragraph of the directive, as proposed for consideration prior to the April 14 F.O.M.C. meeting.

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To implement this policy, open market operations shall be conducted with a view to maintaining free reserves in the 0 to 200 million dollar range, the three-month bill rate at an average within the 3.45 - 3.65 per cent range, and the Federal funds rate near the discount rate most of the time--conditions that have been accompanied by an appropriate rate of reserve growth in recent weeks.

3. ...In the light of these developments, it is the Committee's current policy to achieve moderate growth in the reserve base in order to facilitate the financing of further expansion of the economy while sustaining the improved position for the capital account of the U. S. balance of payments and avoiding the emergence of inflationary pressures.

To implement this policy, open market operations shall be conducted with a view to maintaining free reserves in the 0 to 200 million dollar range, the three-month bill rate at an average within the 3.45 - 3.65 per cent range, and the Federal funds rate near the discount rate most of the time--conditions that have been accompanied by an appropriate rate of reserve growth in recent weeks.