To Members of the Board of Governors and Presidents of the Reserve Banks

July 7, 1964

From Alfred Hayes

Attached are some notes commenting on the seminar held on June 16 at which Governor Mitchell discussed a number of areas in which further research is needed. The first part of the notes, relating Governor Mitchell's comments, is fairly complete, although I should add that Governor Mitchell left on vacation about the time the notes were compiled and has not seen them; should he have any changes, corrected copies will be distributed. The second part of the notes, relating to the round-table discussion, is quite fragmentary since there was no formal note-taking at the seminar. They seem to me to convey a good deal of the flavor of the discussion, however, and I thought that some of the advantages of the meeting might be preserved by the preparation and circulation of such fragments of notes as are available.

EVALUATING THE EFFECTS OF MONETARY ACTION

Summary of Discussion at Seminar of
Federal Reserve Bank Presidents and
Members of Board of Governors

Washington, D. C., June 16, 1964

I. Remarks by Governor George W. Mitchell

Logical assumptions underlying discussion. Governor Mitchell began his remarks by pointing to several logical assumptions that underlay his comments on the subject at hand. First, money, credit and interest rates matter in the sense that they have effects upon basic economic conditions.

Second, monetary policy and economic conditions each affect the other. There are many simple, one-way relationships, and any policy judgments or economic research in the field has to be very careful to recognize the fact of interaction. Monetary policy certainly affects the supply of money and credit, but policy is also affected by the demand for money and credit. Similarly, economic behavior predominantly exercises its influence through demands for money and credit, but also as an element on the supply side, both in the generation of loanable funds and indirectly through its impact on monetary policy.

Third, the System, and the economic profession generally, does not understand nearly enough about these relationships to be able to formulate policy accurately or to explain and defend policy actions to others. Both our own desire to improve monetary policy and the increasing criticism of the Federal Reserve from Congress and the academic community should encourage us to seek a better understanding of the effects of monetary action. This means the System needs to undertake a great deal more research in the field.

The current state of economic theory suggests that there are two broad conceptual approaches to studying the effects of monetary actions: effects channeled through credit conditions, financial markets, and interest rates; and effects channeled through the volume, distribution and use of money and liquidity.

Research into credit conditions. On the credit side, Mr. Mitchell argued that the System needed to develop a great deal of more pertinent knowledge both concerning what credit conditions were and how they were changing, and how such conditions affected and were affected by the economic decisions being made in various sectors concerning spending, saving, and investing. He indicated analysis of effects of credit condition changes would be very much handicapped until a better specification could be developed of changes taking place in credit terms and interest rates. The deficiencies of the quarterly survey of interest rates on business loans were a good example in this respect. That series did not rest on any reliable sampling basis that permitted inferences as to changes taking place in universal business loans. It also did not provide any reliable indication of the several important terms of credit extension other than the simple interest rate, namely such things as maturity, level of compensating balances, or other restrictions or conditions of credit availability. What was needed, he felt, was a series that gave a reasonable measure of the level and changes in each of the major terms of credit affecting its cost or cost and availability. The interest rate could not be relied upon as a proxy for all these other changes, because of the possibility of trade-offs between one term and another. He pointed out that real progress had been made in some other areas of credit, notably mortgage credit and consumer credit, in pushing ahead with endeavors to measure all the major terms and conditions of the loan, and also those characteristics of the borrower, particularly his income, that can have a major influence on the terms on which he borrows. He advocated pushing such data collection forward in these other areas, and making similarly imaginative efforts in the business loan area.

Mr. Mitchell also emphasized the need for qualitative interviews of bankers and their customers to add to understanding of how credit conditions were changing and how they were affecting the decisions being made in the economy. At the current time, he felt a program of such interviews in the field of construction would be very helpful. He suggested such a study could proceed in something like the same way that the System had carried forward its path-breaking studies of consumer credit and business finance in the mid-1950's.

Mr. Mitchell pointed out the need for better analyses of the relation of the flow of bank credit to total credit flows in the economy. This is one of the significant sets of relationships affecting the influence of monetary policy on economic activity, but there are two particular obstacles that have to be dealt with in such analysis. Techniques are needed for dealing analytically with shifts in the degree of intermediation taking place in total financial flows. Techniques are also needed to deal analytically with the shifts in particular institutional totals of credits and liabilities that can result from the changing competitiveness of one class of financial intermediary with another. Until something can be done to deal with these two problems in better fashion, studies of the linkages of current flows and economic behavior are seriously handicapped.

Research into money and liquidity. A second broad research approach, Mr. Mitchell pointed out, is to study the role of money in the economy: how much there is, where it is distributed, how it is used, and how it affects the decisions being made within the private economy. In this area there has been a good deal of research using data on the total money supply. Because, however, there are important differences in the motivations and responses of different kinds of money owners, there is a crying need for sector breakdowns of money ownership in order to permit more meaningful analysis. This means, Mr. Mitchell said, that the System needs to get back into the deposit ownership survey business. His own preference for deposit sectors were as follows: small personal accounts (a proxy for which might be the budget accounts at many banks); large personal accounts (say, over $5,000 where some acquaintanceship with alternative financial outlets would exist); accounts of small and medium-sized businesses; and large corporate accounts (which ought to be segregated because of their significance and activity, even though it is hard to infer corporate money management patterns from bank account data alone). Particularly in the large corporate accounts Mr. Mitchell was inclined to favor efforts which would distinguish financial-type from nonfinancial-type of activity. He would not advocate any further type-of-business breakdown, because he felt the empirical results of past deposit ownership surveys would not justify the burden of such reporting. He emphasized his feeling that data on both deposit ownership and activity were necessary in order to permit meaningful analysis. In this connection, he referred to a recent speech by George Garvy, in which the use of turnover as an indicator of monetary response was discussed.

Besides money itself, Mr. Mitchell felt analysis needed to extend to movements in near-moneys as well. He believed ownership detail was necessary for near-moneys as well as for money and indeed was more available for most near-moneys than for money itself. Any analysis of near-money behavior, however, needs to be very wary of changes in the significance of near-moneys as the result of market shifts. Two kinds of shifts could happen. One was a shift in the scope and variety of assets that provide sufficient liquidity to perform some of the functions of near-moneys (in strong real estate markets, for example, houses can be liquid). The second is a shift in the competitive relationships within the total of near-moneys, which can happen with sufficient frequency to make it hazardous to use any single money or near-money variable as a proxy for all.

Mr. Mitchell indicated that there was some useful evidence being collected on money ownership and use. While the deposit ownership survey had been held in abeyance for several years, consumer finances surveys were being undertaken by the Board, series on near-money flows and activity were being maintained at the Chicago Bank, and a series on corporate liquid assets was being tried out by the Cleveland Bank. Considering how important money and liquidity was to the central bank, however, he felt a great deal more empirical research in this area was needed.

Portfolio behavior of intermediaries. Mr. Mitchell said that the subject area of portfolio behavior of financial intermediaries deserves special attention because actions by intermediaries were such a key element in the transmission of credit and liquidity effects within the economy. Bank behavior especially should be the subject of a great deal of System analysis, for abundant data were uniquely available to System economists and banks were the preeminent class of institutions through which the impact of monetary policy was transmitted.

Resources for research. Mr. Mitchell indicated that his comments thus far had described a rather ambitious research program, but he felt that the System had resources at its command to undertake this kind of program if it wished. He felt there were four conventional limits to research efforts that might be considered--money, time, personnel, and public relations. Money, however, should not inhibit the System's research effort in any real way, since its financial resources are limitless and the likelihood is that the kind of program outlined would not cost a great deal more than present research outlays. Time should also not be a serious limitation, for, while System needs for knowledge are important they are not urgent, in the sense of demanding a crash research effort. What rather is involved is a redirection and enhancement of the Federal Reserve research program over a span of years. The public relations aspect of that enhanced research program he felt should not be awkward. Data requirements on the banking system as a whole should not be heavy, if the System makes good use of sampling procedures and if the Federal Reserve undertakes to provide interviewing and recording personnel in various instances in order to collect evidence right in the respondent bank itself. The biggest bottleneck was likely to be the availability of trained personnel in the System. This might be especially true insofar as trained statisticians and econometricians were concerned. He felt the System already had a substantial number of well-trained economic analysts of the more conventional type, and that with them it was more a question of freeing them from alternative use of their time than of adding to their number. In sum, Mr. Mitchell indicated that he felt the need for monetary research was obvious, and that the requisite resources were within the grasp of the System. What was needed was a determination to push forward in the application of its resources to the task.

II. Round table discussion

Significance of money ownership and use. The comment was made that the System's decision to hold the deposit ownership survey in abeyance for a time stemmed partly from reservations as to the causal significance of changes in money supply holdings. It was noted that decisions to spend were a complex phenomenon, reflecting the influence of income flows and the whole range of financial assets and liabilities held. In this context, the money balances that depositors leave in checking accounts may be more a consequence than a cause of the basic economic and financial decisions made.

It was pointed out that different experts have different ideas as to the relationship between money and spending. Milton Friedman claims to have found a powerful causal association between money and expenditure totals. He does not purport to explain that linkage in detail; he simply asserts its existence, and apparently feels that the linkage is strong enough that the monetary authorities should use money as their principal target variable. It was noted in this context that money may serve as a proxy for other forms of liquidity.

The question was raised as to how closely Friedman analyzes the leads and lags between changes in money and changes in spending, for it is by no means clear whether causation runs from money to spending or vice-versa (or both ways). These relationships were regarded as being important but intricate, and the comment was made that Friedman's own work in this area was muddled.

In further discussion the question was raised whether the initiative for monetary expansion under present circumstances, which of course include the Committee's current policy posture, comes primarily from the nonbank sector or the bank sector of the economy. Mr. Mitchell observed that the kind of sectoring of money ownership and use he had in mind ought to help reveal answers to such questions. Concerning appropriate bases for sectoring, several Presidents suggested it might be advisable to eliminate the deposit activity of dealers and brokers and perhaps the entire financial area, because of its exaggerated turnover and volatility, in order to be able to more clearly discuss the relation between money and real spending decisions. Mr. Mitchell agreed that some segregation of financial activity in checking accounts was a good idea in principle, but he argued that data on financial activity should be looked at separately rather than discarded, for some of the sharpest cyclical responsiveness to changes in monetary policy might take place in such account activity.

Information as to activities in process. Mr. Stone indicated that studies were being developed at the New York Bank aimed at illuminating some of the short-term linkages between reserves, interest rates and credit conditions. These studies were being undertaken to try to better quantify the interrelations at work within the central money market, where the System's open market operations are focused and the economy's over-all supplies of and demands for liquidity are balanced out.

A series of intensive studies of the behavior and determinants of interest rates was reported to be in process at the National Bureau of Economic Research. Some of the results to date had been very interesting, particularly regarding the structural determinants of rates and the cyclical relationships among rate movements.

Experimental work was being done at the Board on models of the financial sector and of particular financial markets. It was reported that the System Research Advisory Committee had established a subcommittee to develop an outline to guide research into the linkages between monetary policy and ultimate economic conditions.

A number of Presidents expressed the desire for a better exchange of information as to significant developments in the area of monetary research. The idea of an outline of possible research projects in the field was welcomed. Specific requests were made for summaries of the discussions at two recent meetings of Federal Reserve and academic economists, one on monetary research held at the Board in March, and another on research in banking markets held at the Chicago Bank in May. (Copies of such summaries are being distributed.) Discussion extended to the possibility of a periodic newsletter that might be issued by the Board to keep the Reserve Banks informed of significant developments in this and other major areas of activity.

<u>Means of fostering further monetary research</u>. The comment was made that it was shocking to consider how little economists knew for certain with respect to

the linkages between monetary policy and economic response. A great deal of new research clearly needed to be done. The challenge to the System was how to concentrate the requisite analytical resources on the task. One suggestion was that the System contract out some relevant research projects under a system of grants to qualified scholars. The National Bureau program provided a constructive example of how academic research personnel might be used in this respect. Judged by Bureau experience, the cost of sponsoring this kind of academic research was not very great.

Another suggested way of tapping academic resources was to hire professional talent on a part-time or temporary basis. This had been done at some Reserve Banks and the Board with profitable results.

Several Presidents pointed out, however, that the System had a large number of capable analysts in its employ, with a great deal of information available for their use. What was needed was administrative determination to free good men from some of their day-to-day responsibilities in order to allow them to devote greater portions of their time to longer range research.

Significance of findings in empirical research. It was regarded as conceivable that even a major and highly competent research effort might not turn up very clear or striking answers to the question of the relationships between monetary action and spending decisions. There then ensued a discussion of the impact that interest rates and various nonprice factors might be expected to have on investment decisions and consumer spending decisions. The point was made by several participants that, in terms of the performance of the economy as a whole, only marginal effects need be exerted by monetary action in order for such action to have a significant impact on the course of aggregate economic activity.

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