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

April 12, 1978

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida

Attached is a report of the Subcommittee on the Directive, dated today and entitled "Advisability of setting 3-year monetary growth ranges." This report will be considered at the forthcoming FOMC meeting under agenda item 3.

Attachment

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TO: Federal Open Market Committee

DATE: April 12, 1978

FROM: Subcommittee on the Directive (Messrs. Eastburn, Partee (Chairman), and Volcker)[1/]

SUBJECT: Advisability of setting 3-year monetary growth ranges.

In a memorandum to the FOMC dated March 6, 1978, President Baughman suggested that the FOMC "seriously consider setting money growth targets for a 3-year period and announce that our purpose is to enable private markets and private contracts to anticipate that insofar as inflation is affected by monetary policy, the future will be less inflationary than the recent past."[2/] At the FOMC meeting of March 21, 1978, Chairman Miller asked this Subcommittee to review Mr. Baughman's proposal and to report to the full Committee before the April meeting, at which the next discussion of longer-run targets will be held. This memorandum has been prepared in response to that request.

As Mr. Baughman notes, the Committee's practice of establishing longer-run ranges for the aggregates each quarter was initiated pursuant to Concurrent Resolution 133 and is now carried out under the terms of the Federal Reserve Reform Act. The Act, like the preceding Resolution, calls for ranges covering the year ahead, so that the Committee could not replace the one-year ranges with three-year ranges. However, there presumably would be no Congressional objection if the Committee chose to announce ranges for each of the three coming years, or for a three-year period

1/ Governor Gardner, also a member of the subcommittee, was unable to participate in the preparation of this report.

2/ A copy of Mr. Baughman's memorandum is attached.

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as a whole (in addition to the year ahead). Indeed, the version of the Humphrey-Hawkins bill recently passed by the House calls for the Federal Reserve, in reporting on its intended policies for the coming year, to consider their implications for employment, production, and prices over a five-year period.

There appear to be two potential advantages to the proposal made by Mr. Baughman.

First, as he suggests, a program setting forth a strategy for monetary policy in summary form over an extended period might tend to reduce the public's uncertainty about the course of inflation, reduce inflationary expectations, and hence contribute to a more stable economic expansion. Such a result would depend on, among other things, the particular targets chosen and the credibility of the program to market participants. They would need to view the prospects as brighter and more certain than before that monetary policy would in fact work to reduce money growth as times goes on.

Second, the proposal might benefit the Committee's internal policy-making procedures. Since monetary policy actions affect the economy with a long lag, especially in the case of prices, the incorporation of an extended period in the analysis of policy alternatives would make it necessary for the FOMC to explore more fully their possible implications.

Against these advantages, the subcommittee considered a number of problems and disadvantages.

(1) Three-year ranges for the aggregates necessarily would have to take account of probable changes in underlying economic

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and financial conditions throughout the period covered--and experience suggests that our ability to project with any degree of reliability becomes weaker as the projections extend much beyond a year or so.

(2) The ranges--presumably showing declining rates of monetary growth over the three-year period--probably would not at first be taken very seriously by the market, especially in view of our well-known difficulties in staying within a specified range even for a one-year period.

(a) If they were not part of a credible over-all anti-inflation program involving an all-out effort by Government as a whole, as well as the Federal Reserve, the Fed's ability to attain and stay within the ranges for any length of time would be considered to be doubtful.

(b) In any event, very long-run ranges--such as three-year growth rates for monetary aggregates--would in the nature of the case be taken less seriously by the market than shorter-run ranges. As the time period lengthens, it becomes increasingly probable that unexpected changes in conditions will make attainment of the projected growth rates more and more difficult. Moreover, the public is probably conditioned to viewing longer-run ranges, even if billed as targets, with a grain of salt in light of the large number of such expectations of various kinds that have turned out to be wrong.

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(3) A three-year commitment to lower monetary growth rates would attain credibility only if the Federal Reserve actually achieved a lowering of growth rates as the three-year period progressed. In short, for the strategy to have more than a transitory effect, the commitment to an announced three-year growth path would have to be demonstrably firm. To make the announced growth rates effective would, in practice, tend to lock the FOMC into a specified path for the aggregates over a very long period more or less without regard to other events or consequences--such as changes in income velocity, levels of interest rates, exogenous forces affecting the rate of inflation, rates of real growth, the level of unemployment, etc. Thus, a three-year program for the aggregates, to the degree that it represented a commitment, would have the great disadvantage of impairing the flexibility of monetary policy in responding to changing circumstances. If successful in achieving credibility over time, that same credibility would presumably flow, in much the same degree, from demonstrated effectiveness in meeting successively lower annual targets.

(4) If the three-year projection were not treated as a firm commitment by the Federal Reserve--and we do not believe such a commitment is practical under present circumstances--then it is very unlikely that the projections would be taken importantly into account in contract negotiations and wage settlements. The conflict between emerging cost increases and pressures to finance the associated rise in prices with relatively rapid monetary growth would remain. And unless the Federal Reserve was prepared to pursue its

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course of gradually reducing monetary growth rates in a flexible manner, the result almost surely would be an economic recession.

(5) Prospects that some type of a Humphrey-Hawkins bill will be enacted cast further doubt on the wisdom of the Federal Reserve's establishing very long-run ranges for the aggregates on its own at the present time. As indicated earlier, the version of that bill passed by the House calls for the Federal Reserve to set forth its intended policies only for a year ahead but to review their implications for the economy over a five-year period. In its present form, the bill does not specifically call for projections of monetary growth rates over that period. However, it would seem very awkward in practice to review the implications of monetary policy for the economy extending five years ahead without making assumptions about monetary growth rates for much or all of the period. Thus, whether or not the bill as finally enacted contains a provision calling for monetary growth rates over, say, a five-year period, the System may well finds that it is in fact forced into making such projections. They presumably would be part of a legislatively sanctioned exercise that would also involve longer-run Administration projections or goals for unemployment, prices, etc. There would be considerable advantage in awaiting the specifics of the bill as finally enacted.

. . . .

In conclusion, balancing disadvantages against advantages, the subcommittee believes that it would be unwise at this time to publish three-year projections of the aggregates. The subcommittee

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is of the view that there could be more value to three-year projections if they were part of a well-conceived, realistic long-term anti-inflation program pledging other branches of Government as well as the Federal Reserve. But even then, there would need to be sufficient flexibility to allow for adaptations to changing economic circumstances. The more flexibility that is allowed, of course, the less likely that the announcement will be successful in achieving the objective of reducing inflationary expectations. Thus, even under those exceptional circumstances, it is not clear how effective a statement of three-year monetary growth intentions would be as a tool to influence public attitudes, although some rethinking of the proposition would be desirable in that event.

While recommending against publication of any multi-year plan for the monetary aggregates under present circumstances, the subcommittee would also urge that, when the FOMC discusses longer-run policy strategies each quarter, the staff should make special efforts to provide projections of key variables under alternative monetary policy assumptions that extend well beyond the normal six-quarter forecast period. Even though highly tentative and uncertain, such projections should help to evaluate more fully the longer-term implications of the various monetary policy strategies under current consideration.

Attachment

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FEDERAL RESERVE BANK
OF DALLAS

BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM
1978 MAR -7 PM 2:43
RECEIVED
OFFICE OF THE CHAIRMAN

ERNEST T. BAUGHMAN
PRESIDENT

DALLAS, TEXAS 75222

March 6, 1978

TO: Federal Open Market Committee

FROM: Ernest T. Baughman ETB

I have been thinking for some time about the contribution our long-run growth ranges for the monetary aggregates, established each quarter pursuant to Concurrent Resolution 133 and the recently enacted Federal Reserve Reform Act, may make to achievement of full employment, stable prices, and balance in international payments, three overriding goals of economic policy. The exercise has tended to focus attention of the public and the Congress on the medium-term aspects of monetary policy. Also, it has helped to keep before us the fact that our day-to-day operations must be constrained by our medium-term objectives. Given the thrust of inflation, it seems to me that the economic problems we are attempting to address now require attention to the longer term to a degree not heretofore experienced since the 1930's.

I propose, therefore, that the time horizon over which our targets are announced be extended. I would think it useful to indicate aggregate targets over, say, the next three years.

This would strengthen any positive features inherent in the current quarterly announcement of target ranges for the ensuing 12 months. It would indicate more strongly to the public that prospective monetary policy should be taken into consideration in any long-term private contracts such as wage and mortgage contracts.

So long as monetary policy can be presumed to adjust in the short term to the consequences of private long-term contracts, we would appear to have only very limited ability to impact on the wage-price spiral. Historical evidence indicates inflationary expectations, once built in, are next to impossible to liquidate. An announced goal to slow the rate of growth in money over the next three years would help to reinforce the idea that the battle against inflation must be an ongoing one and that the monetary authority has an ongoing battle plan. I think such an announcement would make the job of this Committee easier in that it would keep more in the forefront our long-run goals and help to insulate short-run actions from attack.

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It's unfortunate that monetary policy influences real activity before it has much impact on inflation. This allows us to stimulate economic activity for a while at no apparent cost, i.e., with no immediate worsening of the rate of inflation. And it makes efforts to restrain inflation seem almost futile since the initial impact of monetary restraint tends to reduce economic activity with any slowing in the rate of inflation coming only later.

This unfortunate timing of lags makes easy money very popular and tight money very unpopular in the short run and the short run is always with us. It leads to urging on nearly all fronts for easier money and cries that tight-money policies cannot cure inflation and should be abandoned. Consequently, if we don't constantly keep the long run before us and the public we tend to stimulate the economy too much too long and to restrain it too late and too little. The end result of over a decade of such activity has been the building in of an inflationary thrust that is proving extremely difficult to contain.

Obviously, none of what I have said here is news to any of us. And it is to the Committee's credit that it has taken steps in the last few years to stretch out its policy horizon. Nevertheless, it is disturbing to note that the pattern of monetary growth on an annual basis in recent years may be encouraging further entrenchment of inflationary expectations even though we have stated repeatedly our intention was the opposite. It can be argued we should have had more rapid growth of money in 1975 and then the record would look better. Even so, we would be hard pressed to find a persuasive rationale that monetary policy in the past three years has been countercyclical.

In conclusion, then, I suggest we seriously consider setting money growth targets for a three-year period and announce that our purpose is to enable private markets and private contracts to anticipate that insofar as inflation is affected by monetary policy the future will be less inflationary than the recent past.