

SHIFTING TARGETS OF MONETARY POLICY

Remarks

by

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INTRODUCTION

I would like to talk with you this afternoon about the Federal Open Market Committee of the Federal Reserve System. There is much, I am sure, that you already know about the Committee: for example, that it is responsible for deciding System open market policy--the strategy, in other words, of Federal Reserve purchases and sales of Treasury and Federal agency securities. As a consequence, it is able to influence to a considerable extent (1) the reserves of U.S. commercial banks, (2) short-term interest rates and (3) such monetary aggregates as bank credit and the money supply.

You also know that the Committee is made up of the seven members of the Board of Governors and the twelve presidents of the Reserve Banks, and that it meets every four weeks or so in Washington to decide open market policy. But you may not be familiar with the Committee's modus operandi--how it formulates open market policy, and how, over the weeks between meetings, it gives practical effect to its policy decisions.

The fact is that the Committee does not operate as it did a decade ago or, for that matter, even a couple of years ago. For one thing, it is much more concerned about the behavior of the monetary aggregates than it was. For this reason, the monetarists--the System's most persistent critics--should be happier than they were with the way it is now operating. But even among those who recognize how the Committee has changed, there are some who are still critical. And there are, it seems to me, a couple of suggestions for further modifying the Committee's way of operating that should be taken seriously. I want to consider them with you, but only after I have described how the Committee actually operates today.

COMMITTEE DECISIONS

At one extreme, the Federal Open Market Committee has a responsibility for ensuring against financial crises, a responsibility that it shares with the Board of Governors and the Reserve Banks. We tend to think of the Reserve Banks, with their discount windows, as our lenders of last resort. But the Committee, through its instructions to the New York trading desk, is able to purchase securities in the open market and thereby relieve pressures that in times past might have led to a liquidity crisis. It demonstrated its awareness of this responsibility only recently, after the failure of Penn Central, when for several meetings during the summer of 1970, it gave highest priority to maintaining confidence in financial markets.

Fortunately, the threat of financial crisis looms only rarely, so the Committee is free most of the time to make what contribution it can to economic stability in a more prosaic way. As you would guess, the Committee focuses its attention on the expected course of the economy over the months and quarters ahead. Among the array of variables in the model, it is of course particularly sensitive to anticipated changes in price levels and the unemployment rate. It also keeps one eye on the U.S. balance of payments, and on occasion is influenced, at least in some degree, by changes in that balance. Nor is the Committee indifferent to the composition of output. The output of housing, for example-- a national concern--is also a Committee concern. But understandably, it is the expected behavior of the unemployment rate and the price level that carry the most weight.

At a typical meeting, however, the Committee does not come to any explicit agreement on desired future changes in the unemployment rate or, say,

the GNP deflator. Rather, in light of its best judgment as to the likely behavior of these variables, it decides on desired rates of increase for selected monetary aggregates--the money supply and bank credit--in the belief that action with respect to these monetary variables will influence--with a lag--the behavior of the real economy.

It is important to recognize that the desired path for the monetary aggregates selected by the Committee has a time dimension of several months. In a time sense, therefore, between the short and the long run, as well as in a functional sense, as a link for influencing the real economy, one can appropriately think of the desired rates of increase in monetary aggregates as the "intermediate targets" of open market policy.

I should also point out that the Committee has selected three aggregates or intermediate target variables to aim at, not one. These are M_1 , the narrowly defined money supply that includes only currency and demand deposits; M_2 , which adds to M_1 time and savings deposits other than large CD's; and finally, bank credit--the asset side of the ledger. This multiple target approach may result in part from the fact that the Committee is not entirely agreed on how open market operations influence economic activity. But I believe it is fair to say that M_1 , the narrowly defined money supply, is regarded by all Committee members as an extremely important aggregate and, further, that most of the time the Committee pays greatest, although not exclusive, attention to the behavior of M_1 .

At the outset of a typical meeting, the staff of the Board of Governors presents the Committee with its view of the economic outlook. In doing so, it makes certain assumptions as to the course of fiscal policy and also

assumes unchanged monetary policy. The Committee therefore starts the meeting with a reasonably reliable assessment of the consequences of not changing long-term open market policy. But the staff's outlook may appear to the Committee to be too bearish or bullish. If so, then the Committee selects new desired rates of increase for M_1 , and M_2 and bank credit for a quarter or two ahead. It also focuses on what I shall refer to as acceptable or tolerable short-run or monthly rates of increase for the aggregates.

Now it may seem strange that the Committee should decide not only desired quarterly rates of increase for the aggregates, but monthly rates as well. The Committee may think it appropriate for M_1 , say, to increase at a six percent annual rate over the coming three or six months. Should it not then want this aggregate to increase at the same rate over the several weeks immediately ahead? The answer, surprising perhaps, is "not necessarily." And the explanation is that the Committee does not have perfect control over M_1 or, for that matter, any other aggregate.

If the Committee operated differently over the weeks between meetings, it might do better controlling its aggregates. I shall come back to this possibility. But let me say here that however it operates, it will, I believe, always have only imperfect control. More often than not, actual rates of increase will turn out different from desired rates. This has been the Committee's experience, and as a result it has frequently been in the position of having to decide how quickly the aggregates should be forced back on their respective chosen paths. The speed of this return is really what the Committee decides when it selects acceptable monthly rates of increase.

What prevents the Committee from moving back to a desired path immediately? The answer is, its concern about the behavior of interest rates. If it cared only about the behavior of the aggregates, then selecting monthly rates of increase could be a trivial task, one that might be managed with second grade arithmetic. For example, suppose the Committee decided originally on a six percent rate of increase for M_1 over the longer term. Despite its efforts, though, it finds that M_1 has been increasing at a nine percent rate. What should the desired rate be for the coming period? One possible and plausible answer is "three percent." But the attempt to achieve this rate of increase could involve unacceptably sharp increases in interest rates.

This is why I said before that the Committee decides on "acceptable or tolerable" rates of increase for its aggregates over the short run. The Committee may choose rates of increase for the coming month which it does not like, but which, because of its concern about the near-term behavior of interest rates, it is prepared to accept or tolerate.

There are economists--both within the System and without--who believe that Committee concern about the behavior of interest rates is mistaken. Some would go so far as to have the Committee disregard interest rates entirely. I do not myself see this as possible. We can't assume that financial institutions in the future will be any less vulnerable to fluctuations in interest rates than they have been in the past, and we have seen some pretty severe strains during periods of rapidly rising rates. And we can hardly ignore the impact on international markets of uninhibited swings in U.S. interest rate levels. Nor can we expect the Federal Government to manage the public debt in the face

of gyrating interest rates, at least until we've perfected the system of auctioning securities. And finally there is the fact that interest rates, like wages, have great political significance. An increase in interest rates, however justified in market terms, can produce an emotional reaction that the Federal Reserve, any more than the Supreme Court in its sphere, would be foolish to ignore. But having said all this, I want to emphasize that there are degrees of concern, and it is possible that the Committee has, even of late, been too concerned about the behavior of interest rates.

Let me get back, though, to my description of how the Committee operates. I said before that at the typical meeting, the Board staff provides the Committee with a conditional economic outlook. It also provides the Committee with several sets of projections for the monetary aggregates--projections for the weeks and months immediately ahead. Each set of projections is based on certain assumed money market conditions as reflected in the Federal funds rate, free reserves, member bank borrowings and the rate on three-month Treasury bills. One set of projections is based on prevailing money market conditions. Thus the Committee has the judgment of the staff as to the likely rates of increase for M_1 , M_2 and bank credit if no change in money market conditions is permitted. It also has some idea, provided by the other sets of projections, of what kind of change in money market conditions would be required to get different rates of increase in the aggregates, or to get the aggregates back toward their respective long-term target paths. The Committee is thus able to choose target paths for the aggregates that are consistent with the limits on near-term fluctuations in interest rates that it is prepared to accept.

THE OPERATIONS OF THE ACCOUNT MANAGER

You know of course that actual purchases and sales of Treasury and Federal agency securities are made in New York, on the decision of the Manager of the System Open Market Account. The Manager is the agent of the Committee, with the responsibility for carrying out open market policy. He therefore attends each meeting of the Committee, both to explain what he did in the weeks since the last meeting, and so that he can hear the discussion of what policy is to be for the coming weeks. The Committee, at the close of each meeting, adopts a statement of policy--a directive, so-called, that is issued formally to the New York Reserve Bank. This statement, written in what amounts to a shorthand verbal code, is of some help to the Manager, but the discussion leading up to its adoption is certainly much more so. The Manager thus comes away not only with a formal directive, but with a set of target values--or, more accurately, a set of ranges of target values--for money market conditions that are his operating variables in the conduct of open market purchases and sales. These are the values which, in the judgment of the Committee and staff, are consistent with, or most likely to produce, the desired short-run rates of increase for bank credit, M_1 and M_2 .

Several years ago, the Manager would have been expected to hold money market conditions more or less unchanged over the entire interval until the next Committee meeting. Today, however, he is not. In 1966, the Committee began including a so-called "proviso clause" in its directives. It began, in other words, to give the Manager a conditional instruction, which might be paraphrased as follows: try to achieve the targeted money market conditions, but only so long as the aggregates seem to be behaving as desired; should

they not, then shift to appropriate new money market conditions. For a while after the Committee began using the proviso clause, it was not clear exactly how serious it was about having the Manager make between-meeting adjustments. But it gradually became more insistent on such variations, and today this has become more or less standard procedure.

In effect, the Manager is expected to keep his eye on the aggregates and, when they are increasing more, or less, than desired, to make the appropriate adjustments in money market conditions. Of course, there are circumstances which, in the judgment of the Committee, preclude between-meeting adjustments--for example, during Treasury refundings. And the Manager is not expected to make large adjustments. But it is significant that the Manager often does change or adjust money market conditions for the specific purpose of providing better control over M_1 , M_2 and bank credit--and this is the significance of the proviso clause.

The contrast between how the Committee operates today and how it used to operate is, I think, quite marked. The change to the use of the aggregates as the intermediate target variables can be explained in part by academic criticism of the Committee's strategy, criticism which during the early 1960's was intense. But the Committee's own experience, particularly in the years 1967-68, was also a major ingredient in the change. You may recall that the U.S. economy went through an inventory adjustment in late 1966 and early 1967. In the spring of 1967 there was widespread fear of recession developing, even though it never did occur. But what is important here is that M_1 increased at a very rapid rate through the late winter and spring of 1967. Later, the Committee was roundly criticized for letting M_1 increase so rapidly; and there

are many Committee and staff members who believe that if the Committee had been using aggregates as its intermediate target variables, we would not have had as much inflation subsequently as in fact we have had.

You may also recall that for a while after the tax increase of July 1968, many forecasters were concerned about overkill. Again, while no recession developed, through the second half of 1968 M_1 , M_2 and bank credit increased at very high rates--too high in retrospect. In general, there is reason to believe that more emphasis on the aggregates as intermediate target variables would have made a difference in 1967-68. And several of my colleagues on the Committee who were members during those years are of the same view.

I come now to what may seem an awkward fact: that the monetary aggregates, M_1 included, have to all appearances behaved quite erratically over the past couple of years, just as erratically in fact as in the years before 1970 and possibly more so. From the record, it might be concluded that the Federal Open Market Committee, although well-intentioned, is not really able to control M_1 , M_2 and bank credit. However, I don't believe that this is a fair conclusion.

For one thing, the behavior of M_2 and bank credit has not been all that erratic. Both increased very rapidly in the second half of 1970. But this was largely attributable to (1) the suspension of the ceiling rate on large denomination CD's of ninety days or less maturity following the Penn Central affair, and (2) the dramatic decline in market interest rates which made all time and savings deposits more competitive.

Explaining the wide swings, both from month to month and from quarter to quarter, in the rate of increase of M_1 is more difficult. In

the first and second quarters of 1971, for example, M_1 increased at rates of nine and eleven percent respectively. But in the third quarter, the increase dropped to a rate of only 2 1/2 percent, and September actually registered a decline of four percent.

But if actual rates of increase for M_1 have jumped around, month by month and quarter by quarter, so have the rates of increase which, for the short-run at least, the Committee has been willing to accept. As I mentioned earlier, the Committee, while concentrating on the aggregates, is still very much aware of the behavior of interest rates, and what is perhaps a corollary, it is not convinced that variations in the rate of increase of M_1 from month to month are of very great consequence. The only requirement is that these monthly rates average out to an appropriate longer-term rate of increase.

Yet it would be going much too far to say that all the month-by-month variations in the rate of increase of M_1 in the last couple of years have been intentional. Indeed, the experience of the last year or so has led some members to recommend that the Committee go a step further in the use of the aggregates and take a monetary aggregate such as unborrowed reserves as its operating variable rather than money market conditions as at present.

While it's possible that having the Manager use some reserve aggregate rather than money market conditions might give better control over M_1 , I, for one, have seen little evidence so far that this is necessarily so. My own view is that the Committee might do at least as well continuing to use money market conditions, provided it were more tolerant than it has been in the past of larger fluctuations in short-term interest rates. That is what controlling M_1 may on occasion require. As I've said, the Committee is

already more tolerant of interest rate fluctuations than it used to be. The question is whether it ought to become more so.

Before concluding, I'd like to discuss one other issue, which is conveniently put in the form of a question: In choosing target rates of increase for the monetary aggregates, how much freedom or discretion should the Committee have? As things stand now, the Committee has complete discretion; it can choose whatever rates of increase seem appropriate. There are some, however, including the redoubtable Professor Friedman, who would have the Committee operate, if it can be called that, with no discretionary authority whatever. They would have the Committee keep to a predetermined rate of increase for M_1 or M_2 . Among proponents of non-discretionary open market policy, there is disagreement about which aggregate to use and about what the steady rate of increase should be. Here, though, I am interested in the principle of discretionary authority.

For some critics of the Committee, its discretionary authority is simply the freedom to make disastrous mistakes. The Federal Reserve's performance during the 1930's is still being cited as evidence that the Committee ought to be bound to a fixed rate of increase for, say, M_1 . I am not impressed, though, by far-distant performance, believing as I do that the System of the 1970's is quite different from the System of the 1920's and 1930's. In an ideal world, with institutions sufficiently flexible to absorb any change in interest rates, a fixed monetary rule might be feasible; whether it would be desirable or not is something else again. In the world as we know it, such a rule is not feasible. There are too many rigidities and, beyond

these rigidities, perhaps entirely legitimate objectives other than those of economic stabilization, narrowly defined, which can be honored only if the Committee has discretionary authority.

But we do have to keep in mind that the lags of monetary policy are long, and that even the near-term future can be highly uncertain. The responses of the Committee to the changing economic outlook should therefore be moderate, and the range of variation in policy paths kept within reasonable bounds. This is what economic theory suggests and what I believe.

A while back, there was considerable discussion in the Congress about passing a law that would require the Committee to keep the annual rate of increase of M_1 in the two to six percent range, except in unusual circumstances. It was proposed that the Committee provide the Congress with an explanation whenever the rate of increase of M_1 went outside this range. I have serious doubts about the wisdom of legislating monetary policy, but in point of fact, the Committee, in its own thinking, is very close to those who urged passage of this law.

CONCLUSION

I have not served on the Federal Open Market Committee very long-- only a few months. I have been rather close to it, though, for a decade, And it is apparent to me that the Committee has changed and improved its modus operandi over the years. While there is no overwhelming empirical case for the use of the aggregates as intermediate target variables, the greater emphasis by the Committee on the aggregates does seem well-placed.

Quite rightly, the Committee's way of operating is no frozen thing. Further change could well be desirable, although I do not at the moment see

any pressing need to switch from the use of money market conditions as the Manager's operating variable to some reserves aggregate. And it would be a mistake, it seems to me, for the Congress to bind the Committee, or for the Committee to bind itself, to some fixed rate of increase for M_1 or any other aggregate.

As I have said, the Committee has greater tolerance for interest rate fluctuations today than it used to have. But it might think hard about the desirability of even somewhat greater tolerance. I for one would be prepared to experiment with greater fluctuations in short-term interest rates to see whether this wouldn't permit better control over the aggregates.