



CONFIDENTIAL--(FR)

To The Federal Open Market
Committee

October 15, 1964

From Alfred Hayes

Subject: The Ellis-Mitchell-Swan
Proposal Revisited.

The basic issue before the Committee is whether the Ellis-Mitchell-Swan proposal offers real advantages in the formulation, implementation and expression of monetary policy decisions. The proposal calls for the Committee to agree at each meeting on four to five pages of specific language embodying its decisions with regard to:

- (1) the nature and interpretation of economic and financial developments (Elements 1 and 2),
- (2) the policy objectives to be pursued in light of developments (Element 3), and
- (3) the instructions to be issued to the Desk for the next three weeks in light of policy objectives (Element 4).

I. Elements 1 and 2 (A detailed and analytical statement of recent economic and financial developments, emphasizing those of greatest significance for policy)

The present directive incorporates the Committee's decisions with regard to points (2) and (3), but the Committee has not previously sought to agree formally on the key facts and analysis underlying its policy intent and instructions. I can see no reason to alter the present satisfactory procedures under which the facts reviewed by the Committee at the time of its decision are summarized in the policy record. The Committee's present procedures recognize that its members may reach agreement on policy issues without their arriving at the decision by the same analytical route.

The authors say that the main purpose of debating and voting on an official analysis such as is presented in elements 1 and 2 (either in the form of the directive or of a "consensus"--see the authors' September 29 memo, p. 8)

is to sharpen the Committee's assessment of economic and financial developments with the expectation that this would lead to better policy decisions. Committee members would thus have to agree not only on statements of policy intent and operating instructions, but also on the specific rationale leading to those conclusions. Even if it were desirable, this would be a tall order for a single meeting--far more difficult than agreeing on one of a fairly limited number of policy choices. While specific language in the directive might enable each participant "to identify precisely his points of agreement and disagreement--not only with respect to the conclusions expressed by other members", the question remains whether the Committee members could forge an internally consistent statement out of these agreements and disagreements over three or four pages of text. The problems of substance are too deep, and shades of emphasis too subtle and personal, to expect agreement to come readily--unless substantive decisions were delegated to the staff.

It seems inevitable to me that policy making would almost certainly bog down in drafting problems if this approach were followed. Our discussion at the September 29 meeting of the inclusion in the directive of a reference to the wage settlements in the automobile industry illustrated perfectly the kind of problem that would be magnified many times over under the proposed procedure. In contrast, I presume that there will be little difficulty in including an appropriate reference to the wage settlements as a part of the policy record of background economic and financial information.

Moreover, I do not feel the same degree of dissatisfaction with present procedures that the authors apparently feel. It seems to me, from my own observations of Committee meetings over the past eight years, that each member seeks to capture within his own analysis the dynamics of the unfolding economic situation and arrive at his policy judgment. That judgment, and the

analysis that underlies it, is tested several times each meeting as the discussion proceeds around the table and each member presents his views. In this way issues are constantly being brought into focus and resolved--at times in extended debate after the go-around. But what each member then votes on is whether he is or is not willing to identify himself with a consensus of the group's policy conclusions as embodied in the directive being voted upon. He does not vote on a single official analysis underlying that consensus. The fact is that no such single analysis exists; and I do not believe that one can be made to exist by any procedural change. I also believe, as I indicated earlier, that the attempt to make one exist by such a procedural change would so enmesh us in debates over language that the quality of our performance in formulating policy would be impaired rather than improved.

Each member of the Committee is interested, of course, in any change that will contribute to improving the quality of the Committee's policy discussions. However, recent drafts of elements 1 and 2 in the new style directive give little promise of increasing significantly the clarity of interpretative issues before the Committee or contributing to their resolution. The recent drafts have been essentially factual, rather than analytical. Moreover, the facts reported have already been covered in considerably more detail by the individual Research staffs throughout the System and in the written staff reports (including the green book) circulated to the Committee.

By the time of each meeting, Committee members individually have already incorporated the available facts into their analyses and are moving to make judgments on the significance and policy implications of the facts. And before the go-around begins, the Committee hears the individual oral reports of the staff in which the salient facts, and the staff member's view of their significance, are reviewed. Against this background, it is hard for me to

see how making the kind of drafts presented to us the focal point of Committee discussion and debate can add anything to the Committee's efficiency or enhance the quality of its discussions.

II. Element 3 (The specification of the Committee's policy intent)

The authors have modified their original proposal for the structure of this element to include statements on money supply and bank credit as well as general credit conditions. The authors feel that the revised version avoids a commitment to any particular theory of monetary causation and accommodates the views both of those who feel that the impact of policy runs from reserves to the money supply to economic activity and of those who feel that it runs from reserves to bank credit to credit conditions to economic activity. The policy statements included in the new style draft directive for the September 29 meeting are as follows:

"...it remains the objective of monetary policy to accommodate moderate expansion of bank credit and the money supply. To this end, it is the policy of the Federal Open Market Committee to supply sufficient reserves to support (1) renewed gradual rise in currency in circulation over and above seasonal fluctuations, (2) changes in U.S. Government balances, (3) actual growth in private time and savings deposits, and (4) a seasonally adjusted annual rate of increase in private demand deposits over the months ahead averaging lower than in the past three months."

At first glance it appears that the Committee's policy intent is to encompass rates of growth in money supply, bank credit, and bank reserves--albeit in a somewhat more complex form than the straightforward statement of the current directive. ("It is the...Committee's policy to accommodate moderate growth in the reserve base, bank credit, and the money supply...") However, if this were the case, the authors would be specifying three objectives which could not necessarily be achieved simultaneously, so that their prior claim to internal consistency would have to go by the board. Accordingly,

the authors must be seeking to draw a fine, and rather doubtful, distinction between the objectives of policy--here stated in terms of the money supply and bank credit--and the policy itself, stated in terms of reserves. A more careful reading strongly suggests to me, however, that the proposed rule would require the Federal Reserve support any growth in currency, any bulge in United States Government balances (irrespective of its temporary nature), and any growth in time deposits, and aim at a constant rate of growth in private demand deposits, irrespective of the liquidity preferences of the public.

I am very dubious about the desirability of the Committee's choosing any single intermediate variable as the target, much less endorsing the authors' specific selection. I do not see how the Committee can make such a choice and at the same time concede, as I believe we must, that our knowledge of the linkage between the variable selected and economic activity is not sufficient to justify the particular, and rather peculiar, choice made. I am quite skeptical of the views of those who would have the Committee make a specific rate of growth in the money supply its target. My skepticism increases when confronted with this proposal to pick this particular component of the money supply.

If the present directive is imprecise in these matters, it is because our knowledge is imperfect. The issue is one of causation that cannot be resolved by skilled draftsmanship, and what we already know from experience of linkages suggests that the dynamics of reserve utilization, monetary and credit expansion, and economic activity are not reducible to any simple formula. Moreover, the Committee may wish to address its policy at times to other objectives, such as the country's international position, which cannot readily be expressed in terms of reserve measures.

As for the formula chosen, it is a little disconcerting to find that the staff's reserve guideline, which was dropped a few months ago because

of a general disenchantment with its usefulness as an aid to policy discussions, is to be revived and incorporated in the directive as the major means by which the Committee is to achieve its broader objectives.

As I have noted before, the guideline approach prejudges mechanically some of the most vital issues involved in monetary analysis and policy making. It makes private demand deposits the System's major concern in providing for the reserve needs of the banking system. Under the authors' definitions, the sharp rise in recent years of bank time and savings deposits--including the spectacular increase in negotiable time certificates of deposit outstanding--becomes irrelevant to policy decisions in the sense that whatever reserves are necessary in relation to such deposits are to be provided automatically. The frequently strong, but often uncertain, links between Treasury deposits and private demand deposits--a notable feature of experience with the guideline--are left out of the accounting.

Attention is to be focussed on the movements in private demand deposits, not on the causes of such movements. Changes in the public's preferences for currency are to be accommodated without question, but shifts in the public's preferences for demand deposits as against near-money assets, whatever the reason, must be frustrated or they will nullify the Committee's policy intent. To be sure, Committee members who are not willing to slide over these questions could try to guess what rate of change in reserves related to private demand deposits would be consistent with a rate of change in bank credit or the money supply they deemed desirable. Such guesses could be built up (as the Ellis-Mitchell-Swan memo of September 29 suggests on page 13) by making specific assumptions concerning the behavior of currency, Government deposits, and time and savings deposits. But how much confidence could one have in chains of hypotheses strung together in this way? In any case, the published

directive would forego such subtleties, conveying instead the clear impression that after fifty years the System had at last discovered the truth.

III. Element 4 (Short-run operating instructions to the Account Manager)

The authors say that a first instruction in terms of free reserves qualified by a number of subsidiary instructions allow for as much scope and flexibility for formulating instructions as is likely to be required under about any circumstances. Under this structure, they say, the Committee could give the Manager whatever discretion it believes appropriate. Under present procedures, according to the authors, the Manager cannot be held as closely accountable for his operations as would be desirable.

The main thrust of the arguments advanced for this part of the proposal is that the Committee should focus more intently than it now does on the desired course of open market operations over the succeeding three weeks. At each meeting the Committee would vote on a free reserve target or range that was suitably adjusted to reflect any special factors such as expected changes in the distribution and rate of utilization of reserves. To be sure, the instruction to the Manager would permit him to deviate from the target under certain specified conditions relating to the Treasury bill rate or serious variations in the availability of Federal funds or dealer financing. Moreover, the Manager can be directed to pay as much or as little attention to reserve statistics at any particular time as the Committee may wish. But generally the quantitative target is the means chosen to make the Manager "more closely accountable".

It seems very doubtful to me that the Committee's policy making or its control over implementation, would be improved by devoting greater attention to the fine details of prospective money market developments. The Committee now concentrates on broader policy issues, although some critics

have mistakenly taken the Manager's operational concern with money market technicalities as indicating that the Committee was not sufficiently concerned with broader monetary objectives.

Under the new style directive, however, the Committee would have to immerse itself in guesswork about many details of future--and highly uncertain--market developments in order to reach a judgment in advance about whether, and to what extent, free reserves ought to be allowed to ride up or down during periods when, for example, reserve distribution and utilization are likely to change--such as at the Christmas holidays and around the time of corporate tax dates or Treasury financings. I doubt whether the Committee's performance in forging its broader policy objectives would be improved by increasing the proportion of Committee time allocated to guessing about the details of market developments over the succeeding three weeks.

The new style directive reduces the flexibility of the Manager's response to unfolding conditions by instructing him in terms of a single indicator of money market conditions qualified by a specification of several contingencies. At present, like any good field commander, the Manager has a strong sense of the Committee's central purpose, which guides him in assessing the variable, and often unpredictable, elements in the money market and in reaching his day-to-day decisions. This kind of understanding of the Committee's central purpose has made it possible for the Committee to achieve quite subtle shifts of policy posture even under potentially volatile market conditions. If the Committee relies instead on stipulating a specific number and a check list of priorities in the directive, the Manager will presumably be expected to hew to the terms outlining the extent of his discretion. And since they would have to be set out in precise fashion ahead of time, I think the conclusion is inescapable that the new instruction would be far narrower than the existing type of instructions, and would necessarily introduce

important new constraints on the Manager's actions. Since those actions are undertaken in a market that is dynamic and changeable in frequently unpredictable ways, I believe those new constraints would redound to the disadvantage of the Committee in the achievement of its central objectives.

Finally, the problem remains of hitting the free reserve target closely enough to demonstrate unequivocally the Committee's control over the Desk's conduct of open market operations. In almost one third of the 1964 statement weeks thus far, the free reserve figure finally published deviated by more than \$50 million from that published initially. Large deviations were even more frequent if one compares the final figure with the Manager's best estimate of where reserves stood after all operations on the final day of the statement week. It is hard to see how the Committee could avoid criticism if its targets were missed so much of the time.

The Committee could, of course, specify a single number rather than a range for free reserves, with the understanding, as the authors note, that the Committee would not expect the number to be hit with any precision. But if the Committee does not specify the limits of whatever range it has in mind, then the directive will not exhibit the increased degree of control over the Desk's operations that the authors apparently wish to achieve. If the Committee does formally specify those limits in discussion, but does not reflect them in the directive, daily operations would be subject to about the same constraints as if they were in the directive, with attendant disadvantages to the achievement of the Committee's broader objectives.

Some of the problems with reserve targets could be relieved if we had more current reporting of member bank reserve positions, and if the Desk had certain additional tools at its disposal, but I feel it would be a mistake to believe that close adherence to a narrow free reserve range is either possible or desirable. Given the varying nature of short-term demands for excess

reserves, both over time and as among different banks, I think it is desirable that free reserves should move flexibly up or down in order to accommodate the market's short-term preferences. Not that we should aim for perfect uniformity of money market atmosphere, but it seems preferable to me that variations in atmosphere should emerge as a result of an ebb and flow of market pressures, and not as an arbitrary result of a Federal Reserve fixation on a particular statistic.

The Case for the Current Form of the Directive

The present form of the directive has proved an efficient instrument, enabling the Committee to focus on policy making while insuring that the monetary machinery operates smoothly and efficiently. The directive is now the servant of the Committee rather than its master, as I believe would be the case under the new proposal. The Committee's deliberations are now concerned primarily with real policy issues rather than with the search for phrases. Inescapably, the language used to cover a broad consensus will itself be broad. The directive cannot be a clean analytic statement of the monetary process that will resolve satisfactorily substantive issues of causation--and the deficiencies of the Ellis-Mitchell-Swan proposal illustrate this clearly. Fortunately, the quality of the Committee's policy decisions does not depend on its devising a single, clearly articulated formula purporting to set forth a collective reasoning process.

One of the Committee's great sources of strength is its ability to assess repeatedly, at short intervals, the performance of the economy and the contribution of monetary policy to that performance. The Committee does not have to design an automatic pilot that will steer safely over an extended period of time. It is on the job following developments daily and, at intervals of only three weeks, making judgments as to the direction of needed

marginal adjustments in bank reserves. This does not mean that the Committee's deliberations cannot be aided by research efforts to improve our knowledge of the various interactions operating between economic and monetary variables. But the Committee is able to minimize the risks that would surely stem from conveying, through its directives, an impression that it possesses the undiluted truth about the monetary and economic world in which it operates.

The Ellis-Mitchell-Swan proposal does point up questions of substances that deserve the Committee's continuing attention. Efforts to quantify the linkages extending from reserves through financial variables to economic activity are all to the good, and periodic reports by the staff and discussions of these matters by the Committee could prove fruitful. Also more probably can and should be done in spelling out the implications of expected broad movements in GNP for the financial variables and the flows of funds with which we are most immediately concerned. These are matters, however, to which the Committee should be able to give attention outside the framework of the directive.