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January 4, 1971.

TO: Board of Governors

FROM: J. Charles Partee

Attached for the Board's consideration is a revised version of the proposed article describing the role of monetary aggregates and money market conditions in the FOMC's directives. In preparing the revision, Steve Axilrod took into account comments received from Board members as well as some from the staff.

Attachment

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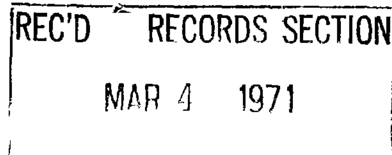

MONETARY AGGREGATES AND MONEY MARKET CONDITIONS IN OPEN MARKET POLICY

There has been widespread discussion over the past year or so as to emphasis given monetary and credit aggregates, as compared with such traditional operating variables as money market conditions, in the formulation and conduct of the Federal Reserve System's open market policy. This article discusses the role in the decision-making process of the Federal Open Market Committee (FOMC)[1/] and in the day-to-day conduct of open market operations of such monetary aggregates as the money supply and bank credit in comparison with other financial variables. Such aggregates are, of course, only one of many other financial variables, including interest rates and credit flows through nonbank institutions and the market directly, that are evaluated in monetary policy decisions. And financial conditions as a whole are evaluated against the underlying purpose of monetary policy--the encouragement of a healthily functioning economy, both domestically and in relation to the rest of the world.

The policy decisions of the FOMC are based on a full-scale evaluation by Committee members of likely tendencies in such critical economic indicators as output, employment, prices, and the balance of payments. In deciding on the stance of monetary policy, the Committee

1/ The Federal Open Market Committee is the statutory body responsible for open market operations (purchase and sale of U.S. Government securities in the open market), the most flexible and frequently-used instrument by which monetary policy affects bank reserves, bank credit, money supply and ultimately overall credit conditions. The FOMC consists of seven members of the Board of Governors of the Federal Reserve System, the President of the Federal Reserve Bank of New York, and four of the remaining eleven Reserve Bank Presidents serving in rotation. The Chairman of the Board of Governors has traditionally been elected by the Committee to serve as Chairman of the Open Market Committee.

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considers whether these tendencies in domestic economic activity and the balance of payments appear desirable, and, if not, how they might be influenced by changes in financial conditions--including the pace of monetary expansion, credit availability, interest rates--and by expectational factors. Once a policy stance is adopted, guidelines are set for the day-to-day conduct of operations in the open market. During 1970, somewhat more emphasis was placed on monetary aggregates --such as money supply and bank credit--in providing guidance for the day-to-day conduct of open market operations.

Since it has always been recognized that monetary policy has its effect through its influence on bank credit, money, interest rates, and financial flows generally, this greater emphasis on aggregates basically represented a modification of operating procedures rather than a change in the fundamental objective of policy. But under conditions of uncertainty--such as uncertainty as to the impact on interest rates of expectational factors or uncertainty as to the strength of future demands for goods and services--some emphasis on the aggregates helps guard against the potential that open market operations might end up supplying either too much or too little bank reserves, credit, and money as a result of unexpected and undesired shifts in, for example, demands for goods and services and for credit.

At the same time, however, an approach utilizing aggregates as one operating guide has to take account of shifts in the demand for money and liquidity at given levels of income. Such shifts that are relatively long-lasting would have to be accommodated by open market

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operations if financial conditions were not to become unduly tight or easy. And short-run, self-correcting variations in money and credit demands, too, would tend to be accommodated so as to avoid inducing unnecessary, and possibly destabilizing fluctuations in money market conditions.

Thus, in practice, allowance has to be made--in the formulation of monetary policy and in the guides to the conduct of policy--for uncertainties with respect to both the demand for goods and the demand for money. And trends in monetary aggregates, interest rates, and other financial variables have to be evaluated against the continuing flow of evidence as to the likely course of economic activity.

The FOMC's directives

The policy decisions of the FOMC are embodied in its current economic policy directive, voted on near the end of each meeting. This directive is issued to the Federal Reserve Bank of New York, which, because of its location in the nation's central money and credit market, undertakes open market operations for the Federal Reserve System. The directive is carried out by a senior officer of that Bank, who is designated by the FOMC as Manager of the System Open Market Account.

The form and content of the FOMC directive have changed over the years. Since 1961 the directive has contained two paragraphs. The first paragraph has contained statements about recent

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key economic and financial developments, and also a general statement as to current FOMC goals with respect to economic growth, price stability, and the balance of payments.[1/] The second paragraph of the directive contains the FOMC's instructions to the Account Manager for guiding open market operations in the interval between FOMC meetings. The second paragraph is, in essence, a highly condensed summary of

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1/ The first paragraph of the directive issued December 16, 1969 is quoted below for illustrative purposes:

> The information reviewed at this meeting indicates that real economic activity has expanded only moderately in recent quarters and that a further slowing of growth appears to be in process. Prices and costs, however, are continuing to rise at a rapid pace. Most market interest rates have advanced further in recent weeks partly as a result of expectational factors, including concern about the outlook for fiscal policy. Bank credit rose rapidly in November after declining on average in October, while the money supply increased moderately over the two-month period; in the third quarter, bank credit had declined on balance and the money supply was about unchanged. The net contraction of outstanding large-denomination CD's has slowed markedly since late summer, apparently reflecting mainly an increase in foreign official time deposits. However, flows of consumer-type time and savings funds at banks and non-bank thrift institutions have remained weak, and there is considerable market concern about the potential size of net outflows expected around the year-end. In November the balance of payments deficit on the liquidity basis diminished further and the official settlements balance reverted to surplus, mainly as a result of return flows out of the German mark and renewed borrowing by U.S. banks from their foreign branches. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.

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the Committee's conclusions as to the sort of operations that will be required to reach its longer-run policy goals. These directives are made public with a three-month lag, in a brief "record of policy actions" that also includes a resume of prevailing economic and financial conditions and of the Committee's discussion of policy implications at the meeting.

The nature of the operating instructions in the second paragraph of the directive has changed from time to time. Money market conditions have remained as important guides in determining day-to-day open market activity. Such conditions have generally been construed to include the net reserve position of member banks (excess reserves of banks less member bank borrowings from the Federal Reserve discount window), the interest rate on Federal funds (essentially reserve balances of banks that are made available to other banks usually on an overnight basis), and at times the 3-month Treasury bill rate. But since 1966, reference to money market conditions in the operating instructions has been more or less steadily supplemented by reference to certain monetary aggregates.[1/] The desired behavior of these aggregates has been given increased emphasis during the past year.

From mid-1966 through 1969 the reference to certain aggregates was generally to bank credit and was contained in a so-called proviso clause. The second paragraph of the directive

1/ There was also occasional reference to monetary aggregates in directives during the first half of the 1960's.

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issued on December 16, 1969 is illustrative:

> "To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing firm conditions in the money market; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections or if unusual liquidity pressures should develop."

In 1970, monetary aggregates came to play a more prominent role in the phrasing of the second paragraph, and money supply (currency and private demand deposits) was included along with bank credit. On March 10, 1970, the Committee's desires with respect to aggregates were stated more directly in the directive, and the FOMC dropped the earlier proviso clauses dealing with monetary aggregates. The second paragraph of the directive of that date read as follows:

> "To implement this policy, the Committee desires to see moderate growth in money and bank credit over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining money market conditions consistent with that objective."

The operating instructions in the second paragraphs of FOMC directives are not confined to money market conditions and a desired

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pattern of behavior in the monetary aggregates. The System Account Manager has also been directed to take account of Treasury financings, liquidity pressures, and the possible impacts of bank regulatory changes in his operations in the process of achieving satisfactory conditions in the money market and for monetary aggregates.

As the nature of economic and financial problems altered, so has the phrasing of the second paragraph of the directive. The second paragraph of the directive issued May 26, 1970, for instance, emphasized the need to moderate pressures on financial markets, and read as follows:

> "To implement this policy, in view of current market uncertainties and liquidity strains, open market operations until the next meeting of the Committee shall be conducted with a view to moderating pressures on financial markets, while, to the extent compatible therewith, maintaining bank reserves and money market conditions consistent with the Committee's longer-run objectives of moderate growth in money and bank credit."

The short-run bulge in bank credit expansion expected to result from the Board's action around mid-year in suspending ceilings on maximum interest rates payable by banks on large certificates of deposit in the 30-89 day maturity range was allowed for in the second paragraph of the directive issued by the FOMC on July 21, 1970, as follows:

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"To implement this policy, while taking account of persisting market uncertainties, liquidity strains, and the forthcoming Treasury financing, the Committee seeks to promote moderate growth in money and bank credit over the months ahead, allowing for a possible continued shift of credit flows from market to banking channels. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective; provided, however, that operations shall be modified as needed to counter excessive pressures in financial markets should they develop."

And in the directive issued August 18, 1970, an easing of conditions in credit markets was construed as an objective of open market operations parallel with desires with respect to monetary aggregates, as follows:

"To implement this policy, the Committee seeks to promote some easing of conditions in credit markets and somewhat greater growth in money over the months ahead than occurred in the second quarter, while taking account of possible liquidity problems and allowing bank credit growth to reflect any continued shift of credit flows from market to banking channels. System open operations

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until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective, taking account of the effects of other monetary policy actions."

The first and second paragraphs of all directives issued from December 16, 1969 through are listed in the appendix to indicate the variety of considerations that the FOMC takes into account in formulating its policy and framing its operating instructions.

Policy formation

The FOMC's basic concern is with the real economy, with production, employment, prices, and the balance of payments. But it must translate its broader economic goals into the monetary and credit variables over which the Federal Reserve has some influence. Thus, whatever emphasis is given to the financial variables which influence day-to-day open market operations, it is recognized that the immediate targets of day-to-day operations are not the goals of monetary policy, but rather that they are set with a view to facilitating the broader financial and economic objectives aimed at by the FOMC.

In setting its immediate operating targets, the FOMC necessarily reviews past and prospective relationships between financial conditions and economic objectives. A benchmark in this review is provided several times a year by a presentation by the staff to the

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Committee of an inter-related set of longer-run economic and financial projections. These exercises review in detail recent economic and financial developments, and trace out likely patterns of change in such measures as income, output, employment, prices, and the balance of payments for a period of about a year ahead. Provisional estimates are also presented of the flow of funds--including various monetary aggregates--and interest rates expected to be consistent with these patterns of economic development. The Committee uses these projections as a starting point for formulating its own view as to the likely and desired course of the economy.

A reappraisal of current tendencies in and prospects for economic activity and for financial flows and credit market conditions is presented to the FOMC by the staff on the occasion of each meeting. The written documentation includes a Greenbook, which summarizes current economic and financial developments and updates economic projections; a Red Book, which presents regional developments and certain types of qualitative information; and a Blue Book, which specifies likely relationships among money market variables, monetary aggregates, and interest rates broadly considered for the period ahead. In addition, oral staff reports highlight the key economic and financial developments that the Committee may wish to consider.

Most of the time at a meeting of the FOMC is given over to a free interchange of views by Committee members of their assessment of the economic situation and outlook. As the discussion proceeds,

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Committee members express themselves as to what they believe to be basic tendencies in economic activity, prices, employment, etc; as to how they appraise recent financial developments in relation to desired economic goals; and as to what steps might be taken through open market operations (or other policy instruments that interact with open market operations) to achieve financial conditions suitable to economic goals.

It may turn out, for instance, that most or all Committee members believe that economic prospects are deviating from those that had been previously expected and desired. The Committee may, in consequence, wish to modify its objectives as to money market conditions and desired rates of monetary expansion, so as to achieve overall financial and credit conditions more conducive to desired economic conditions. Or it may turn out that economic activity is developing about in line with expectations, but that this seems to be entailing a pattern of financial flows different from that originally expected. Or very possibly it may turn out that the relationship to broader financial flows and interest rates of the variables specified for the System Account Manager for purposes of guiding day-to-day open market operations is not developing as expected. Under any of these, or other conceivable, circumstances the FOMC could react by changing its operating instructions.

The operating instructions as written in the second paragraph of the directive are expressed qualitatively. But the specific

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variables involved--money market conditions and monetary and credit aggregates--are specified quantitatively (in terms of ranges, either explicitly or implicitly understood) in the discussion and in the Committee's consensus.

Over the past year, the operating instructions embodying the Committee's policy thrust have changed in two general ways. First, as has been noted, somewhat more emphasis has been placed on monetary aggregates as a target for open market operations rather than as an outgrowth of such operations. Second, the time horizon for a path of monetary and credit aggregates (in relation to money market conditions and other financial variables) has been viewed as encompassing several months or, expressed in calendar quarters, at least one quarter ahead. Longer-run paths provide the Committee with a means for focussing on the emerging trend of money supply or bank credit growth, while recognizing that over very short-run periods of a week or a month there may be irregular movements in rates of change in monetary aggregates as a result of erratic shifts in the public's demand for deposits and from such factors as Treasury financings, a large change in U.S. Government deposits, or reflows of funds from abroad.

Role of monetary aggregates

The somewhat greater use of monetary aggregates in the formulation and conduct of open market policy during the past year represents for the most part an extension of the trend of policy over the previous several years. It has always been recognized, of

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course, that the effects of monetary policy were through its influence on bank credit, money supply, interest rates, and financial flows generally. But the benefits that might be expected from an increased degree of emphasis on monetary aggregates in the conduct of open market operations relate to the question of the best method of monetary control under conditions of uncertainty. Greater emphasis on aggregates is consistent with a variety of economic theories and does not necessarily imply any particular judgment as to the importance for the economy of monetary flows relative to interest rates and credit conditions or relative to other influences such as fiscal policy and technological innovation. Operationally, however, by placing more emphasis on monetary aggregates in the instructions to the open market trading desk, there is greater assurance that unexpected and undesired shortfalls or excesses in the demands for goods and services in the economy, and hence in the demands for credit and money, will not more or less automatically lead to too little or too much expansion in bank reserves, bank credit and money.

Giving more weight to monetary aggregates means that, for example, if there were an unexpected and undesired shortfall in business and consumer demand for goods and services, the Federal Reserve would continue to provide reserves to keep monetary growth from weakening at a time when the public, with transactions demand for cash reduced, sought to invest excess funds in various financial assets. In the process, there would be a greater short-run decline of interest rates

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than would otherwise be the case. The drop of interest rates and easing of credit conditions would help to provide financial incentives to encourage a strengthening of demands for goods and services.

While increasing the emphasis on monetary and credit aggregates tends to increase the protection against undesired shifts in demands for goods and services, it at the same time runs the risk of reducing protection against unexpected shifts in the public's demand for cash and liquidity. Thus, for example, if the public comes to want to hold more liquidity relative to income than had been earlier assumed, failure to accommodate this by permitting a faster rise in the money supply would lead to higher interest rates and tighter credit conditions as the public sought to sell other assets to acquire cash. The tightening of credit conditions would tend to lead to a weaker GNP than desired. In contrast, the tendency toward tighter conditions could be averted if the Federal Reserve helped meet the desire for greater liquidity by increasing its purchases of financial assets (through open market acquisitions of U.S. Government securities) and thereby provided more bank reserves to support enlarged bank deposits and money supply and to help keep interest rates from rising.

In practice, allowance has to be made for uncertainties about both the demands for goods and services and the demands for

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money and liquidity. Opinions differ among professional economists as to the relative degrees of stability of these types of demand, and practical experience over the past several years suggests a good deal of variation in both. There have been periods when large increases in Federal Government purchases of goods and services and/ or in private sector demands for capital goods and inventories have caused marked shifts in overall demands for goods and services at given interest rates. There have also been periods, however, when liquidity strains, greatly increased financial transactions, and various international uncertainties have resulted in a sizable up-ward shift in the demand for cash and closely-related assets at given interest rates. Open market policy not only must take account of shifts in both the demand for goods and services and the demand for money and liquidity at given interest rates, but also must evaluate the extent to which such shifts are transitory or more permanent.

The late spring and summer of 1970 is an example of a period when liquidity strains in the economy--as typified by rising long-term interest rates at a time when economic activity was sluggish, the bankruptcy of a major railroad, and a general cautionary attitude on the part of investors toward securities, particularly commercial paper --were giving rise to considerable uncertainty and were threatening a marked erosion in confidence. Under the circumstances, the Federal Reserve in its operations stressed the need to moderate pressures on

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financial markets and to accommodate liquidity needs. The suspension of maximum ceiling rates on large CD's maturing in 30-89 days was part of the effort to reliquify the economy; in this case, banks were put in a position to compete for funds and to accommodate borrowers who were not, in the conditions of the time, able to refinance themselves in the commercial paper market, or were not able to do so without a bank loan commitment as back-up. Open market operations were conducted in such a way as to provide the reserves to sustain the very large increase in bank credit resulting from banks' renewed ability to obtain funds through issuance of certain large CD's. The FOMC's policy directives in that period (see directives of May 26 and July 21, 1970 on pp.7-8) tended to subordinate, temporarily, longer-run objectives for monetary aggregates to the shorter-run liquidity needs of the economy.

In general, in evaluating the appropriateness of particular operating guidelines at a particular time, the FOMC has to make judgments about the nature of the fundamental influences at work in the economy at that time. If, for example, interest rates were turning out to be higher, and overall credit conditions tighter, than expected for a given rate of increase in bank credit or money, the FOMC would have to make a judgment as to whether GNP was stronger than anticipated or whether the demands for money and closely-related assets had shifted at given levels of income and interest rates. This judgment would affect the type of adjustments made in operating instructions--for

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instance, whether or not to change the targets for aggregates and/or whether or not to put more stress on money or credit market conditions.

In looking toward a desired longer-run growth rate in monetary aggregates, the FOMC has focussed on money and bank credit in its operating instructions. The concept of money referred to for these purposes has generally been the so-called narrowly-defined money supply--currency in circulation outside the banking system plus demand deposits other than U.S. Government and domestic interbank deposits. But the determination of what rates of growth may be desired for this concept of money takes into account not only what is happening in credit markets but also the rates of growth in other assets held by the public that are closely related to narrowly-defined money as a store of value and as a source of immediate liquidity.

A number of broader money supply, and liquidity, concepts have been utilized by economic analysts in relating money supply to economic activity. These include, in addition to the narrowly-defined money supply (currency in circulation plus demand deposits other than interbank and U.S. Government) a concept, sometimes called M_2, which adds time and savings deposits other than large CD's at commercial banks to narrowly-defined money; a concept, called M_3, which adds in deposits at mutual savings banks and savings and loan associations as well; and a concept called M_4, which adds in large marketable negotiable CD's issued by banks. These concepts can, of course, be broadened by adding in other money-like assets, such as short-term securities. Annual, quarterly, and monthly rates of change over the past year in the four

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concepts of money noted above are shown in the table below.

(Table: Four Measures of Money)

As can be seen, the rates of change for the various measures can diverge noticeably and show a high degree of fluctuation over the short-run. Differential tendencies in the various money and liquidity measures have in large part been the result of sharp shifts of funds by the public between deposits and market securities when market interest rates moved above and then back below ceiling rates on banks and thrift institution deposits. But divergent movements, particularly in the short-run, often develop even when ceiling rates are not a disturbing element, and this highlights the need to evaluate a variety of money and liquidity measures, among other things, in evaluating the impact of monetary policy on the economy. Moreover, the relatively larger month-to-month variations in growth for any particular money measure--and variations are even larger week-to-week--emphasize the need to evaluate data over a relatively long period of time in judging the underlying tendency of the series.

In addition to money supply, the second paragraph of the directive has also emphasized bank credit. Measured from the liability side, such credit would encompass the money supply defined as M_2 above (except currency) but would also include funds obtained by banks through large time CD's, U.S. Government deposits, interbank deposits and from nondeposit sources such as Euro-dollars and commercial paper issued by bank-related affiliates. The sum of these deposits and nondeposit

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Various Measures of Money, Rates of Change
(Per cent change, seas. adj. annual rate)

Monthly, 1970	M_1 (currency plus demand deposits1/)	M_2 (M_1 plus comm'l bank time deposits other than large CD's)	M_3 (M_2 plus deposits) at S&L's and mutual sav. banks	M_4 (M_3 plus large CD's
January	9.4	2.8	0.4	-0.8
February	-4.1	-1.6	--	--
March	12.3	9.3	8.4	10.0
April	9.9	10.8	9.9	12.5
May	5.2	7.3	6.6	7.1
June	2.3	7.0	7.0	6.8
July	5.7	9.9	11.1	18.1
August	6.8	12.2	10.0	13.8
September	5.7	10.6	10.5	15.3
October	1.1	7.3	8.5	11.0
November	2.8	7.3	7.9	8.9
December				
Quarterly, 1970				
1st Quarter	5.9	3.5	2.9	3.1
2nd Quarter	5.8	8.4	7.9	8.9
3rd Quarter	6.1	11.0	10.7	15.9
4th Quarter				
Annual				
1969	3.1	2.3	2.7	0.4
1970				

1/ Demand deposits other than interbank and U.S. Government.
NOTE: Monthly rates of change based on the daily average levels outstanding. Quarterly and annual rates of changes measured from daily average levels outstanding in end-of-period months.

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sources measures the so-called adjusted credit proxy, which provides a measure of bank credit available currently on a daily average basis for the guidance of the Account Manager.

Inclusion of bank credit in the directive might be considered as recognizing a broader concept of money, since time and savings deposits at commercial banks are a key source of bank credit. In addition, however, it recognizes that bank credit is a key component of total credit availability and one that is immediately sensitive to open market operations.

The amount of bank credit that the FOMC is willing to encourage or to countenance depends, like the money supply, on overall economic and financial conditions. When, for example, banks have been unable to increase time and savings deposits for an extended period because interest rate ceilings on time deposits were unrealistically low relative to market rates, it would be expected that outstanding bank credit would grow very rapidly for a while once ceiling rates again became viable. This growth would represent mainly a shifting of credit flows from market to banking channels as banks sought to restore their previous competitive position and as the public restructured its financial asset portfolios to reflect the changed yield relationships. Federal Reserve open market operations could provide the reserves necessary to sustain the shift in the public's ability and willingness to hold time deposits relative to other assets. The chart below shows monthly changes in bank credit, as measured by the adjusted credit proxy, along with total bank reserves.

(Chart: Bank reserves and credit; ratio scale)

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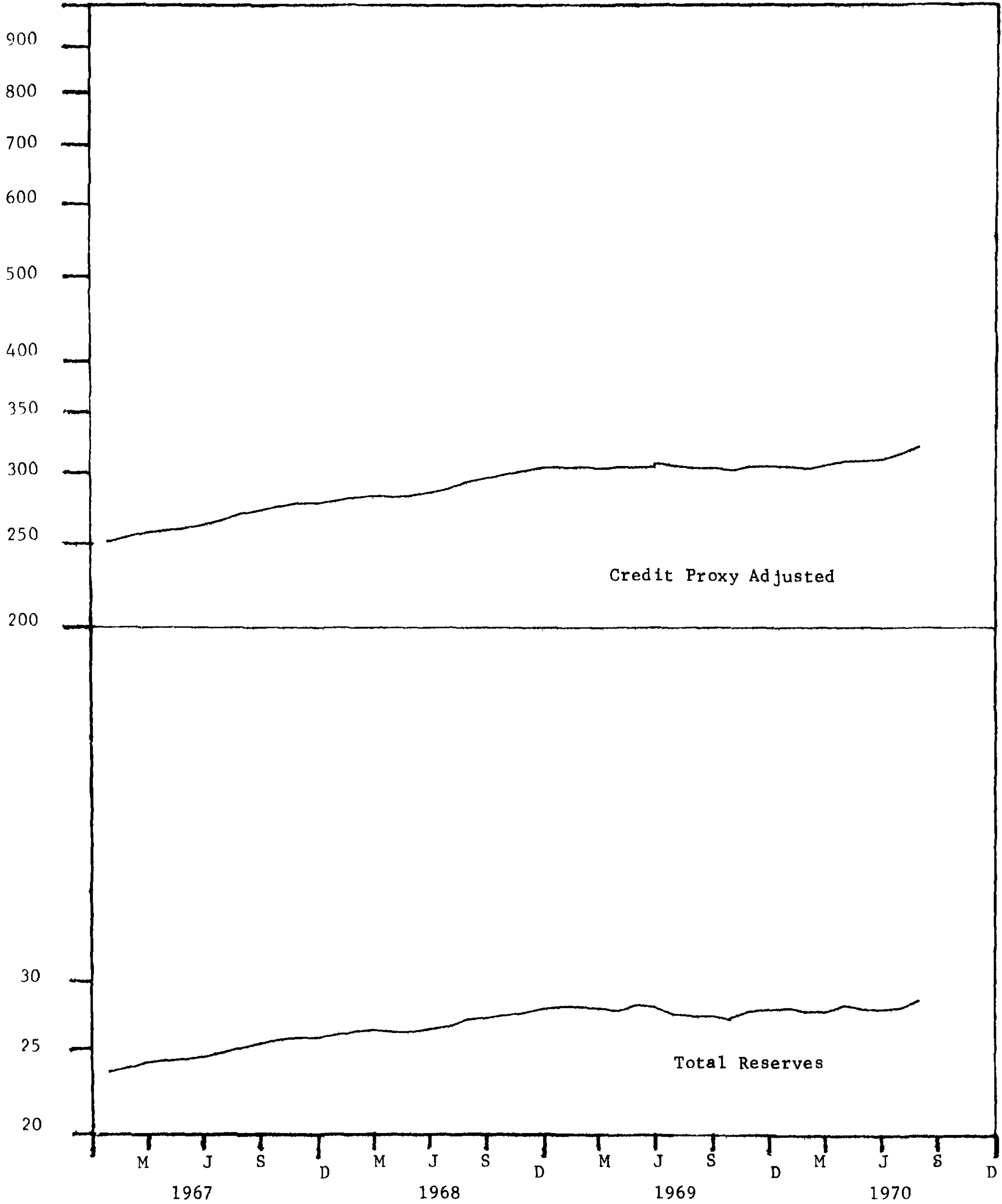

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Day-to-day open market operations

The day-to-day operations in the market by the System Account Manager have continued to be guided mainly by money market conditions partly because information avalable daily and continuously as to the state of the money market--for example, the Federal funds rate and dealer loan rates--reflects the interaction of demand for and existing supply of bank reserves and thereby provides a basis for making daily decisions as to whether the System should or should not be in the market providing additional or absorbing existing reserves; and, if so, by how much and through what means. But the degree to which the Manager seeks to influence money market conditions has been affected by the relationship that is presumed to exist at any given time among money market conditions, reserves, and the monetary aggregates and by the Committee's desires with respect to monetary aggregates and overall conditions in the credit market.

Not all changes in money market conditions, of course, reflect efforts to influence reserve flows in accordance with targets for monetary aggregates. Some changes in money market conditions simply reflect shifts in reserve distribution among banks. Others represent the short-run effects of bulges in demand for day-to-day credit at times of Treasury financings or in tax payment periods. Yet others represent unanticipated, virtually random changes in technical factors--such as float or currency in circulation--that supply to or absorb from the market more reserves than was either expected or seemed likely to be sustained.

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In carrying out operations, the System Account Manager takes into account the relationship between money market conditions and trends in bank credit and money that has prevailed in the recent past and the relationship that is expected to develop in the future. He may begin a statement week by conducting his operations to aim at a condition of tightness or ease in the money market roughly similar to that of previous weeks.[1/] This would mean that such variables as member banks' net reserve position, member bank borrowings from the Federal Reserve, the Federal funds rate, and dealer loan rates would generally tend to fluctuate within the range of recent experience--although there may be special, sometimes unforeseen developments (such as a mail strike) which may cause marked short-run changes in money market conditions.

If and as it becomes evident that monetary aggregates are running above or below desires, however, the Account Manager may aim at correspondingly tighter or easier money market conditions. Also, if it turns out that the apparent new relationship was not long-lasting, the Account Manager may have to reverse the direction of operations. Thus, to the extent that monetary aggregates are given more emphasis in the operating paragraph of the directive, money market conditions may be subject to a somewhat greater degree of fluctuation.

While the counterpart of greater sensitivity to monetary aggregates would be a somewhat greater tendency for actual money market conditions to change more frequently than otherwise, sharp short-run

1/ Factors affecting day-to-day operations are explained in more detail in A. R. Holmes' "A Day at the Trading Desk", Monthly Review of Federal Reserve Bank of New York (October, 1970).

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shifts in money market conditions are not likely to develop, partly because the FOMC is concerned with the state of money and credit markets as well as with tendencies in monetary aggregates. There are a number of reasons for the continuing role of money market conditions as a day-to-day guide for open market operations.

First, the money market reflects the pressure of demand for liquidity, and the nation's central bank has a unique responsibility for seeing to the maintenance of orderly conditions in such a market.

Second, there are large and often unpredictable week-to-week and month-to-month swings in the economy's demand for money and bank credit. These demands are often self-correcting, and as a result there is little need to encourage the sharp fluctuations in money market conditions, and perhaps in credit markets generally, that are likely to develop should the flow and ebb of these demands not be accommodated through operations affecting bank reserves.

Third, because of the key role of the money market in reflecting quickly shifts in the need for and availability of liquid funds,

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presumably in large part as a result of the interaction of the public's spending decisions and monetary policy, sharp shifts in money market conditions may be interpreted by market participants as a harbinger of relatively permanent changes in credit demand or monetary policy. Investors, businessmen, and consumers may vary their credit and perhaps economic outlook in response to the money market in the degree that it is taken as a signal of events to come. This prospect itself counsels caution in undertaking open market operations that lead to large short-run changes in money market conditions until it is fairly certain that longer-run tendencies in money supply, bank credit, and over-all credit conditions require it.

While there are reasons for emphasis on money market conditions, it should be stressed that money market conditions are only instrumental to the attainment of the main financial objective of policy--flows of monetary aggregates and over-all credit conditions. The day-to-day operations of the Account Manager, and their effect on the money market, are made even more complex by awareness that the FOMC generally has in mind not only some view as to the desired longer-run trend in monetary aggregates but also a view as to associated desirable credit conditions. These two desires may sometimes turn out to be in conflict; for example, monetary aggregates may be rising more rapidly than desired while credit conditions may be tightening more than desired. Meeting one desire by holding back on the provision of reserves in order to restrain growth in bank credit and money would tend, at least temporarily, to defeat the other desire by leading to even more tightening credit conditions. Under the cir-

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circumstances, the Account Manager would have to adjust his operations --thereby affecting day-to-day money market conditions--in line with whatever sense of priority among objectives has been given by the FOMC.

While the whole set of objectives would be reconsidered at the next FOMC meeting, the Account Manager's operations are monitored daily through a morning call. This call involves the Trading Desk in New York, senior officials on the staff of the Board of Governors in Washington, and one of the Reserve Bank Presidents who is a voting member of the FOMC. In this call the Manager lays out his program for the day, and the program, or possible alternative approaches, are discussed. As part of this process, not only are current figures on bank reserve positions, money market conditions, and credit conditions more broadly reported, but also information on the latest deposit figures and how these compare with FOMC desires is continuously appraised.

In general, as the FOMC's objectives with respect to monetary aggregates, and also overall credit conditions, have been given increased stress in the directive to the Account Manager, the timing and extent of the System's day-to-day open market operations have, of course, been altered, with consequent effects on day-to-day money market conditions. At the same time, the Account Manager still takes account of the emerging tightness or ease in the money market as a factor affecting the timing and extent of day-to-day open market operations. But this emerging tightness or ease is evaluated against the trend of money, bank

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credit, and overall credit conditions which are, and always have been, among the basic financial objectives of monetary policy.