For release on delivery
6:30 p.m., February 27, 1974

MANAGING MONETARY POLICY

Remarks by

Robert C. Holland, Member

Board of Governors of the Federal Reserve System

before

The Money Marketeers

of

New York University

New York, New York

February 27, 1974

MANAGING MONETARY POLICY

I am glad to be with you this evening, and to join in a discussion of the process of monetary policy-making. I must admit to a feeling that any speaker talking about anything but energy these days runs the risk of sounding anticlimatic, if not downright irrelevant --but if you are willing to run that risk, so am I.

I have chosen my topic--Managing Monetary Policy--with some care. I know that some monetary critics would regard that phrase as a kind of contradiction in terms. There are those who would aver, so to speak, "that monetary policy manages best which manages least." But for the institutional optimists among you who have faith in the discretionary management of the Nation's monetary affairs, I want to make some general comments concerning how the Federal Reserve is managing its monetary policy.

It is certainly no news that our central bank's policy-making processes have changed over time. Skilled Fed watchers are continually calling the public's attention to this or that observed new shading of Federal Reserve activities. And in the judicious language of our own numerous reports and statements, we endeavor to render due account of our policy-making. What sometimes can be lost sight of, however, in the concentration on the substance of policy changes and on the latest nuance of our monetary actions, is the broad framework of the decision-making process which we have currently evolved. In practice, we have developed an integrated, systematic application of a particular type of decision theory across the whole range of our actions in the field of open market operations. I would like to call your attention to that decision-making system this evening.

Let me say it once that this scheme is not some grand design, conceived *a priori* in all its current detail and introduced in one fell swoop. Rather, partly it is a product of deliberate fore-thought and application of theory; partly it results from *ad hoc* adaptations to deal with practical operating problems; and partly, like Topsy, it "just grew." Nonetheless, the end result has been the evolution of a consistent system of decision-making that deserves your consideration.

Basic to the system are certain fundamental assumptions about monetary behavior. These can be thought of as current economic convictions of the majority of Federal Reserve policy-makers, which in part have been validated by empirical studies but which also to some extent reach beyond the bounds of what scientific study has yet been able to prove to the satisfaction of all concerned. First, we believe money matters, but that more than money matters. That is, we believe that the aggregate volume of the means of payment has an important and pervasive influence on the pace of economic activity in this country. We also believe, however, that other monetary magnitudes, such as the volume of time and savings deposits and the flow of credit, exercise an economic influence, and that the same is true with respect to interest rates and other terms and conditions surrounding the extension of credit. The relative significance of each of these variables is thought to vary from time to time, depending on changing environmental circumstances. Moreover, all the causation is not regarded as running in one direction; while these variables do exert causal influences on economic activity, there are also causal forces flowing back from the level and changes of gross national production _et al_ that are at work shaping the performance of the above-cited financial variables. Thus, the observed behavior of monetary variables is partly a cause and partly an effect of the Nation's broader economic developments.

Next, we are persuaded that the lags in the causal influences of monetary aggregates on economic activity are fairly long, and rather variable. While the duration of such lags obviously differs from one set of circumstances to another, they must be thought of in terms of a number of months, at least, and some important influences take one or more years to work through the system.

A corollary to this principle is that short-run variations in monetary aggregates--from one week to the next, or from one month to the next--have no significant influence on GNP so long as those differences are averaged out over a reasonable span of months. We collect and publish weekly numbers on monetary magnitudes in order to provide an adequate series of observations for analysis, but we would encourage every user of these data not to build his or her interpretation of monetary developments upon any one or few such observations.

I think we likewise believe that the fundamental influences of interest rates on the course of overall business behavior usually take at least some months to work their way through the economy.

On the other hand, our experience with financial markets leads us to believe that short-run variations in interest rates, if sharp enough, can have disruptive effects on the functioning of financial markets. To illustrate with an extreme example, I would not expect a 3-month Treasury bill rate that averaged 10 per cent in one week and 5 per cent in the next to produce any up-and-down influence in GNP that was visible to the naked eye; but it would not surprise me if such an interest rate oscillation produced no little consternation and some financial strain among a number of participants in the money market. While both gains and losses would ensue on the myriad of related financial transactions taking place in those two weeks, the ability of individual firms to bear the losses inflicted would be limited, and the disturbances they felt would be registered accordingly. It is such considerations that lead the Federal Reserve to believe it wise to try to conduct its operations so as to moderate wide short-run swings in money market conditions while at the same time aiming for average reserve and credit conditions over the somewhat longer run that would generate the desired overall influence in economic behavior.

Drawing on this whole family of assumptions concerning financial behavior, the Federal Reserve has evolved its current decision-making processs for open market operations. For each of the key stages of decision-making, our staff develops projections of future performance. Each of these projections extends far enough into the future to encompass the observable effects of the Federal Reserve action being contemplated. One projection will almost always describe the future economic or financial developments thought most likely to occur, but careful attention is paid to chances for variation from that outcome, and oftentimes alternate projections are made based on differing monetary policy assumptions. Fed decision-makers will review those projections and may revise them according to their own best judgments, and then will formulate policy directions which are thought to be conducive to the most optimal outcome.

Thereafter, as our implementing operations get underway, our staff will monitor developments closely to see if any significant deviations from projections begin to emerge. If deviations should appear their likely implications are reviewed, and whenever it is thought necessary the appropriate System authority adjusts its policy instructions or implementing actions accordingly.

We are often very pragmatic in the adjustments which we make. Sometimes we may try to alter our actions enough to reverse the deviation; sometimes we will only try to moderate it; and sometimes we will decide that the projection was non-optimal and we will replace it with a new and more realistic version.

Our projections themselves are arrived at partly quantitatively and partly qualitatively. They all are an outgrowth of statistical analysis. Some of the projections, both long-run and shorter-run, go so far as to incorporate results from fairly complex econometric model-building. But most of them also have a healthy component of qualitative judgment injected. The subjective sense of developments that a well-trained and well-informed analyst can bring to bear is a valued ingredient in our projections. He or she has a better chance than any econometric model of detecting what is new in the frequently changing relationships among variables.

The Federal Reserve employs this system of projection-and-response-to-variation at each of its major levels of economic analysis. In considering our ultimate policy targets of output, employment and price performance, we make use of projections of gross national product and related economic and financial measures that often stretch out for a year to eighteen months ahead. We make more detailed projections of what are popularly termed the intermediate-term targets of monetary policy, namely, monetary aggregates and interest rates. We project such measures over periods ranging from as short as one week to as long as a year and a half. Special attention is given to the average expected values for those series over the next several months, for that represents the financial climate that the Federal Reserve can aspire to change with significant ultimate effect on the underlying trend of economic activity.

Finally, various groups within the Fed staff make detailed day-to-day and week-to-week projections of what we regard as our short-run operating variables --various components of bank reserves and related money market conditions. These are, in effect, the chief operating levers by which the Federal Reserve applies its pressure in order to alter financial and economic conditions.

When properly done, all of these projections are consistently related. It is the staff's responsibility to signal to the policy-makers promptly when a significant inconsistency or deviation from projections is seen to develop.

The appropriate parts of this formidable hierarchy of projections are brought into play at each stage of Federal Reserve decision-making. The most important single arena for review of projections is the regular monthly meeting of our major policy-making group, the Federal Open Market Committee. For each such meeting, the entire spectrum of projections is updated. Staff experts are quizzed as to the causes of deviations from the projections of the previous meeting and the implications of such deviations for the future. The Board Members and Federal Reserve Presidents around the table are free also to advance their own personal interpretations on these questions. Oftentimes debate is protracted. At its conclusion, there will have been thrashed out a set of projected objectives of acceptable ranges of values for the various short-run and intermediate-term monetary variables which the Open Market Account Manager is supposed to try to bring about in the coming weeks.

With this guidance, the Manager returns to his Trading Desk at the New York Fed and goes to work. His staff supplies him with day-to-day projections of the variables he can influence which are expected to foster the kind of results the full Committee endorsed. When skill and luck are present in the proper proportions, he is able to return to the next Committee meeting a month hence and report that all the Committee's objectives have been attained. When--as can happen--everything does not go according to plan, and one or more key variables are performing in a way significantly at odds with the Committee's wishes, the Manager consults with the Committee Chairman. Analyses of the probable causes and consequences of the deviation are pored over, and if need be the full Committee is asked to review and revise its objectives and instructions. This kind of reappraisal is engaged in as often as needed in order to keep monetary policy attuned to the onrush of events.

As I said in the early part of my remarks, this kind of procedure did not come into being overnight. To some extent it is a product of foresight and hypothetical analysis; and to some extent it results from painful "trial and error" experience.

We are continually trying to improve the process, often by small technical adjustments and occasionally by broader-gauge retrospective and prospective studies. You have seen the results of some of the latter types of efforts in the published studies of various subcommittees of the Federal Open Market Committee which have been established from time to time. The latest such subcommittee effort, which I happen to be chairing, is now underway; we hope that it, like its predecessors, can add further to the effectiveness of monetary policy-making.

I do expect that any proposed changes in our policy-making procedure will build upon the decision system of projection-and-response-to-deviation that I have outlined tonight. That system, while still in some respects experimental, has in my judgment proven its worth. One of its key features is that it keeps policy-makers aware of the probable consequences of what they have been doing and of what they contemplate doing. It helps us learn from our mistakes as well as our successes. And it is a stern disciplinarian of the temptations to procrastinate and to rationalize that can come to any organization, public or private. In sum, I believe it is a decision system that can help the Federal Reserve to keep improving its own performance--and if we can succeed in that endeavor the public interest will surely be served.