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Monitoring Monetary Policy

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Monitoring Monetary Policy

Monetary policy deals most directly with banks, financial markets, credit flows and interest rates. To monitor its course, its ebbs and flows, one should, therefore, observe the state of banking and the tone of the money and capital markets, noting the flows and yields on funds that the economy is using.

J. P. Morgan once voiced the best forecast ever made for a financial market. "It will fluctuate!" was his prediction. No doubt many of you, drawing on recent experience-hardened judgment, would be willing to add some impressive dimensions to that cautious platitude. For recent experience has driven home anew to all financial officials two expensive lessons: not only can prices and yields in our money and financial markets fluctuate--they have fluctuated, and very widely on occasion. Further, these fluctuations, whether within the day, the month, or the year, are extraordinarily difficult to predict and, thereby, to anticipate when portfolio decisions are made.

Security prices necessarily mirror the changing flows in the demand for, or supply of, credit funds. But as a practical matter, these changing demand and supply influences are only inadequately and tardily apprehended by present-day public economic intelligence systems.

As a consequence, every shred of additional public and private evidence about money flows is sought by professional market participants and reporters of the financial press at the earliest possible moment. Their purpose is to evaluate such evidence in the least possible time and to inform their principals, clients or the financial community at large, and thus to aid portfolio managers in establishing market positions from which profits are most likely to be maximized or losses to be minimized.

These analysts must also have a feel for the general course or trend of the "real" economy--whether it is expanding, stagnant or receding, whether it has under-utilized manpower and capital resources or is fully employed, whether it suffers from inadequate demand and hence is subject to deflationary tendencies, or whether from excessive demand and so is experiencing inflationary pressures.

In attaining their ends, financial managers rely on a wide range of financial instruments and maturities and the arbitraging mechanism of money and capital markets. In doing so, they try to anticipate security price and yield changes and trends as closely as possible.

One of the elements in understanding the operation of this very complicated financial system is the role of the Federal Reserve. That role is to serve as a marginal source of supply of market funds--to a small extent directly in the Government securities market, but to a much larger extent indirectly, as commercial banks pyramid their loans and investments and deposits on the basis of the reserve credit which the System has furnished. Accordingly, what the Federal Reserve is doing by way of supplying funds or what will it do, under some assumption of market conditions, is a common query among professional traders and speculators. Even a few small, innocent-appearing clues can give the knowledgeable market participant a "leg up" on his less well-posted counterpart.

Over the years the System has developed a method of communicating with the market which is as straightforward, accurate and objective as quantitative relationships can make it. It is a "you see it as we do it" policy. A weekly financial statement is released to the public every Thursday afternoon, showing

a detailed breakdown of System assets and liabilities as of the close of business the preceding Wednesday. These statements are supplemented by weekly and monthly releases, reporting changes in aggregate commercial bank assets and liabilities. From these data one can ascertain if the System is replacing gold with bills or bonds; if it is expanding or contracting Reserve Bank credit and commercial bank reserves; to what degree the discount window is being used; how the banking system is responding to available investing opportunities, and so forth.

Now it is true there are no adjectives, no judgments and no explanations of present actions or inaction in these financial statements and reports; nor are there tips, predictions, threats or promises of future action. Nor, given our present state of knowledge, does it seem desirable or appropriate that there should be.

The time may come when analytic capacity built into a commodious computer will enable market analysts to identify, quantify and date the demands for and supplies of goods and services and flows of funds, and to work out the effect of arbitraging time and market alternatives. Such a program might also assimilate the feedback from alterations in future business and financial expectations and indicate an appropriate course for monetary policy. When, and perhaps if, operations research practically achieves this control over the data and accompanying business and financial decisions, I have no doubt it can also reveal the current shade of tightness, ease, or neutrality in monetary posture to market participants and further suggest what the Federal Reserve ought to be doing next. This is probably as close to functional obsolescence as either monetary or portfolio managers would ever care to get.

Regardless of what the future may make possible by way of communication between the Federal Reserve and market participants it seems clear to me that the present flow of quantitative data on current banking operations, and the economy generally, provides enough information, supplemented by occasional interpretive comments, for professionals to function effectively within tolerable limits of financial risk. And most of these quantitative facts can be made available without prejudicing to a significant degree future monetary policy decisions.

Two additional types of information are frequently sought from the participants in money management: one has to do with the rationale of current policy--what are the economic factors and assumptions with respect to financial behavior that underly current policy? The other has to do with the likely course of future policy. Not only the Federal Reserve System but central bankers everywhere have continuing difficulty with these informational requests.

Historically, the solution to both types of questions at most central banks has been "no comment" and the prevalence of this policy gave rise to the tradition of "tight-lippedness" which has long been associated with central bankers. The Federal Reserve, in its annual reports to Congress, in hearings before Congressional Committees, and in the official records maintained on meetings of the Board and Federal Open Market Committee has endeavored to provide as complete a record of policy decisions and considerations leading up to them as is practicable.

The policy record in the Annual Report, for example, carefully summarizes the economic and financial background of each action taken. No written document, however, can accurately record why each of seven Governors on the Board or each of twelve members of the Open Market Committee voted for a given course of action.

The reasons enumerated are relevant but unweighted. The assumptions with respect to linkage among monetary variables are often vaguely stated because the state of our economic, financial and monetary knowledge does not, at times, permit greater precision. Semantic compromise unavoidably runs all through the record, not only because the same words have different meanings to different people in the unexact business of monetary management but also because decisions have to be made and semantic compromises are of less consequence than substantive concessions.

Reasons are important and it is reassuring to be able, in retrospect, to know that the monetary managers were often right for the right reason. But it must always be borne in mind that our facts are sometimes limited or our theoretical framework for certain situations deficient and, under these circumstances, rather than be wrong it is better to be right for the wrong reason and admit that intuition, "market sense" or luck saved the day.

The informant who alleges he has an inside look at a central bank's prospective monetary posture is convicted by his own ignorance. However he comes by his information it can hardly include all the caveats, the qualifications, and amendments needed to raise gossip to the level of speculation. As monetary policy is made today, no one knows how soon or how much economic events, financial conditions, or expectations will modify the current thrust of policy. Monetary management works through markets and decisions that are exceptionally sensitive to changing environment. As a consequence, monetary management itself is exceptionally flexible and responsive to market conditions and psychology; it could hardly be otherwise.

My remarks have been directed at communications with the business and financial community. The related problem of communication with the general public, not covered here, is certainly no less important. However, that problem does not seem to me to involve the same measure of technical difficulty. The public's concern is mainly for a timely and certain understanding of the broad and evident thrust of System policy. This is readily met by the System's official announcements and press releases and from the wide coverage of monetary developments in the nation's news media.

Some monetary analysts say that the best view of the changing monetary scene does not come from observing the tone and feel of the money and capital markets, or from following the trend and churning of interest rates. Nor, they say, can it be found by sifting through the masses of daily, weekly or monthly banking data, however carefully and selectively. Among these observers are a few who contend that it does little good to listen to what the Federal Reserve says or thinks it is doing because its methods of communication are too often too obscure. And coming to the end of the line, there are those who believe that the System itself is unaware of its monetary moves and, hence, can hardly describe them adequately to others.

To what monetary monitoring measures do these analysts (and others) look for an indication of the direction and force of monetary policy? Among the measures used none is more widely observed, if not deified, than changes in the active money supply--(currency and demand deposits)--and which for convenience I will call M-1.

As a measure of monetary action, M-1 has a long tradition in theory and academic respectability. It is simple to understand, to compute, to graph.

It is verifiable and has the ring of authenticity. And even for those who do not accept the quantity theory of money, it can be a good first or second approximation to variables they regard as more significant. It is theoretically plausible if not over-exposed to a close examination of its quantitative and generative relationship to goals sought by the monetary authority. Moreover, it has variants devised by disciples who probably have actually improved the original gospel, or at least better adapted it to our present financial structure and system.

One of these variants, which I will call M-2, adds time deposits at commercial banks to the currency and demand deposits included in M-1. Impressed with the fact that there is little to distinguish time deposits at commercial banks from shares at savings and loan associations, deposits at mutual savings banks or short-term money market instruments, other students have suggested that the relevant definition of money should cover a whole family of near-money aggregates. Thus, they would extend the definition to include some or all of deposits in savings and loan associations, mutual savings banks, credit unions, policy loans at insurance companies, short-term marketable securities of the U.S. Government and its agencies, short-term municipal securities, short-term corporate securities, Euro-dollars, and so on. We can refer to the broadest of such definitions as M-x.

These expanding definitions of money share, to decreasing extent, a characteristic that only money, narrowly defined, has to the nth degree, that quality so essential for transactions use--namely, instant liquidity. And near-monies which more and more have taken over the store of value function of money can usually be converted into M-1 without delay or significant loss. It is the

ability of our intermediaries and security markets to effect such conversions that imparts monetary significance to M-x.

Without any doubt, recent years in the United States have seen an enormous shift from the use of money narrowly defined (M-1) toward the use of money broadly defined (M-x), i.e., including income-yielding financial assets or time deposits. This conceptual shift is evident in the financial management of individuals, corporations, and governments. At least in the United States, money in the narrow sense of the word is being reduced closer and closer to the simple role of a transactor or medium of exchange. And this trend is about to be greatly accelerated by the computerization of the entire money settlement process.

The over-all statistics of money stock and money use have long revealed an economizing trend. Today, turnover of private demand deposits in New York City metropolitan area is twice weekly, more than double the levels prevailing in a period of high economic activity a decade ago. In six other large financial centers, current turnover rates are once a week and up 80 per cent over the past decade. In 200-odd other reporting metropolitan areas, turnover is roughly 34 times per year and up 50 per cent over the mid-fifties. The very high levels of turnover in New York and other major centers are a reflection of a large volume of financial transactions. But the increases in rates of turnover in all centers are a manifestation of closer money management by banks' customers, including increasing readiness to invest idle balances in interest-earning instruments.

On the other hand, liquidity, the non-transaction characteristic of money, is becoming an increasingly important feature of the stock-in-trade of financial intermediaries and a broadly-based resilient money market. Inevitably

these markets and institutions will increasingly become the evident target of monetary action.

Turning now to the 1966 experience with money supply as an indicator of monetary action, let me illustrate some of the practical difficulties of using M-1 or M-2 as a chief monitor of monetary trends.

Changes in M-1 most directly mirror the combined effects of changes in the economy's demand for money--especially in recent years for transaction purposes--and the Federal Reserve's policy with respect to supplying the reserves for bank credit and monetary expansion. But the mixture of significant and insignificant influences at work on M-1 do not trace out any simple pattern. Distracting movements in M-1 of the order that produce large annual rates of change derived from weekly or monthly data often arise from unexpected seasonal fluctuations, erratic changes in velocity, and shifts between the private money supply and the Federal Government's demand deposits in commercial banks. In the background of economic and financial developments in 1966 affecting changes in M-1 are changes in the timing of personal and corporate tax payments, wide fluctuations in the Government's balance for reasons having a non-symmetrical effect, and, in addition, a sustained tightening in monetary policy. All of these recent shifts, I might add, make it increasingly difficult to discern seasonal from non-seasonal movements.

It is of some help in explaining the behavior of M-1 in 1966 to ignore the changes in currency and coin in circulation, which have been rising about \$2 billion annually for the past four years and whose seasonal fluctuations are stable enough to be reliably adjusted. The remainder--the seasonally adjusted demand deposit component of M-1--was stable in the first 10 weeks

of 1966 at about \$131.5 billion. Around the March 15 tax date it rose about \$1 billion and around the April date another \$1.5 billion, hitting a peak of \$134.0 billion in a week when the U.S. Government deposits were at their lowest point of the year (thus far). Early in May, demand deposits settled back to \$133 billion, rose briefly but sharply after the June 15 tax date and have been in the range of \$132-\$133 billion ever since (early October).

This record, as it developed during the year, was, by some observers, first assailed as highly inflationary when the temporary bulges around March, April and June tax dates appeared. It was later assailed as dangerously deflationary when August levels were compared to the last-half June peak. Since August, demand deposits have risen somewhat in addition to the September tax period bulge; they are now above the June level.

In retrospect, and considering the transitory factors at work (i.e., the frictional affects of changes in the Government balance and tax payment schedule changes), it appears M-1 has increased very modestly during the year and that such variations as were thought to indicate sharp changes in policy direction were simply manifestations of temporary aberrations that took some time for the market to adjust out. It should be obvious that the very slow growth in M-1 has been one of the signals of a steadily tightening monetary policy throughout the year.

If one shifts the spotlight to M-2--the money supply plus time deposits--the combined effects of varying economic demands and monetary restraint are still clear, but the timing and magnitude of the changes are quite different from those shown by M-1. This is not in the least surprising, since M-2 incorporates the results of the banking system's competitive efforts to attract time funds from

other intermediaries and from the money and securities markets, as well as the modest incidental effect of such competition in pulling down the aggregate of its own demand deposits.

During the 1960s and until recently, the banking system has been spectacularly successful in the game of intermediation. The growth in its time aggregates averaged about 15 per cent per year. The time deposit component of M-2, therefore, has been a robust element indexing the competitive success of the banking industry--but hardly a dependable indicator of change in the monetary climate.

In recent months time deposits have been rising much more slowly, as the differential between deposit rates and market rates has turned against depository institutions. Up to September, the rate of time deposit growth has been at only two-thirds of the growth rate in 1965, and, in recent weeks, time deposit growth has ceased altogether in the face of attrition in CD and passbook totals, as rate ceiling barriers serve to shunt funds into market instruments and other intermediaries' offerings.

Thus, it is impossible to interpret recent M-2 movements in the light of monetary factors alone and it is hard to see the rationale for isolating this one component of near monies for inclusion with demand deposits and currency in a measure of monetary action. As we are indeed increasingly using demand deposits and currency for transaction uses only, M-1 has to be interpreted accordingly. M-2 is a hybrid of very limited use in today's environment. As intermediaries and market instruments take on more and more of the task of providing liquidity for the economy, we need to sharpen up the definitional and the data requirements necessary to develop the more comprehensive money concept, M-x, a significant monitor of monetary change.

One final monetary monitor merits our attention--not because of outstanding quality but because of its widespread use and ease of misuse. I refer to total bank credit at all commercial banks.

This indicator has some technical disadvantages; it is available but once a month and then only on the basis of bank balance sheets as of a single day. Thus it tends to be erratic and even misleading in its signals as well as late in its availability. However, another set of numbers with greater stability and availability can be used as a proxy for total bank credit--namely, total net member bank time and demand deposits. These data are available weekly on a daily average basis which proofs them against single day irregularities, such as window dressing.

In performance, total bank credit, or its proxy, closely resembles M-2 but avoids net, some of the erratic movements in that series due to the exclusion of Government deposits. Its major shortcoming is the same one which disqualifies M-2 as a measure of monetary action--its sensitivity to intermediation trends in the banking system.

If public preferences are turning away from cash and demand deposits and toward near monies generally, this is an important fact for the central bank to recognize and, if possible, accommodate. It is the kind of change that some variant of M-x would usefully portray. But any indicator such as M-2 or aggregate bank credit which merely registers the shifting competitive positions among intermediaries is more likely to be misread than correctly interpreted.

Consider the accelerated intermediation in the banking system beginning in 1962 and the disintermediation of recent weeks; these appear to have symmetrical effects so far as monetary policy implications are concerned.

When banks in 1962-64 were gaining time deposits at the expense of other intermediaries and of market instruments, bank credit and bank deposits rose at an accelerated rate, giving an exaggerated impression of the degree of stimulation from monetary policy.

Under present conditions, holders of negotiable CDs and other time contracts with banks which they do not wish to renew are probably purchasing short-term agency issues, municipals, commercial and finance company paper, and bankers' acceptances. To the extent banks hold these types of paper, we can simply imagine that banks redeem maturing time instruments by handing over such short-term assets, thus reducing both their assets and liabilities.

Although bank credit and bank deposits would thus appear to contract, total credit available to the economy would not necessarily be affected nor need there be any further impact on interest rates. All that is happening is a reshuffling of assets between the banks and the public with attendant effects on the distribution of total credit availability and the shape of the yield curve. In short, there is a trend away from intermediation by the banks.

Now to return to our indicator--total bank credit. In the current environment it is signaling great tightness just as it signaled excessive ease from 1962 until the summer of 1966. But if the monetary managers had choked off the economy's credit resources earlier we would not have had the expansion and prosperity of the 60s. Similarly, we should not exaggerate the degree of monetary tightness being signalled by the slower growth of bank credit today.

This speech has dealt with a problem of communication--communication between the Federal Reserve and the financial and business public. It covers much the same issues I am often called upon to discuss with student and study groups who will ask: how does monetary action affect the economy, what are the evidences that it is having its intended effect, how can I tell what is taking place? Often, after I have finished my work I realize the still attentive audience before me is still unenlightened. And so, with reverence, if not confidence that my mission has been accomplished I conclude then, as I do now. One must always bear in mind, that monetary policy works in mysterious ways its wonders to perform.