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**Dilemmas in Monetary Management**

**Remarks of George W. Mitchell**

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## Dilemmas in Monetary Management

Your chairman provided a topic for my remarks today and I, being unsure as to how the topic would develop, chose the stilted ambiguous title. The speech he wanted me to prepare could have been entitled "A participant's undocumented recollections and reflections on attempts through fiscal and monetary policies to achieve economic growth and stability in the 60's." Unfortunately, when I got down to work I found my interest digressing to a related topic--to a problem of communication. How should the business and financial community gauge the actions of the Federal Reserve? What are the monetary variables that provide reliable guides to a day-to-day appraisal of the Federal Reserve System's monetary posture and actions?

While current interest in this problem is rising, the difficulty of monetary communication is certainly not of recent origin. My interest in this topic is obviously unavoidable as I am constantly being called upon to explain and interpret, if not to justify, monetary management's moves. It is difficult to tell the whole truth to the naive questioners--some of them believe the Federal Reserve fixes interest rates and interest rates fix the economy, and that is that. Others, equally naive, believe the Federal Reserve fixes the money supply, the money supply fixes the economy, and that is that.

At a higher level of sophistication, the questioner is aware of the numerous ways in which a variety of monetary actions can affect expectations, credit flows, interest rates, liquidity, and asset positions. He knows that changes in these variables

influence spending and investment decisions, but with variable and often unpredictable lags, so that tracing through a typical or specific case can become extremely complicated. Thus, an expositor may, in many circumstances, have to fall back on modesty (the linkages and the lags are just not that well understood) or an appeal to faith (monetary policy, too, works in mysterious ways its wonders to effect). And at this point some mild-mannered questioner may deflate the discussion with the observation that monetary policy appears not yet to have reached a very scientific stage of development.

Confrontations with money supply adherents usually involve little modesty on anyone's part. This group needs no assistance whatever in determining what monetary policy is up to, because they can get regular weekly reports from the Federal Reserve Bank of St. Louis in which the effects of policy in the form of the movements of money are set forth in seasonally adjusted tabular and graphic form. What they usually want to know is how can the Federal Reserve be making such egregious errors.

I could hardly address a group of statisticians and economic forecasters without saying something about monetary variables--their use or misuse. Some of you may be charting your forecasts around money supply indicators, a reserve measure of some type, or the credit proxy, in the belief that the monetary maneuvers reflected in some monetary variable or variables anticipate or cause changes in economic activity. Thanks for the compliment in either case,

but my judgment is that even when the Federal Reserve causes a change in economic activity, or correctly anticipates one, and accommodates it, you as forecasters are going to be hard put to it to find a dependable, easily interpreted, single monetary indicator to which you can hitch a forecast or an explanation.

Monetary policy is usually represented as being in a posture of varying degrees of tightness or ease--pushing on a string or pulling on the reins. By implication the economy is viewed as instability prone and constantly in need of "touching up" by the money managers. In reality, however, much of the time monetary policy has no activist or controller's role to perform. Major economic disturbances requiring active monetary intervention are relatively infrequent. When they do occur they may well have their origin in public sector policies that are actively destabilizing. Wars and their accompanying large deficits are the usual culprits.

Ordinarily monetary policy is directed to accommodating money and credit needs of the economy as they arise in the more or less regular growth patterns of savings and investment. The framers of the Federal Reserve Act may have had this intuitively in mind when they referred to the "accommodation of trade and commerce."

When monetary policy is in a passive phase it is changes in the economy that give rise to changes in monetary variables--rather than changes in the monetary stance that give rise to changes in economic activity. The idea that changes in money supply or in credit terms and availability can be both the cause or the effect of

changes in economic activity is not very difficult to accept as an abstract proposition but it is less easy to demonstrate in terms of the families of monetary variables--credit flows, liquidity changes and interest rates.

The reason why ex post empirical observations are so difficult to interpret is, of course, exactly because those developments that we can observe--interest rates, money supply, bank credit, and even reserves--usually represent a combination of the effects of policy, policy itself, and a host of other influences, some operating with a lag.

The money stock, for example, could be rising because of an "easy" policy and low interest rates, or it could be rising because of the increased tempo of economic activity--that is, the demand for it could be expanding, and the demand for money could be rising because of exogenously induced inflationary expectations, because of interest rate changes, or because of international developments or because money substitutes were becoming decreasingly available and competitive. If we look at another monetary variable--interest rates--rising rates may stem from either a restrictive monetary policy or increased demands for credit. And, nonprice term of credit--seldom fully reflected in interest rates--can change drastically and swamp the effects of changes in the prime rate, for example.

Historical examples may clarify how difficult it is to judge the stance of monetary policy by sole reliance on one or two monetary measures. To be sure, there are times such as the changes

from 1965 to 1966 when almost any indicator would have suggested that policy was restrictive. But even in this period, some measures were showing widely different rates of change--for example, bank reserves dropped from a 5 per cent rate of growth in 1965 to 1 per cent in 1966 but bank credit, because of the time deposit expansion, dropped from a 10 per cent growth in 1965 to "only" 6 per cent in 1966--and in the early months of 1966 the money supply school remained convinced that policy was still easy.

Take another example. Over the spring and summer of 1966 May to September most interest rates rose sharply, reaching 40-year highs and almost all financial measures were indicative of policy restraint: the money stock did not expand at all, member bank borrowing averaged almost \$750 million, free reserves averaged a negative \$365 million, nonborrowed reserves declined at an almost 2 per cent annual rate, and total member bank deposits expanded at about a 4 per cent annual rate.

But, in the same months of 1967 interest rates rose even more rapidly to even higher levels while most other measures indicated policy ease: the money stock was rising at a 9 per cent rate, member bank borrowings were small, free reserves averaged a positive \$280 million, nonborrowed reserves expanded at a 9 per cent rate, and total member bank deposits rose at almost a 12 per cent rate.

The difference can be explained, I think, in terms of demand factors. Corporations, for example, were issuing bonds at a pace considerably higher than the high rate of the similar period

of 1966. This high demand for capital market funds can be explained in turn by borrowing shifted from 1966 to 1967 by monetary policy actions in 1966, by the need to restructure balance sheets, by the greatly accelerated tax payments, and by expectations of higher yields to come--in large part related to Federal financing requirements. To have concluded that policy was restrictive because interest rates were high and rising would, in my view, have been misleading because of the importance of demand factors in this period. Credit was clearly more easily obtainable in 1967 than in 1966. Obviously, monetary policy could have kept interest rates from rising as much as they in fact did, but even more rapid increases in bank credit and deposits than took place would have been required.

One more point might be in order. The problem of interpreting monetary policy measures is made even more difficult as the effects of policy are widely diffused in the economy. As the level of yields increases, and financial assets become more substitutable for each other, the effects of policy fall not only on commercial banks and market yields but also on nonbank intermediary inflows and the asset portfolios of the contractual type financial institutions. You are all aware, I am sure, of the effect of rising market yields on nonbank deposit inflows in 1966, 1967, and during the last few weeks. These variables must certainly be included among the traditional measures, and they, too, must be interpreted in light of supply and demand factors.

All of this suggests to me that observers and central bankers should not measure policy--or the need for policy changes--by the movements in any one or even a few financial variables. It is clear that both the framing and the evaluation of policy requires the weighing of the first, and in some cases the second, differences of many variables together and the joint assessing of their meaning for the ultimate nonfinancial targets of policy.

And since each financial variable has its own peculiarities and idiosyncrasies, including quite diverse lagged reactions or effects, it is not surprising to find that interpretation of the entire complex of monetary indicators often involves significant differences of opinion among qualified observers as to what is going on now, and what is likely to happen in the future.

The explicit Federal Reserve position on this matter is an eclectic approach to monetary indicators. At some junctures certain variables are regarded as more critical than at other times and it is necessary to project how environmental and expectational considerations will react on each of the various monetary variables. Generally, families of variables are less likely to give false clues than individual representatives. For example, if one were looking at evidences of money market conditions--the typical or predominant movement in the Federal funds rate, the dealer loan rate, borrowings at the Federal Reserve, and net free or borrowed reserves would be much more dependable than the change in any single member of the family.

There is always the potential for offsetting shifts, and thus conflicting signals, within families--for example, between demand and time deposits in the money family. There are varying arbitrage efficiencies that can diversely affect members of the interest rate and credit flow families, and thus add to the monetary static.

To sum up, monetary navigation is a fairly complicated business, especially when the destination is somewhat uncertain. We do not attempt to navigate by following any single star, ignoring the storms or calm in financial markets, the flows of funds to competing intermediaries and market instruments or shifts in aggregates or sources of credit demand. At the Fed, we try not to be that narrow-visioned. Our analysis of the economic picture, as summarized in the policy record released 90 days after each FOMC meeting, attempts to integrate information on the widest possible range of domestic and international events. To bring order out of the welter of data available, we use synthesizing frameworks such as the GNP accounts and the Flow of Funds accounts. But these are just frameworks on which to hang data; analysis of the forces affecting the accounts depends on our insights into the relationships among the financial variables and developments in the real economy, which is the ultimate target of policy.

We have invested--and are continuing to invest--large efforts in obtaining a better grasp of these relationships. I can hardly claim that our efforts to date have been entirely successful, but

we are making progress in winnowing out the more stable and important relationships from a monetary point of view. As this work has progressed our ability to forecast the consequences of alternative policy actions has improved. While progress has been slow, it has become clearer and clearer that in a dynamic economy, with flexible and adaptable financial markets, no one aspect or variable is an adequate guide to, or target of, policy for all times and conditions.