

A COMMENT ON MONEY MARKET COMMENTARIES

Speech by
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to the
St. Louis Society of Financial Analysts
Washington University Club
St. Louis, Missouri
March 26, 1973

It is a pleasure to be with financial analysts this evening and to discuss with you some aspects of monetary analysis that I find of special interest at this time. My discussion will center around two aspects of published money market commentaries that I believe are highly misleading to their readers. One topic concerns the role of Federal Reserve actions and interest rates, and the other concerns the ability of the Federal Reserve to control the growth of money.

Discussions of financial developments are a regular feature of our daily newspapers, and a number of widely read weekly newsletters specialize in financial affairs. These publications desire to inform the general public, and especially money market participants, about economic developments. Since Federal Reserve actions exert a major influence on economic activity, it is only natural that news analysts and commentators search for information about Federal Reserve

policy and its expected influence on activity. In turn, the public watches the news sources for such information.

People outside the Federal Reserve System are not informed as to current Federal Reserve policy since the policy record is published with a 90-day lag. Thus, only incidental evidence of current policy is available to the financial public. Market commentaries can provide a useful service by interpreting Federal Reserve actions.

In many instances, however, I find analyses in widely circulated commentaries regarding Federal Reserve actions that tend to be misleading. Misplaced emphasis in such reports can often misdirect the public's expectations and possibly result in actions that are subsequently regretted. For the public at large, an inappropriate analysis can lead to actions and political pressures which conflict with hoped-for results.

As background for this discussion, let us consider the method of operations employed by the Federal Reserve System in carrying out its economic stabilization responsibility. The "ultimate" goal of such responsibility is to promote a high level of output and employment accompanied by a relatively stable price level. The Federal Open Market Committee sets these ultimate goals, within the context of

other Government programs. It cannot, however, observe progress toward achieving such goals during the short four-week time interval between committee meetings, or even between quarterly release of broadly based economic data. Consequently, the Federal Open Market Committee specifies desired movements in more readily observable data series which are thought to be under some degree of System control and closely related to the ultimate goals. These are referred to as "intermediate" targets. The trading desk at the New York Federal Reserve Bank is, in turn, instructed by the Committee to conduct open market operations which are expected to lead to achievement of the intermediate targets. Since the desk operates daily, it is given instructions in terms of an "operating" target.

To be informative to the specialist or the general public, market analyses must carefully consider all aspects of these procedures. In recent years, changes have occurred regarding both operating and intermediate targets. Many market commentators, however, have tended to lag behind these changes in their analyses. Let us now review these changes.

From the Federal Reserve-Treasury accord of 1951 to well into the 1960's, Federal Reserve monetary policy was based

on achieving conditions in the money market which were believed to be conducive to achieving its economic stabilization goals. I am sure you are familiar with measures of so-called money market conditions such as free reserves and the Treasury bill rate. Qualitative terms such as "tone and feel of the market" were also used. During this period, the operating and intermediate targets were identical and far from precise.

Then in the last half of the 1960's, monetary aggregates began to receive some emphasis in the conduct of monetary policy. By monetary aggregates, we mean such items as the amount outstanding of bank reserves, money, and bank credit. Money market conditions were used as previously, to achieve the System's ultimate goals, but they were to be altered if a specified monetary aggregate, or set of aggregates, did not move in an expected manner.

In 1971, another change in emphasis occurred when monetary aggregates became the intermediate target of Federal Reserve actions. The practice was to specify changes in monetary aggregates which were believed to be consistent with the System's goals of output and prices. However, money market conditions, or movements in interest rates, remained the short-run operating target for achieving desired movement

in the monetary aggregates. In other words, movements in money market interest rates were used in an attempt to achieve a desired growth of aggregates.

In summary, the twenty-year period ending in 1971 was characterized by Federal Reserve efforts to produce interest rate movements thought to be consistent with its ultimate goals or of its intermediate target. Therefore, it is understandable that market analysts developed the practice of using interest rate movements as an indicator of the intent of monetary policy. The experience of the late 1960's and early 1970's, however, demonstrated that such analysis can be highly misleading. In addition, the experience of 1971 demonstrated that market interest rates are a poor operating target for controlling movements in monetary aggregates.

Hence, last year the Committee again changed its operating procedures. The money stock became the intermediate target, and another aggregate, reserves available for private deposits (RPD's, for short), became its operating target. A growth rate of money was specified which the Committee believed would lead to its longer-run goals for output and prices. Then a rate of change in RPD's was specified which was expected to produce the desired growth of money. Actions to achieve the specified RPD growth, however, were

constrained by instructions to hold money market conditions within a set range.

In view of the experience of recent years and the foregoing change in operating procedures, I would like to comment on two features of recently published market analyses which I find disturbing. First, there is often an improper imputation of Federal Reserve actions as the cause of fluctuations in interest rates. Secondly, there are a number of unwarranted conclusions about the ability of the Federal Reserve to control the money stock.

The following are some typical comments about changes in interest rates:

Interest rates have firmed because the Federal Reserve has not supplied enough money and credit to satisfy demand.

Higher interest rates are a means to achieve slower growth of the money stock.

These statements infer that the Federal Reserve deliberately causes movements in interest rates to achieve its ultimate goals. Under procedures adopted last year, this is simply not true. Moreover, System actions are not the only cause of movements in interest rates. The inference left by some commentators, that an analyst can gain insight into the thrust of monetary

actions by watching interest rates, is highly misleading. This is not to say, however, that market traders should not have any concern regarding the movements in interest rates.

Actions of the Federal Reserve in the short-run have only a temporary and marginal effect on market interest rates. Numerous studies have provided evidence supporting the view that the level of market interest rates is primarily determined by real economic growth and by the rate of inflation expected by the general public -- both borrowers and lenders.

Statements which attribute the cause of a change in interest rates to Federal Reserve actions frequently overlook the impact of a change in demand for credit. The association of a given change in interest rates or other money market conditions to Federal Reserve actions is often misleading. This is especially the case when the association is made without regard to the state of economic activity, Government borrowing, or other factors influencing demands for credit.

The recent increase in short-term interest rates is an instance where the rise was not associated with a slow rate of growth in Federal Reserve credit. A look at the facts shows that Federal Reserve credit, the monetary base, and the money stock grew more rapidly in 1972 than in most other periods since World War II. Yet short-term interest rates rose

significantly. This indicates to me that an exceptionally strong growth in demand for credit, which accompanied the very strong economic expansion, was the primary cause of the rise in interest rates and not Federal Reserve actions.

Let us look now at what I consider to be some erroneous conclusions about the problem of money stock control. The following statements are typical of published market commentaries:

There is uncertainty as to how high monetary authorities will have to push interest rates in order to get growth of the money stock into an acceptable range because economic expansion raises demand for money and encourages monetary expansion.

Controlling money is an art; Federal Reserve officials do not have a formula for controlling it.

These statements attribute difficulty in controlling the money stock to difficulty in predicting the demand for money. They assume that the public's desire to hold money is responsive to changes in market interest rates. More particularly, they assert that this response is such that interest rates several months ago exercise a dominant influence on this month's money stock. The implication frequently left is that there is little hope for adequate money stock control.

Such a result may be partially true under the old operating procedure when policy was based on the money market conditions approach. With the procedures adopted last year, however, such statements promote confusion. They do not consider both sides of the market and totally ignore current procedures for implementing monetary policy.

The confusion could be minimized if writers would explicitly recognize that two theoretical strategies have been advanced for controlling money. One strategy involves predicting the relationship between demand for money and interest rates, and then achieving the interest rate at which the quantity of money demanded equals the desired money stock. The second strategy involves predicting the relationship between a reserve aggregate and money and then achieving the level of the reserve aggregate consistent with the desired money stock.

Policy records of 1971 reflect the explicit use of the first strategy by the Federal Open Market Committee. Most analysts, including the Chairman of the Board of Governors, rate its performance less than successful. Within the framework of this strategy, failure to achieve the desired money growth could be, and was, easily attributed to changes in the demand for money. In such a case, the demand for money

with respect to interest rates and other factors was said to have departed from that expected by monetary authorities. Thus, a ready-made reason was provided for the failure to achieve desired intermediate objectives of policy.

The other approach to the control of money was employed in a limited way last year. Policy actions in 1972, as I mentioned earlier, were guided by a strategy in which Reserves Available to Support Private Nonbank Deposits served as the operating target. Chairman Burns, in a July statement before the Joint Economic Committee, said:

"Early this year, the Federal Open Market Committee decided that the pursuit of its monetary goals might be aided by focusing less heavily on the Federal funds rate as an operating target and instead giving more weight to the desired growth of the bank reserves held against private deposits. This change in operating procedure did not, of course, mean that money and capital market developments would be disregarded. It merely meant that, in the Committee's judgment, greater emphasis could be placed on the reserves needed to attain the desired growth rates of the monetary aggregates, while still giving attention to interest rates and other dimensions of financial markets."

Many commentators, however, have continued to interpret policy actions as being aimed largely at interest rates. The worst examples of such reports are the ones which question how high the Federal Reserve will have to push interest rates in order to slow money growth. Such statements leave the impression that the Federal Reserve is seeking higher interest rates.

This is definitely not true under the procedure adopted last year. It's true that System actions to slow money growth are often accompanied by higher short-term interest rates for a few months. The probability is much greater, however, that actions to slow money growth will be followed by lower market interest rates after a period of four to six months. In other words, as the rate of spending subsides and inflationary expectations decline, interest rates will also decline.

To illustrate how tenuous is the short-term relation between money and market interest rates, I draw your attention to the most recent occasion in which the money stock stopped growing for a few months. The period was September to December of 1971, following the imposition of the Administration's New Economic Program. During those months, short-term market interest rates fell significantly.

I point this out to you only to indicate that there are so many diverse factors influencing interest rates that actions by the Federal Reserve to slow money growth can be accompanied by either rising or falling market rates. Furthermore, to argue, as some have, that these lower interest rates would automatically produce accelerated money growth, is not borne out by evidence. In fact, lack of such evidence is one reason why the new method of operation was adopted last year.

Those observers who argue that in the present economic environment any effort to slow money growth will be accompanied by temporarily higher interest rates may be correct. But such analysis does not justify an interpretation that the monetary authorities desire or are seeking higher interest rates.

It is particularly disturbing to me that many commentators during the past two years have concluded that because the Federal Reserve did not always achieve desired growth in money, it does not have the ability to do so. Jumping to that conclusion could be avoided if analysts recognized that such failures were the result of, first, the interest rate strategy of controlling money, and then the limited reserve aggregate strategy. The 1971-72 experience does not mean

that the reserve aggregate strategy must necessarily be a failure. It does mean, however, that lesser weight must be given to interest rate considerations for this strategy to succeed.

Let me reiterate that a monetary strategy directed toward achieving a growth rate of the monetary base consistent with the desired growth of money can work effectively. The monetary base is derived from the consolidated monetary accounts of the Treasury and the Federal Reserve System. Information about uncontrolled factors of the base, such as the value of the gold stock and Federal Reserve float, can be obtained with sufficient speed to be offset by Federal Reserve open market purchases and sales of Government securities. Monetary authorities thus can control the base with a relatively high degree of accuracy.

Furthermore, we have observed in the past a high degree of stability in the relationship between the monetary base and the money stock, especially over a period of several months. This suggests that a growth target for money could easily be translated into one for the base. I believe that information about factors in the monetary base and about its relation to money could be used to achieve money growth within a fairly narrow targeted range. This is possibly true of other

reserve aggregates as well. If the financial commentators would take special care in presenting this monetary aggregate strategy, I believe that the quality of public understanding will be improved.

I may appear to be belaboring these issues; but my doing so stems from my concern regarding the progress we have experienced in achieving high employment accompanied by price stability. There is a growing body of evidence that variations in the rate of monetary expansion have an important influence in achieving both of these ultimate objectives. Empirical and theoretical research has led a growing number of analysts to conclude that the trend growth of money is a dominant force in determining the rate of inflation. This research has produced considerable evidence that short-run variations in money growth have a major influence on short-run fluctuations in output and employment. There is also considerable evidence that growth of money can be controlled better by using the monetary base, or some reserve aggregate, as the operating target, rather than using money market interest rates.

In recognition of this evidence, as well as actual experience, the Federal Open Market Committee in 1972 decided to place greater emphasis on monetary aggregates and less emphasis than previously on money market interest rates.

In present circumstances, the System does not seek to promote higher interest rates to restrain the expansion. Instead, it is willing, within limits, to accept higher rates which would accompany a move to slower money growth if these conditions are necessary to restrain the economy.

Many market analysts have not yet recognized this change in Federal Reserve strategy and still refer to the Federal Reserve as deliberately pushing interest rates up in order to restrain the economy or to induce a slower rate of money growth. They also continue to allege that money growth is beyond Federal Reserve control. By using these lines of reasoning, these analysts are doing a disservice to their readers and to the cause of sound economic stabilization policies.