

POLICY MAKING AND POSITION TAKING--A COMPARISON  
Remarks by Thomas C. Melzer  
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A question which I am often asked is, "What is it like at the Fed? It must be a big change." My career began at Morgan Stanley where I spent almost 17 years in a variety of activities. The last five years from 1980-1984, I was the Managing Director in charge of U.S. Government securities sales and trading. While I do not propose to talk about all the similarities and differences I have observed between these private and public sector endeavors, I thought one particular comparison might be interesting. That is, the role of a Government securities position taker versus that of a monetary policymaker and the interrelationship between policy and the securities market.

A Government securities market participant must deal with a variety of fundamental inputs when making position decisions. These inputs include the pace of economic activity, inflation trends, money supply growth, foreign exchange market conditions and developments affecting our financial system. In addition, monetary policy and, to a lesser extent, fiscal policy are taken into account.

In addition to fundamental inputs, the technical condition of the market must also be considered. That is, the relationship between supply and demand for securities at any particular point in time and price level. Some years ago, net dealer positions provided a reasonable gauge of the market's technical condition; but as more and more investors have become trading-oriented, this is a less reliable indicator. In addition, sales of large Treasury new issues are constantly changing the technicals and making them difficult to assess.

Recently, however, it would appear that the interruption of normal patterns of Treasury supply by the debt ceiling created a very good technical condition in the market. Because of anticipated bunching of supply, dealers were reluctant to hold long positions and perhaps even established net short positions. Whatever longs they did hold were whittled down by ongoing investment by certain investors. Other investors accumulated cash balances waiting for lower prices when the supply finally did come. The result last week was a four-year which had more than \$34 billion of bids for a \$6.75 billion auction, followed by seven and

20-year auctions which also received good support. Prices increased and yields fell, but from all indications the market movement was technically rather than fundamentally-induced.

The role of the position taker, then, is to make judgments about what positions to take in light of evolving fundamental and technical factors. Often, how the market trades in reaction to a new input provides additional insight into the positioning decision. For example, say the market receives new information about a fundamental input--perhaps it is the latest employment estimate--which is expected to result in lower prices. This, in fact, was the case a week ago when non-farm payrolls were up 414,000 rather than an expected 150-200,000. Suppose, however, that instead of trading down, bond prices actually rise. What does this tell us about the market? A position taker might conclude that the market is in better technical condition at that time than previously thought. In other words, that the estimate had been more than fully discounted in the price level. Or he might conclude that the focus of the market had shifted to other fundamental factors, say inflation, as a guide to future bond prices. Again, this might have been a consideration last Friday

when there was also talk of lower oil prices. Although possible strength in the economy was reflected in the employment estimate, this might not present a problem for interest rates if inflation remains subdued, or so the rationale would go.

Clearly, then, a market professional, if he is to survive, must be very knowledgeable about the fundamental factors. He needs to have an informed view on what's happening in a fundamental sense. But he must also know how other market participants are evaluating these fundamental factors, as well as the technicals. In other words, he must understand the psychology of the market. As a result, he can often end up taking short-term positions which are inconsistent with his fundamental view. However, because of market psychology and technical factors, they seem to represent good risk/reward opportunities.

Finally, one last comment on the market participant. A good position taker never stays with a bad position--at least not too long. He must have the humility to recognize that, despite a tremendous amount of information and analysis, he simply did not properly understand what was going on in the market at the time. Instead, others had different

information or expectations than he assumed them to have. It is important to recognize and respect the ability of the market to discount possible future events that may not be evident to every position taker concurrently.

What about the policymaker? Are there any important similarities between his role and that of a professional market participant? Certainly a policymaker cannot reasonably take actions which are inconsistent with his fundamental view as does the position taker. On the other hand, the fundamental views and how they are reached are surprisingly similar. The state of the economy, inflation, money, the dollar and financial market conditions, together with the impact of fiscal policy, are the chief ingredients that lie behind monetary policy decisions. This list is almost identical to the fundamental inputs of a position taker.

Of course, there is one major difference between making policy and taking positions in bond markets. Market participants look at monetary policy--both current and expected--as a fundamental input into their decisions. Consequently, they devote considerable time and effort--and, I might add, ingenuity--to Fed-watching; they are trying to find

apparent nuances in policy to update their fundamental views, hopefully before their competitors have time to do the same. What I have discovered, somewhat to the surprise of my former self, is that policy actually changes far less frequently than market participants think it does, and certainly far less frequently than their expectations about policy change.

Frequently, we see bond prices jump around due to trading based on fear of Fed tightening or hope of Fed easing; these trades usually follow changing news or expectations about some fundamental factors that shape monetary policy-making. What should be realized, however, is that monetary policy decisions, while certainly influenced by these fundamental factors, cannot possibly jump around as quickly and as often as market expectations seem to do. Policy decisions must be geared to a long-term perspective on what is going on in the economy; they must aim at a horizon somewhat farther out than next month's inflation figure or next quarter's merchandise trade balance.

Responding to ever shifting expectations, which is characteristic of position taking, is generally not appropriate for policymakers. Of course, policymakers must be sensitive to what markets are saying about future events; policymakers do not have a monopoly on all the information that is relevant to future economic conditions. Accordingly, just as market participants watch the Fed for insight into the fundamentals, so too does the Fed watch--and try to interpret--market activity.

What we end up with, then, in comparing position-taking and policy-making, is a somewhat curious result. The fundamentals are key, and both the Fed and market participants watch them very carefully. Then, to provide additional insight into the main event, market participants attentively watch the Fed. And, of course, the Fed, in turn, attentively watches the market.

What do the fundamentals say? The news from the inflation front remains amazingly good. Both consumer and producer prices have risen at annual rates of about 2.5 percent since April. At the present time, price developments show no departure from the low inflation pattern that took hold back in 1981. This seems to be confirmed by anecdotal information

as well. At various meetings with businessmen held at our Bank recently, no one saw any evidence of increasing inflation in their cost or price structures. To the extent that there is upward pressure on wages, productivity gains were expected to offset the higher cost.

Data on payroll employment for October and retail sales, industrial production, and housing for August and September show moderate to sharp increases, indicating that perhaps the hoped-for acceleration of real growth has begun. While some analysts have argued that these gains are only temporary, other fundamental factors point toward continued resurgence of the economy. For example, the Department of Commerce's Index of Leading Indicators, although not necessarily the most reliable guide by itself, confirms the underlying strength of the U.S. economy; it has risen for four successive months and for seven out of the past eight months.

Another factor influencing real economic growth in the short-run is the growth in M1, the money stock measure consisting of currency and checkable deposits in the hands of the public. When M1 growth accelerates sharply, real growth and employment historically have risen about six to

nine months later. And while certain special factors may have affected normal patterns of money velocity in recent months, M1 has grown very sharply. Since October of last year, M1 has grown at about a 13 percent annual rate. This rapid expansion in M1, supported by strong reserve growth, should provide a continuing push to the economy for the remainder of this year and into the early part of 1986. Of course, rapid money growth could present some threat to our ability to maintain low inflation rates in the years ahead.

And what is the market telling us? While the funds rate has been trading slightly higher than 8 percent in the last couple of weeks, there is no expectation of Fed tightening in present price levels. In fact, one might argue that six-month bill and two-year note yields are anticipating some easing at spreads of 25 basis points below and 75 basis points over funds, respectively. On the other hand, this might be attributed to the supply distortions mentioned earlier and longer-term investment funds temporarily being parked in shorter-term instruments.

A market relationship which gives some insight into inflationary expectations, the two-year/ten-year note spread, is presently at about 130 basis points. For a long period of time this relationship had been in the 140-160 basis point range, indicating that inflationary expectations have perhaps decreased despite the rapid money growth since October of last year. If the market perceived that Fed policy had become too accommodative, short-term yields would stay low because they are tied to the funds rate, but long-term yields would rise as a result of higher expected inflation. Again, the flattening in the yield curve might be attributed to the lack of longer-term supply.

Finally, what about policy? There have been, and continue to be, a number of fundamental cross-currents which currently affect policy and hence create uncertainty. While the economy finally seems to be improving, questions remain as to the extent and sustainability of this improvement. Money supply has been growing rapidly, as a good deal of stimulus has been provided in recent months. And yet there are questions about the behavior of velocity and just what effect this monetary stimulus

will have on real growth and employment. Right now, the combination of some apparent improvement in the economy, together with rapid money growth, seem to argue for no further easing.

Inflation measures remain extremely favorable for now, although could be vulnerable to a sharp downward adjustment in the value of the dollar. In addition, historically increases in money growth are associated with higher inflation rates in the years ahead. Nevertheless, in the short-run inflation might be considered a neutral factor in relation to policy--neither a reason to ease nor a reason to tighten.

The dollar has declined significantly since early in the year, which is welcome news for those sectors of the economy dependent on exports. On the other hand, should foreigners' willingness to hold dollar assets diminish significantly as the result of a continually eroding dollar, this could have important ramifications in the capital markets, particularly in light of our large budget deficits. Recently, of course, the dollar has stopped declining and has actually recouped some of its earlier losses. Were a downward adjustment to continue, the dollar could become a factor arguing in favor of at least maintaining or possibly firming policy.

Finally, there continue to be strains in the financial system as the result of international, energy and agricultural loans. Because continued economic growth provides a more favorable climate in which to deal with these problems, they certainly argue against any tightening of policy. On the other hand, there is a question as to whether further stimulus could actually help solve these problems, particularly given the already high level of activity in the interest-sensitive sectors of the economy.

To the extent I thought that policy-making would be any easier than position-taking, I sure was wrong. While I may have more and better information now, when the fundamentals are uncertain, the right answer is no easier to find whether you are a policy-maker or a position-taker. Of course, the stakes are much higher now, so the pursuit of that right answer is all the more important.