Address by
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It is a great pleasure for me to appear before so many of our city's financial analysts. Yours is a difficult profession, requiring close attention to a range of facts and clues that affect pricing and investment decisions in financial markets. In my remarks today, I will try to explain how recent changes in Federal Reserve procedures for implementing monetary policy might be most accurately interpreted by you and by those whose investment decisions are so importantly influenced by your opinions. In so doing, I shall concentrate on the significance of the program announced by the Fed on October 6, what it means for our nation and how you as financial analysts can best adjust to the new environment in which you will be functioning.

It is especially timely that we consider these issues now as the events which began in October are still unfolding. I'm sure that the Fed's new practices have not made your lives any easier; in fact, they have probably made short-term financial analysis more difficult. I am concerned that some in your profession have failed to appreciate the full significance of the important changes that have occurred and that considerable misinformation is being circulated about the direction in which monetary policy is headed.

The traditional focus on short-term interest rates, particularly the federal funds rate, and on weekly money supply figures as indicators of future monetary policy decisions, has been rendered virtually obsolete by the actions taken by the Federal Open Market Committee on October 6. While the usefulness of those figures has always been questionable, to use them now as measures of the future direction of monetary policy is like forecasting the length and severity of winter according to whether or not the groundhog sees his shadow.

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Because the forecasting of market changes is so crucial to the business community and the investing public, I believe you as professional financial analysts have a special responsibility to discard the erroneous indicators that have been so widely used in the past so that you may interpret monetary policy actions with greater accuracy. Misinformation deceives market participants, and more importantly, it fuels adverse social and political reactions that tend to impede the implementation of sound monetary policy.

Last October the Federal Open Market Committee announced that it was revising its traditional methods of implementing policy in favor of devoting more attention to controlling the growth of bank reserve aggregates. Prior to that change, as you know, the Fed had concentrated on controlling and stabilizing short-term interest rates. To be sure, it had also set targets for money growth, but when the interest rate and monetary growth targets were incompatible, control over the money supply was frequently sacrificed in favor of a stable federal funds rate. In times of strong credit demand, this tended to fuel the fires of inflation.

Apparently the suddenness of the October 6 announcement both surprised and confused the financial community. The federal funds rate rose quickly by 350 basis points and fluctuated much more widely than it had in the past. Other short and long-term interest rates rose significantly, and bond and stock prices fell. Early in November, as markets adjusted to the change, interest rates declined and stabilized at lower levels, although it became apparent that short-term rates would continue to fluctuate in a more volatile pattern than under previous conditions when the Fed stabilized the federal funds rate within a narrow range.

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Preliminary indications . . . and I would point out that we have had only three months of data since the change was announced, and this is not enough to form any hard conclusions about the success of the new program . . . are that the program so far has been successful. Money growth, which skyrocketed at an alarming 12% rate during the summer and into the fall of 1979 has been brought down to about the middle of the Fed's announced annual target range of 3 to 6%. While some of you are understandably concerned about how to cope with greater volatility in the federal funds rate, I think you will agree that this is a small price to pay if it will help in the long run to eradicate inflation.

How can you as financial analysts best adapt to the new Fed procedures? One suggestion I would offer is that you base your analysis on indicators that are truly reflective of the direction of monetary policy and reject those that are meaningless or misleading. An example of a misleading basis of analysis is trying to interpret movements in the federal runds rate as an indication of whether the Fed is "tightening" or "easing" monetary policy. In the past whenever the federal funds rate moved higher, financial analysts assumed that the Federal Reserve was tightening credit. Conversely, falling interest rates were usually seen as a signal that monetary policy was being eased. This type of analysis was never very meaningful. Even before the changes of last October, it was erroneous to assume that when the federal funds rate rose the Federal Reserve was "tightening" monetary policy. Consider the period immediately prior to October, 1979. The federal funds rate had been climbing steadily, and many financial pundits interpreted that rise as a signal that Fed policy was restrictive. Nothing could have been father from the truth! The federal funds rate was increasing as a reaction to strong credit demand and not because of restrictive monetary policy. In fact, bank reserves were growing at a record rate. Thus, although short-term interest rates were rising, policy was not tight.

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When the Federal Reserve announced its new program on October 6, the federal funds rate moved up for a short period of time and then began to decline. The falling federal funds rate normally would have implied an easing of policy. However, even as the rate was going down, bank reserves were being contracted. Isolated indicators, notably the federal funds rate, have always tended to be misleading. This is even more true now that short-term rates are being allowed to move more freely in response to market conditions. So what does the federal funds rate tell us about likely future Fed policy? It tells us nothing!

We come now to a second false signal, the weekly money supply figures. Many investors wait breathlessly for Thursday afternoon to roll around so that they can learn what happened to money supply figures that particular week. Their fascination is apparently based on the belief that fluctuations in money growth in any one week beyond the boundaries of real or imagined targets will cause the Fed to adjust reserve growth the following week. Bond traders, in particular, have tended to view weekly changes in money growth as signs that the Fed would probably move the federal funds rate to compensate for the upward or downward change in money supply. As I pointed out earlier, prior to the October changes, if interest rate stabilization and monetary targeting could not be reconciled, control over money was relaxed. Thus, even under the previous practice of concentrating on interest rates, the Fed was less likely to react to short-term movements in money than to fluctuations in the federal funds rate. So while the weekly numbers were never a particularly illuminating figure for those who tried to anticipae the direction of monetary policy, they are even less useful now!

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Weekly money supply figures are susceptible to major variations . . . and I do not refer to reporting errors . . . that have nothing whatever to do with policy-directed actions. Treasury deposits in commercial banks, for example, can vary dramatically from time to time. Shifts in consumer preference between demand and time deposits, as have occurred recently, tend to distort the weekly numbers. Factors such as these in no way denote changes in Fed policy, nor do they form a reliable basis for forecasting future policy adjustments. Monetary policy cannot and should not respond to short-range changes, and the weekly money supply figures should not be used to predict the future course of monetary policy.

The use of false indicators in financial analysis can have seriously adverse effects on policymaking. In spite of the fact that increases in the federal funds rate means little under the Fed's new operating procedure, analysis that persists in viewing rises in the federal funds rate as a signal of "tight money" tends to raise in the public mind the specter of an impending credit crunch which, in turn, elicits demands on policymakers to ease up and supply additional reserves. Consider, if you will, what happened last November when the growth of bank reserves slowed. Clearly, the Fed was buying fewer securities than it had in previous months, and this implied a tightening of credit. But in November the federal funds rate was falling, so anyone who relied on the behavior of short-term interest rates to predict policy response would have interpreted the fed funds decline as a sign of "easier money." This was the opposite of what was happening. Had the fall in rates been an accurate reflection that policy was easing, market participants would have been misled.

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Conversely, the mistaken belief that the October rise in interest rates was a signal of monetary tightening . . . which it was not . . . could have evoked pressure to expand money growth. Had policymakers responded to such pressure, any possibility of bringing inflation under control would have been lost, and the dollar would have been in much greater trouble than it was.

My point is that the manner in which the financial community interprets Federal Reserve actions can have broad political and psychological implications, both at home and abroad. Any instant analysis that relies on daily fluctuations in the federal funds rate or weekly changes in money supply figures, always of doubtful value, now under the new Fed procedures, is worthless. Only patterns that emerge in the longer term can indicate which way the Fed is heading.

If short-term fluctuations in fed funds rates and weekly money supply figures are poor indicators of monetary policy, where should you look for clues to the future? Fortunately, there are more reliable indicators, and I would invite your attention to two of them.

The most accurate indicator of the direction of monetary policy is the monetary base. As you know, the monetary base consists of currency in circulation and bank reserves that generate deposits in commercial banks. The Federal Reserve directly controls the size and rate of growth of the monetary base through its open market operations. Through its control of the monetary base, it can directly influence the rate of growth of the supply of money and credit.

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Consequently, by watching the growth of the monetary base you can derive useful information about the likely stance of monetary policy. This is due to the close relationship, over all but the shortest time periods, between the growth of the monetary base and the growth of the money stock. If money stock growth is outside of announced target ranges, monetary base growth can be expected to be adjusted to bring the money growth back into line with the desired targets. Therefore, I would advise you to keep your eye on the monetary base . . . not, I must caution, on a week-to-week basis . . . but, rather, on an extended basis over several months. This will provide you with a good estimate of, and explanation for, the growth of money that is forthcoming.

It must be emphasized . . . and repeatedly stressed . . . that even the strictest control of the monetary base does not produce smooth money growth. Bank preferences for excess reserves, public preferences for currency and time (vis-a-vis demand) deposits, and Treasury deposits in commercial banks are all subject to continuous change. Therefore, the transformation of reserves into money is not a smooth one in the short run. In the longer term, however, such as six to twelve months, growth in money will accurately reflect reserve growth. And it is this longer-term growth that affects output, prices and interest rates.

Some of you are interested in the future direction of interest rates. If that is your primary concern, it is important that, in addition to observing monetary policy, you keep your eye on those factors which influence the demand for credit. Amoung such factors are, of course, business inventory accumulation, government borrowing, corporate borrowing, and so on.

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If the Federal Reserve under its new operating procedures produces fairly stable growth in the monetary base, short-term fluctuations in interest rates will be determined primarily by changes in the demand for credit. Thus, by estimating the long-term growth of the monetary base and ascertaining short-term changes in credit demand, you should be able to forecast interest rate variations in the near term.

My remarks so far have been confined to specific suggestions as to how you as financial analysts can most effectively adapt to recent changes in Federal Reserve practices and procedures of implementing monetary policy. There is an even more fundamental question to which you will doubtless be addressing yourselves: namely, what chance does the new Fed program have in achieving its goal of reducing inflation? Personally, I am convinced that, by gradually reducing the growth of the money supply, we can bring about a reduction in the rate of inflation and we can do so without plunging the nation into a serious recession. I am optimistic that this will be done, because I am impressed with the resolve of the Federal Reserve to persist in the attainment of the goal announced by Chairman Volcker on October 6. If only because the past practice of interest rate stabilization is generally recognized as having failed, and the new approach is the only course of action left in our arsenal of economic weapons, we must persevere in the new direction upon which we have embarked.

This is not to say that the course will be an easy one. In an election year there are bound to be pressures for quick results and certainly, the ravages of past monetary excesses cannot be overcome instantaneously. We cannot expect the underlying rate of inflation to decline overnight . . . at best, the first results of the

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new efforts will not be evident for a year or more. But expectations of future inflation can be affected quickly and it is quite possible that, if financial markets become convinced that the Fed is serious in its purpose, a decline in long-term interest rates might occur fairly soon.

While, as I have explained, the new program might seem to be a "mixed bag" to some of you to whom volatility in the fed funds market poses a problem, I believe that on balance you will agree that, if control of money growth leads to long-term economic stability and a reduction of inflation, the interests of all of us will have been well served. Nothing in this world comes easy . . . and certainly, changes in economic practices can be expected to cause apprehension among those who find change in itself to be threatening. I am convinced that what the Fed has undertaken is sound and in the long run will prove its worth to the satisfaction of all. In closing, I would urge you as leaders of the financial community to throw your support behind the Fed's new thrust so that together we may look forward to a sounder and more stable economic future.

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