



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

April 10, 1975

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida *ALB*

In connection with a contemplated discussion at next week's meeting of the Committee, there is enclosed a copy of a memorandum from the Committee staff, dated today and entitled "Proposed Procedures With Respect to the Concurrent Resolution."

Also enclosed is a copy of a memorandum prepared in the Department of Research of the Philadelphia Reserve Bank, dated April 4, 1975, and entitled "FOMC Response to the Congressional Resolution on Monetary Policy," which President Eastburn has asked be distributed to the Committee.

Enclosures

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significant questions with respect to Committee procedures. Growth in monetary and credit aggregates has rebounded since the early weeks of the year (when the resolution was being formulated) and the Desk has already stepped up its purchases of longer-term U.S. Government securities. The results of recent policy will be adequately conveyed through normal reporting of Committee actions in the policy record, although it may be desirable for the policy record to indicate that--to the extent consistent with objectives for reserves and the monetary aggregates--sizeable open market purchases of coupon issues were undertaken in an effort to moderate upward pressures on longer-term interest rates related to exceptionally heavy Treasury and corporate borrowing. The Committee may also wish to consider the desirability between now and mid-year of a specific reference to long-term interest rates in the last paragraph of the directive; such a possible reference is contained in brackets in the specimen directive shown in attachment B.

Some changes in Committee procedures would appear to be desirable, however, to take account of the need to consult with Congress on longer-run objectives for monetary and credit aggregates. As indicated above, the specific language refers to objectives in terms of "ranges of growth or diminution" and to a time period covering the "upcoming twelve months".

There is nothing in the language to indicate whether growth ranges should be quantitative or qualitative. Earlier versions of the resolution referred to numerical specifications, but the present language represents a compromise that could encompass either ranges presented in descriptive language or ranges with numerical bounds. In the interest

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of facilitating communications with Congress, however, the staff recommends that numerical ranges be presented.

With regard to the width of the range, we would suggest a relatively limited 2 percentage point spread--e.g. 5 to 7 per cent--although the range might vary depending on the volatility of the particular aggregate. Little would be gained, we believe, by utilizing very wide ranges of, say, 4 to 5 percentage points. Such wide ranges would not appear to be responsive to the sense of the resolution. In any event, the ranges are subject to continuous review by the System in light of changing conditions. The resolution specifically states: "Nothing in this resolution shall be interpreted to require that such ranges of growth or diminution be achieved if the Board of Governors and Open Market Committee determine that they cannot or should not be achieved because of changing conditions."

A literal reading of the phrase "upcoming 12 months" in the resolution would appear to require a growth rate that covers 12 months from the time that the Board consults with Congress. On the other hand, there is a good argument for relating monetary growth rates to planning horizons for fiscal policy (i.e., the fiscal year) or to commonly accepted periods in business planning or economic forecasting, such as the calendar year, or years ending with quarter-end months. A reasonable compromise under current circumstances would be for the System, at the present time, to adopt longer-run targets for the year ending March 1976.^{1/}

^{1/} The Blue Book would present alternative targets for such a period for the monetary aggregates, and would also include consistent targets for other shorter-run periods as well as for the year as measured from the first quarter of 1975 to the first quarter of 1976.

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With the Chairman scheduled to testify on May 1 on monetary policy, such a target would clearly be consistent with the Congressional resolution. Moreover, the Committee would be positioned to move its longer-run target range ahead as time passes to, for example, a year ending in June or a year ending in September. It should be observed that beginning next year the Federal fiscal year will run from October 1 to September 30 of the following calendar year.

While it seems most consistent with other economic information for the Committee's annual growth targets to refer to years ending with quarter-end months, that of course does not mean that target ranges should be reviewed no more than four times a year. It has been Committee practice to review longer-run targets at each meeting, though the review has been more intensive at meetings in which more detailed charts show projections have been presented. Continuation of this procedure is consistent with the Congressional resolution and is, in fact, implicitly allowed for by the sentence in the resolution, quoted above, that refers to changing conditions. Indeed, some changes in the specified growth ranges are likely to be needed solely on technical grounds, since relationships among the various aggregates will shift with changing interest differentials and the vagaries of consumer and investor attitudes.

Thus, at each meeting the staff would present alternative longer-run growth rates for Committee consideration. When a new quarter-end month is past, the year could be moved forward by a quarter. The Committee would not, of course, be bound to the practice of moving the target year forward four times per annum. It may prove to be desirable--given the incoming flow of new economic information, especially the

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timing of information on the Federal budget--to move the target year forward less frequently, say, twice a year. In any event, irrespective of the particular target period, the specifications adopted would need to be reviewed and, if necessary, re-adjusted at each meeting.

The concurrent resolution refers to monetary and credit aggregates in the plural, which also represents a substantial change from earlier draft versions of the resolution. The FOMC already sets longer-run targets for three aggregates--specifically M_1 , M_2 , and the bank credit proxy. Because there may be unexpected shifts from time to time among various forms of deposits, and since broader measures of liquidity have considerable economic significance, the staff recommends that the Committee set its longer-run targets in terms of an even broader family of aggregates by the addition of M_3 , M_4 , and M_5 .

M_3 includes deposits at thrift institutions (as well as credit union shares). These deposits are as liquid as the bank time deposits included in M_2 . Moreover, deposit flows at thrift institutions are critical to mortgage market conditions.

M_4 is defined as M_2 plus large CD's, and M_5 encompasses M_3 plus large CD's. Large CD's represent immediately available funds in the hands of corporations and others. Thus, they serve the same liquidity function as other time deposits, and can also--through reserve requirements and the potential reach of Regulation Q--be influenced by Federal Reserve policy instruments. The broadest monetary aggregate recommended-- M_5 --would represent a comprehensive measure of currency plus all deposits at banks and other financial institutions.

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The numerical growth ranges adopted for these several monetary and credit aggregates would be utilized in the Board's testimony to Congress in connection with the concurrent resolution. It would therefore also be logical to include them in the FOMC's policy record. The record would contain relevant explanatory material, particularly at times when significant changes were made in the longer-run targets.

As an alternative, the FOMC may wish to consider including the growth ranges directly in the penultimate paragraph of the directive since they can be construed as part of the general policy stance described in that paragraph. If that were done, the staff believes that the shorter-run operating targets should also be included as a part of the last paragraph of the directive. Putting shorter-run targets in the directive would avoid any possible market confusion that the longer-run growth ranges apply month-by-month. It would also make it clear that the FOMC continues to have both money market and aggregates objectives, and that it is willing to tolerate relatively wide short-run fluctuations in the monetary aggregates around a long-term norm.

Use of numerical specifications in the directive would also eliminate the ambiguities of language in the last paragraph of the directive whereby, among other things, the span of time referred to with respect to future and past growth rates for the aggregates is unclear. The last paragraph would, with specifications included, clearly refer to the interval between meetings. A sample draft directive revising the last two paragraphs to show long and short-run specifications is attached (attachment B).

Attachment A

94th CONGRESS
1st SESSION

H. CON. RES.

(Original Signature of Member)

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IN THE HOUSE OF REPRESENTATIVES

Mr. Rees submitted the following concurrent resolution; which was referred to the Committee on Banking, Currency and Housing

CONCURRENT RESOLUTION

Whereas article I, section 8 of the Constitution provides that Congress shall have the money power, namely "...to coin money and regulate the value thereof";

Whereas Congress established the Federal Reserve Board as its agent, and delegated to its agent the day-to-day responsibility for managing the money supply;

Whereas the United States economy is now suffering from excessively high unemployment and a decline in production and the gross national product, together with inflation;

Whereas the economy's performance in part is affected by changes in the rate of growth of the monetary and credit aggregates: Now, therefore, be it

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Resolved by the House of Representatives (the Senate concurring),
That it is the sense of Congress that the Board of Governors of the
Federal Reserve System and the Federal Open Market Committee --

(1) pursue policies in the first half of 1975 so as to encourage
lower long term interest rates and expansion in the monetary and
credit aggregates appropriate to facilitating prompt economic
recovery; and

(2) maintain long run growth of the monetary and credit aggregates
commensurate with the economy's long run potential to increase
production, so as to promote effectively the goals of maximum employ-
ment, stable prices, and moderate long term interest rates.

Pursuant to this resolution, and taking into account the international
flows of funds and conditions in the international money and credit
markets, the Board of Governors shall consult with Congress at semiannual
hearings before the Committee on Banking, Housing and Urban Affairs of the
Senate and the Committee on Banking, Currency and Housing of the House
of Representatives about the Board of Governors' and the Federal Open
Market Committee's objectives and plans with respect to the ranges of
growth or diminution of monetary and credit aggregates in the upcoming
twelve months. Nothing in this resolution shall be interpreted to require
that such ranges of growth or diminution be achieved if the Board of
Governors and Open Market Committee determine that they cannot or should
not be achieved because of changing conditions. The Board of Governors
shall report to the Congress the reasons for any such determination
during the next hearings held pursuant to this resolution.

Attachment B

SPECIMEN DIRECTIVE
(Last two paragraphs; growth
ranges shown are purely illustrative)

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to stimulating prompt economic recovery and increased utilization of the nation's resources, while resisting inflationary pressures and working toward equilibrium in the country's balance of payments. For the 12 month period from March 1975 to March 1976, the following growth ranges for the major monetary and credit aggregates are presently thought to be consistent with this objective: M_1 , 4-7 per cent; M_2 , 9-11; M_3 , 10-12; M_4 , 8-10; M_5 , 7-9; and bank credit proxy, 7-10.

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee over the next five weeks seeks to achieve bank reserve and money market conditions consistent with a weekly average Federal funds rate in a $5\frac{1}{2}$ - $6\frac{1}{4}$ per cent range and with percentage annual rates of growth during April and May, on average, ranging between $4\frac{1}{2}$ - $6\frac{1}{2}$ per cent for M_1 , $7\frac{1}{2}$ - $9\frac{1}{2}$ per cent for M_2 , and 5-7 per cent for the bank credit proxy. [To the extent consistent with these objectives, open market operations should be conducted in such a way as to encourage lower long-term interest rates.]

April 4, 1975

CONFIDENTIAL (FR)
CLASS II FOMC

TO: David P. Eastburn
FROM: Department of Research

SUBJECT: FOMC RESPONSE TO THE
CONGRESSIONAL RESOLUTION
ON MONETARY POLICY.

INTRODUCTION AND SUMMARY OF CONCLUSIONS

This memorandum lays out a suggested general framework for the Federal Open Market Committee to respond to the resolution recently passed by Congress concerning monetary policy. That resolution brings to the fore a need for the Committee to reevaluate some of its procedures for establishing and disclosing policy strategy. While the Subcommittee on the Directive will be coming to grips with the fundamental issues of goals and targets, the Congressional resolution makes it appropriate to review aspects of these issues at this time.

This memorandum concludes that the resolution represents a useful affirmation on the part of Congress of the importance of long-term targets and of the role of Congress as an overseer of the basic objectives and overall implementation of monetary-policy. We believe, therefore, that the FOMC ought to react positively to the basic thrust of the resolution.¹
In addition, we believe that a good-faith response will encourage Congress

¹In this connection, the staff believes that certain specifics of the resolution are ill-conceived and counter-productive and these should be brought to Congressional attention. In particular, we are concerned with Congress' apparent misunderstanding of how interest rates are determined. A detailed discussion of this, however, is beyond the immediate scope of this memorandum.

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to view specific FOMC criticism of the resolution and suggestions for improving it as constructive rather than defensive or obstructionist.

As a result of these general conclusions, we make the following specific recommendations:

1. That the Committee greet the resolution in the spirit of a meaningful framework for meeting Congressional objectives.
2. That the Committee avoid giving any impression of desiring to evade the intent and spirit of the resolution. In particular, aggregate targets should continue to be set nearly as specifically as they now are.
3. That the Committee should adopt the letter and spirit of the resolution by extending the policy horizon to a full year.
4. That the required reports to the Congress reflect the views of the entire Committee and include dissenting opinions where appropriate.

GENERAL GUIDELINES

There are a variety of general principles we believe ought to guide the Committee in its policy procedures. Two seem particularly relevant to the Congressional resolution.

Atmosphere of Cooperation

The first of these principles is that the System ought to be as cooperative as possible in the establishment of a proper Congressional overview of monetary policy. Clearly, under the Constitution, Congress possesses important monetary powers. Congress has created the Federal Reserve System to act as its agent in carrying out its monetary policy responsibilities. Thus, it is only proper that Congress should attempt to determine how well its agent carries out delegated duties.

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By adopting a cooperative attitude, the System stands a better chance of playing a major and constructive role in establishing the nature and extent of the overview, while at the same time seeing that the conduct of monetary policy is kept appropriately aloof from political pressures. Congress seems to be searching for the best way to hold the Federal Reserve accountable, as evidenced by the looseness of the wording of the resolution, and would most likely respond favorably to a positive initiative by the System.

Because of the wide latitude provided to the Committee in interpreting its obligations under the resolution, the practical impact of the resolution could turn out to be small. There might be some temptation to take advantage of its looseness to proceed largely as before. Thus, the Committee might respond to the resolution only with great reluctance and only with further prodding by the Congress. However, if Congress were to tire of this struggle, it might be catalyzed into further action. It could pass even more restrictive legislation that would do neither the Nation nor the System any good.

Although we recommend a positive response by the System to the general spirit of the resolution, such a response does not imply acceptance of all its specific provisions. Indeed, as footnoted on page 1, we believe there are legitimate objections to parts of the resolution. But if the attitude of the Fed is cooperative, Congress probably will be less suspicious of the System's motives in raising objections and the FOMC will be in better position to play a major role in setting the broad goals of monetary policy and how it should be judged in implementing monetary policy.

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Openness of Policymaking

The second general principle is that the System should be as open as possible about its policies. Such a stance is consistent with the characteristics of a democratic society, is responsive to the greater demand for less secrecy in government, and has potential economic advantages as well.

The issue of disclosing FOMC policy targets goes beyond the narrow question of whether the letter of the law or of the current resolution requires the Committee to disclose its targets in an explicit and specific way. The real issue is that in our kind of society the presumption should always favor open government, and that presumption is in sharper focus now than ever before. Only if it can be clearly demonstrated that it is in the nation's best interest should information be withheld. That is, the burden of proof rests on those who do not want to disclose information.

It has been argued that timely publication of long-run targets will (a) worsen the performance of the money markets and make the conduct of monetary policy more difficult, (b) increase the profit opportunities of the more sophisticated money-market participants, and (c) confuse the public about policy. These assertions are largely unsubstantiated, however, and, therefore, do not make a compelling case for withholding long-run targets. In fact, there seems to be more logic on the side of those who argue that publishing the long-run targets would (a) improve, not worsen, the performance of money markets, (b) decrease, not increase, the profit opportunities of the more sophisticated, and (c) enlighten, not confuse, the public about policy.

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(a) Disclosure and the performance of financial markets

No one can be certain whether money markets would function better or worse in light of additional information. Normally, however, more and better information makes markets more efficient. In addition, publication of two-month targets has apparently had no adverse impact on the functioning of markets. Moreover, speculation tends to result from uncertainty. If market participants had more information, there would be less undesirable speculation and implementation of monetary policy could be made easier.

(b) Disclosure and profit opportunities

Contrary to the view that more information would help the sophisticated investor to the disadvantage of the less sophisticated, the opposite outcome is more likely. The comparative advantage of the more sophisticated stems from being able to draw sound conclusions from slim evidence. Thus, providing more information would probably be more equitable because information now available in practice to sophisticated market participants would be available to all participants.

(c) Disclosure and public understanding of policy

After a learning period, disclosing longer run targets would likely provide more, not less, understanding of policy. Under present procedures, with only two-month

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targets published, the public might infer that the Fed's concern with the aggregates is primarily with short-run growth and that it does a poor job at achieving this. Long-run targets, in contrast, are usually easier to relate to the basic thrust of price and employment policy and are less difficult to hit.

RECOMMENDED PROCEDURES

With these general principles in mind, we suggest several ways the FOMC might adapt its current procedures to accommodate the resolution. We recommend that in following the dictates of the resolution the FOMC should avoid procedures that could be construed as an attempt to evade the intent of the resolution. Thus, the FOMC should not draw back from the fairly explicit way in which long-run targets are now formulated. Instead, it should strive to clarify its targets for the Congress, and to assist in developing a framework for holding the Fed accountable in hitting its targets.

Being Specific About Targets

The resolution calls upon the Board of Governors to consult semi-annually with the Congress about FOMC objectives for growth of the monetary or credit aggregates over the ensuing year. The Congress has apparently left up to the Committee which of the aggregates it should focus on and how precise the targets should be.

Targets. We see no reason why the act of reporting to the Congress ought to change the aggregates the Committee monitors. Therefore, until it is decided on analytical grounds to change aggregates, we recommend the

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FOMC should continue to monitor M_1 , M_2 , M_3 , and the Adjusted Credit Proxy. Moreover, we recommend that the Committee should continue its current practice of concentrating most frequently on M_1 and M_2 , and should make its reports with this emphasis to the Congress. The weight of empirical evidence suggests that these variables are linked to economic activity more closely than other aggregates. Furthermore, introducing too many aggregates may appear as an evasive tactic by the Federal Reserve to avoid accountability, especially since systematic evidence seems to suggest that little or no additional information is obtained by looking at many as opposed to a few aggregates.

Target Ranges. The resolution also is not explicit about the precision of the growth rate targets to be reported to Congress. The resolution requires only a report on ranges of growth targets, without specifying the width of the ranges. We suggest that the target ranges should be narrow.

There are two possible rationales for using a target range as opposed to a target number. The first is that the Committee cannot precisely hit a predetermined monetary growth rate and so a target range is used to accommodate likely misses. The second rationale is that because of the lack of precision of policymaking the Committee cannot reasonably make fine distinctions in choosing exactly the right target growth rate, and a range is used to acknowledge the imprecision of policy. The second rationale has more merit than the first in our view. In the current discussion, targets should be based primarily on what is desirable-- not what is easily attainable. Only by following this approach can the Committee know when the aggregates growth rates have deviated from the "ideal," and so be prompted to take corrective action.

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From a review of Committee discussions, it appears that the threshold for discerning policy differences has been about one-half percentage point. That is, the Committee has attached importance to the choice among policies that differ from one another by one-half percentage point. A wider range--and certainly a range wider than one percentage point--would appreciably dilute the significance of long-run targets in the policy process.

Choosing a narrow target range not only is appropriate from an economic point of view, but it would also be a clear demonstration of a cooperative spirit; whereas, a wide range might evoke suspicion and skepticism that the FOMC was trying to "beat" the resolution. No matter how narrow the target range, it would be entirely consistent to explain to the Congress the nature of the constraints that can prevent attainment of aggregates targets. It would be particularly important, in this regard, to "educate" the Congress about the existence of a trade-off between attainment of interest rate and aggregates goals. Congress needs to understand that interest rate constraints can prevent attainment of aggregates targets.

Target period. The Congressional resolution specifies that the length of the target period in which Congress is interested is one year. This is an indication that Congress expects the Committee to lengthen its horizon for monetary policy planning. Such a lengthening of the policy horizon is appropriate. If the Committee consistently had its sights on a long-term target, that would provide it with a frame of reference within which to pursue short-term policy. The availability of a long-term guide for monetary policy would assist the Committee in getting back on course.

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Therefore, we recommend that the Committee not only set, but actively use 12-month targets in making policy. Moreover, we suggest that the FOMC should revise these targets only infrequently--in response mainly to changes in basic economic considerations rather than short-term credit market conditions.

Framing the Report

The resolution calls upon the Board of Governors to speak for the Committee about intended monetary policy. A key issue is how the Board's statement to Congress is to be determined. Since the policy which the Board will articulate will be a statement about future Committee policy, the contents of the statement to Congress should be determined through Committee debate and decision. An extended meeting of the FOMC prior to each report to Congress will probably be necessary for the Committee to deliberate adequately. In addition, dissenting views ought to be included as part of the statement, as is now done in the published policy record. Congress created a central bank with a decentralized structure with the expectation that a diversity of views makes for wiser policy. Minority views, therefore, should be aired along with those of the majority in reporting to Congress.