



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

May 11, 1978

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee SUBJECT: Proposed modification
FROM: Chairman Miller *Bill* in language of the FOMC
directive

On a number of occasions--most recently at the monetary oversight hearings before the Senate Banking Committee on April 25--the FOMC has been criticized for failing to achieve its two-month "short-run targets" for M-1 and M-2 while regularly achieving its targets for the Federal funds rate. This criticism clearly is not fair because the FOMC uses the 2-month ranges for the monetary aggregates not as targets to be hit but as guides for operations. The public, however, does not appear to perceive, or appreciate, such a distinction.

Members of the FOMC are, of course, well aware that the Desk cannot be expected regularly to achieve 2-month growth rates in the aggregates within the ranges established by the Committee, given the length of the lag between changes in the funds rate and changes in the money supply, the constraint imposed on the extent of funds rate movement between Committee meetings, and the fact that a quarter or more of the 2-month period has already elapsed at the time of the meeting. If the Committee can be said to have targets for the aggregates, they would be the longer-run ranges. Adjustments in the funds rate have

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been designed mainly to increase the odds that the aggregates will be in their longer-run ranges, and not to hit a particular 2-month range. But that approach apparently is not understood by the Congress and the public.

The public's confusion on this point can probably be traced, at least in part, to the language of the Committee's directive. For example, the statement in the monetary aggregates formulation that "The Committee seeks to encourage near-term rates of growth in M-1 and M-2 on a path believed to be reasonably consistent with the longer-run ranges for monetary aggregates" would seem to suggest that the Committee believes that near-term growth rates can be strongly influenced by operations in the current period and that the 2-month growth rates are in practice targets. Also, the instruction to the Manager to notify the Chairman if "the operating constraints specified above are proving to be significantly inconsistent" would seem to suggest that the Committee has multiple short-run targets--i.e. targets for both the funds rate and the aggregates--because otherwise inconsistencies could not arise.

In an effort to overcome the apparent misinterpretation of our short-run ranges, I've worked with the staff to develop possible modified language for the concluding paragraphs of the directive. The proposed formulation, which is shown in an attachment, is not designed to change the substance of our instructions. If the modifications were adopted, the FOMC would still have full latitude to stress money market conditions or aggregates--by, for example, narrowing or

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widening the relevant ranges. But the new language is designed to be less likely than the current formulation to lead to mistaken inferences about the role of the short-run ranges for the aggregates.

I would appreciate the Committee's consideration of language along these lines when it addresses the subject of the directive at next week's meeting.

Attachment

Draft May 11, 1978

Suggested substitute for final four paragraphs of domestic policy directive

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster bank reserve and other financial conditions that will resist inflationary pressures while encouraging continued moderate economic expansion and contributing to a sustainable pattern of international transactions. At its meeting on April 18, 1978, the Committee agreed that these objectives would be furthered by growth of M-1, M-2, and M-3 from the first quarter of 1978 to the first quarter of 1979 at rates within ranges of 4 to 6-1/2 per cent, 6-1/2 to 9 per cent, and 7-1/2 to 10 per cent, respectively. The associated range for bank credit is 7-1/2 to 10-1/2 per cent. These ranges are subject to reconsideration at any time as conditions warrant.

In the short run, the Committee seeks to foster money market conditions that are consistent with the longer-run ranges for monetary aggregates cited above, while taking account of more general financial market conditions, including the conditions in foreign exchange markets. During the period until the next regular meeting, System open market operations shall be directed initially at keeping the weekly average Federal funds rate at about the current level.^{1/} Subsequently, operations shall be directed at maintaining the weekly Federal funds rate within the range of _____ to _____ per cent. The specific level of the

^{1/} Or, at attaining a weekly average Federal funds rate slightly (or somewhat) above (or below) the current level.

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Federal funds rate sought shall be influenced by the relationship between the latest estimates of annual rates of growth in the May-June period of M-1 and M-2 and the following ranges: _____ to _____ per cent for M-1 and _____ to _____ per cent for M-2. For this purpose, M-1 and M-2 shall be given approximately equal weight.

If the rates of growth in the aggregates appear to be above the upper limit or below the lower limit of the indicated ranges at a time when the objective for the funds rate has already been moved to the corresponding limit of its range, the Manager is promptly to notify the Chairman who will then decide whether the situation calls for supplementary instructions from the Committee.