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

December 13, 1978

STRICTLY CONFIDENTIAL (FR)
CLASS I - FOMC

TO: Federal Open Market Committee

FROM: Murray Altmann

Attached is a copy of a memorandum from the Subcommittee on the Directive dated today and entitled "Implications of the Full Employment and Balanced Growth Act of 1978 for FOMC Aggregate Targeting Procedures."

This memorandum will be discussed by the Committee at its meeting on December 19 under agenda item 9.

Attachment

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December 13, 1978

TO: Federal Open Market Committee

FROM: Subcommittee on the Directive (Presidents Eastburn and Volcker, Governors Partee (Chairman), Teeters, and Wallich)

SUBJECT: Recommendations on FOMC procedures to implement the "Humphrey-Hawkins" Act

The attached report discusses the implications of the Full Employment and Balanced Growth (FEBG) Act of 1978 ("Humphrey-Hawkins" Act) for FOMC operating procedures and incorporates the recommendations of the Subcommittee on the Directive. Foreign travel prevented Governor Wallich from participating in the meeting of the Subcommittee on December 11, but he has reviewed the report and concurs in the recommendations.

Governor Teeters dissented from the Subcommittee's recommendation (No. 4) relating to the basic economic objectives enunciated by the President. A copy of her dissenting statement is attached.

President Volcker dissented from recommendation No. 7 because in his view the 3-month averaging procedure, by sharply dampening growth rates, might tend to reduce the sensitivity of System responses to incoming information on the aggregates, unless the short-term ranges were narrowed quite sharply. At the same time, a marked narrowing of the ranges could tend to convey an exaggerated impression to the public of fine-tuned precision in the setting of ranges. While the difference from recent procedures could be more cosmetic than real, it did not seem desirable to obscure large changes in growth rates for an up-coming month by the averaging procedure.

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Mr. Eastburn also expressed reservations about this recommendation, since he feared that the arithmetically corresponding reduction in the ranges specified by the Committee might appear unrealistically narrow to public observers.

Attachments

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Dissenting Statement -- Paragraph 4, Page 3
of the
Subcommittee on the Directive Report

A clear objective of the FEBG Act is to improve public understanding of the economic policy intentions of the Federal Government and of the analysis on which these intentions rest. The reporting requirements of the Act provide the Federal Reserve with a valuable opportunity to begin an educational program directed to the Congress and the public concerning the interactions between monetary, fiscal and regulatory policies, and the need for consistency between them.

In order to do so, the Federal Reserve need not adopt explicit economic objectives independently. Given the uncertainties associated with economic forecasting and the establishment of public policy objectives, a useful first step would be to include statements in the Federal Reserve reports concerning the probabilities (chances) that the monetary objectives adopted by the FOMC are consistent with the President's economic objectives. The reporting requirements of the FEBG Act also provide the opportunity to make clear that the Federal Reserve is concerned with ultimate economic objectives, and that stating objectives in terms of monetary aggregates is solely a means to that end. In the absence of a forthcoming attitude on the part of the Federal Reserve System, a clear danger exists that the Congress will force the System to operate on the basis of prescribed rules.

Nancy H. Teeters
December 13, 1978

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December 13, 1978

Implications of the Full Employment and Balanced Growth Act of 1978 for FOMC Aggregate Targeting Procedures

A. Introduction

The Full Employment and Balanced Growth (FEBG) Act of 1978 ("Humphrey-Hawkins" Act) replaces the existing legislative foundation of the FOMC's procedure for setting long-term targets with a new approach. The existing procedure was originally formulated in response to Congressional Joint Resolution 133, the relevant parts of which were subsequently embodied as an amendment to the Federal Reserve Act in 1977. The legislative language called for the Board to consult with the House and Senate banking committees, in effect quarterly, regarding the Board's and FOMC's "objectives and plans with respect to the ranges of growth or diminution of monetary and credit aggregates for the upcoming twelve months...."

The 1978 legislation (which amends section 2A of the Federal Reserve Act) retains much of this original wording but requires the Board to report in writing to Congress on its and the FOMC's "objectives and plans" for the aggregates for the "calendar year" by February 20 of each year and again for the current calendar year by July 20. In addition, the July report is to include a statement of "objectives and plans" for the aggregates for the coming calendar year. The Board's report is further expected to "review and analyze" recent developments "affecting economic trends in the nation." Moreover, it is to set forth the "relationship" of the objectives and

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plans for the aggregates to numerical short-term goals for the economy required by the FEBG Act to be set forth in the Economic Report of the President as well as to "any short-term goals approved by the Congress."

In our view, the new legislation calls for a re-examination of several aspects of current FOMC procedures and provides an appropriate occasion for reviewing some other long-standing issues. These various matters include: (a) The time horizon for which targets are set and the method of computation of the long-run aggregate growth rate targets; (b) the scheduling of Committee meetings for setting long-term targets and possible implications for the Committee's meeting schedule as a whole; (c) the implications for the FOMC of the requirement that the Board's report discuss the "relationship" of the aggregate targets to the President's economic goals; (d) the format of the domestic directive; (e) the relationship of short-term targets and operating procedures to the long-term targets; and (f) the possible inclusion of reserve or monetary base measures as long-term targets.

These matters are taken up in some detail following a summary of recommendations.

B. Summary of Recommendations

1. The FOMC should establish long-term growth ranges for the monetary and credit aggregates for the current calendar year at its February meeting. These targets should be reviewed at its July meeting and preliminary targets should then be established for the following calendar

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year. Ranges established at the February and July meetings would, of course, be subject to change at any time as conditions might warrant.

2. Growth rate ranges should be measured in terms of per cent changes from the fourth quarter of the previous year to the fourth quarter of the calendar year being targeted.

3. Certain changes in the Committee meeting schedule appear required by the FEBG Act and, at the same time, suggest that the Committee might consider moving to a 10 meeting schedule. The February and July meetings will have to be held earlier in the month than is normal to give the Board sufficient time to prepare the written reports to Congress required by the FEBG Act. For 1979, Tuesday, February 6 and Wednesday, July 11 appear appropriate. Given this schedule, January and June meetings held at the normal time would take place only three weeks in advance of the "long" February and July meetings. This appears to represent too short an interval between meetings to make good use of Committee members' time and we recommend the January and June meetings be dropped. A suggested 1979 schedule modified along these lines is presented in the final column of Appendix I.

4. The FEBG does not require the Committee explicitly to adopt any particular set of basic economic goals and we do not recommend that it attempt to do so. It only requires the Board on behalf of the Federal Reserve System to set forth the relationship of the FOMC's longer-run monetary growth rates to the short-term goals of the Administration or Congress. To help in determining this relationship, the staff should

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present the Committee with an extensive analysis of the apparent consistency or inconsistency of alternative monetary growth rates with the President's economic goals as well as an evaluation of the extent to which there is internal consistency among the goals themselves.

5. As detailed in the memorandum, some relatively minor changes will be required in the wording of the directive paragraph currently used to refer to the long-term target ranges.

6. The new law does not require any change in the present procedure for formulating short-term tolerance ranges. Nevertheless, the change in the formulation of the long-term ranges will tend to focus greater attention on actual performance relative to these ranges when setting short-term policy objectives. We do not endorse proposals to relate short-term tolerance ranges by fixed rule to the long-term growth ranges. But to assist the Committee in making short-run decisions in light of the long-run targets, the blue book should track actual growth in the calendar year to date relative to the long-run path and should provide alternative projected routes for reapproaching this path when deviations have occurred.

7. We recommend that the short-run growth rate ranges for the monetary aggregates be redefined in terms of the per cent change in the three-month average level of a given monetary measure--centered generally on the month in which the meeting is held--from the average level of the three previous months (e.g., at the November meeting, the range would be the growth rate from the July-August-September average to the October-November-

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December average measured at an annual rate). Such a redefinition of the tolerance range would lenthen somewhat the extremely short-run character of the present policy period, and would therefore tend to reduce the volatility of growth rates. If this approach is taken, the FOMC would also have to narrow the normal width of its tolerance ranges significantly if it wishes to remain as responsive as under current procedures to incoming data on the aggregates. This is technically necessary because the proposed method for setting short-run ranges entails a longer-time period, as well as an end-point that is a three month average (rather than a single month); both changes serve to dampen fluctuations expressed as annual growth rates. The proposal to change the method of setting the short-run aggregate ranges and also to adjust the width of the ranges correspondingly would not change the substance of monetary policy in the short-run, but we believe it would improve communications regarding the role of the tolerance ranges.

8. We would not support the addition of a reserve or monetary base measure to the list of aggregates used as long-term targets at this time. Such measures are subject to the same kinds of problems created for M-1 by the shift into ATS accounts because of the differential reserve requirement ratios for demand and savings deposits. The question of using the monetary base or other reserve measure as an operational variable was also viewed as too complex to be taken up in a report that had to be expedited.

C. Implications for Formulation of the Long-term Targets

With respect to the long-term targets, the new law affects the time periods over which the targets are to be defined and the frequency

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with which reports on the targets are to be made, but has no direct effect on other aspects of target formulation. (The portion of the Act dealing with monetary policy is appended.) In particular, the new law, like the existing legislation, refers broadly to "ranges of growth or diminution of the monetary and credit aggregates." It therefore does not attempt to restrict the list of aggregates to be targeted. It does, however, continue explicitly to mention "credit aggregates," which are currently included by the FOMC in the form of an "associated range" for total bank credit. Similarly, the language of the legislation continues to leave open the question of the widths of the relevant "ranges." In short, beyond specifying the period(s) for which the reported ranges shall be set and the dates by which the Board must report on these ranges, the new law is not more restrictive than the existing legislation with respect to the Committee's approach to long-term targeting. Moreover, the new legislation continues the language contained in the current law stating that "nothing in this Act shall be interpreted to require" that the ranges be achieved if the Board and the FOMC "determine that they cannot or should not be achieved because of changing conditions." Unlike the existing legislation, however, the new law requires that subsequent Board reports to Congress "shall include an explanation of the reasons for any revisions to or deviations from such objectives and plans."

With respect to timing, as noted, the new law requires that ranges be set for the current calendar year and that these ranges be

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reported to the Congress by the Board in February and again in July. It also requires that the July report include ranges set for the upcoming calendar year. Under the present system, four-quarter ranges are set once each quarter on a moving base defined as the quarterly average level for the quarter just concluded. This system has in some respects proven unsatisfactory, or at least confusing, and the new law seems to us to provide a very good opportunity for replacing it with a more orderly approach.

Consequently, we propose that beginning with 1979, the Committee define its aggregate targets solely for periods covering calendar years and that normally such targets be formulated twice yearly, at the beginning and middle of the year. The mid-year review would, of course, consider what changes, if any, should be made in the target for the current calendar year in light of economic developments and the actual performance of the aggregates over the first half. Moreover, preliminary target ranges for the coming calendar year will have to be formulated at the mid-year review as required by the FEBG Act. They, in turn, would be reviewed the following February. Obviously, nothing in this proposal (or in the legislation) is to be construed as inhibiting the Committee from making interim reformulations of its aggregate objectives if circumstances warrant.

We further recommend that the calendar year targets be defined in terms of percentage changes measured on a fourth-quarter average basis. A fourth-quarter to fourth-quarter basis of computation has two

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advantages over computations based on annual averages. First, use of a fourth-quarter average base begins the target period from the last recorded quarterly observation. (We rule out a December-to-December computation as relying on a single month's base that could be too unstable as well as too vulnerable to revisions in the data for the base month.) A yearly average base, by contrast, is centered on a date six months prior to the beginning of the new calendar year. Second, the fourth-quarter average basis is more convenient to use arithmetically when examining the implications of developments over a part of the year. For example, if the full year target defined on a fourth-quarter average basis is 6 per cent, while the fourth-quarter to second-quarter annual growth rate has turned out to be 8 per cent, it is easily seen that the implied growth rate for the remainder of the period (from the second quarter to the fourth quarter) must be approximately 4 per cent to achieve the 6 per cent target for the full four-quarter period. Such manipulations are more difficult (or impossible) to make when targets are defined on a calendar year average basis.

As indicated, we see the changes proposed to bring FOMC practice in line with the requirements of the new legislation as offering an opportunity for dealing more directly with defects long widely felt to inhere in the existing system. In particular, the existing system, in which the base and target period are shifted ahead once each quarter, does not seem well designed to focus on the longer-run performance

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of the aggregates in setting targets or in appraising performance. The system of quarterly resettings of the ranges and of the time periods covered often makes actual performance relative to objectives very difficult to evaluate. Moreover, shifts in the base every quarter tend in practice to reduce the extent to which the long-term targets for the aggregates influence short-term policy decisions.

The existing system has been characterized by prolonged periods of "base drift" for one or more of the aggregates--i.e., a situation in which unchanged target growth rates are set in two (or more) successive quarters, but are set on actual quarterly bases that are, as has been the case for M-1 in recent years, above the midpoint (or even the upper end) of the target growth ranges. Still, the FOMC could at any time have offset base drift, had it wished to do so--by adjusting target growth ranges in subsequent quarters to compensate for the drift and accepting whatever funds rate adjustments might be needed. Thus the phenomenon of base drift should be regarded as more a reflection of policy decisions than a consequence of technical deficiencies in the formulation of the targets. At a more fundamental level it reflects the fact that the objectives of monetary policy relate to economic performance rather than to monetary behavior _per se_. And, of course, the new system could simply lead to annual (or semi-annual) base drift to the extent that targets set for subsequent years are not designed to compensate for overruns or underruns in the previous year. Nevertheless, the proposed new system would appear to encourage a more systematic consideration of past overruns and underruns.

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First, at the mid-year review, the Committee will have to decide explicitly whether it wants to keep the existing target for the full year, given actual first-half performance and its implications for the growth needed over the balance of the year to achieve this target. Second, the extension of the time horizon to a six quarter period at the mid-year review, when preliminary targets for the coming calendar year must be set, may provide a realistically long period over which the Committee might, if it chose, contemplate offsetting first-half misses without unduly sharp movements in operating targets such as the funds rate. Third, the fixing, however arbitrary, on calendar years (measured fourth-quarter to fourth-quarter) will make it possible to say unambiguously whether or not actual behavior did or did not fall within targeted ranges and will provide a convenient (again, if arbitrary) time unit as a common measure of the performance of the monetary aggregates.

D. Timing of FOMC Meetings

As indicated, the beginning-year report by the Board on the aggregate targets must be submitted to Congress by February 20. Moreover, while nothing in the Act suggests that the targets must necessarily be brought into line with the quantitative "goals" for the economy stated in the President's economic report, the thrust of the law does clearly suggest that the FOMC's target decision should at least be formulated with full knowledge of these goals. According to

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the law, the President's report is to be transmitted to Congress "during the first twenty days of each regular session." This is a change from the language of the 1946 Full Employment Act, which specifies that the President's report be made by January 20, and means that in theory the report could be issued quite late, leaving little time before the February 20 deadline for the Board's report. For 1979, however, a Congressional Ajournment Resolution has fixed January 22 as the deadline for the report. Moreover, it appears likely that some key numbers among the "short-term goals" would become known informally by the staff before this date.

For the FOMC, the requirement that the Board report on or before February 20 and July 20 means, as a minimum, that the February and July Committee meetings will have to be held at earlier dates than they would be under current scheduling procedures. (The February and July dates sent to the Committee on September 29 as a "possible" schedule for 1979 were Wednesday, February 21 and Tuesday, July 17.) With respect to the February meeting (and confining options to Tuesdays and Wednesdays with a preference for Tuesdays), the Tuesday-Wednesday period of February 13-14 appears uncomfortably close to the February 20 reporting date. Consequently, we recommend Tuesday, February 6, expecting that the meeting might last for a good part of the day. With respect to the July meeting, Wednesday, July 11 appears the best choice (preferred over Tuesday since there is a BIS meeting on Monday of the same week).

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Given the present schedule of meetings for the remaining months (see attachment), the interval between the January and February meetings would be only three weeks, with the interval between February and March amounting to 6 weeks. Similarly, the June-July interval would be three weeks while the July-August interval would be 6 weeks. Given the availability of telephone conferences if needed, the 6-week intervals, especially following major meetings do not seem unacceptably long. On the other hand, 3 weeks is certainly a shorter-than-ideal interval between full dress FOMC meetings and leads us to question whether the travel and use of time of the Committee and its staff is justified.

We would propose instead that the schedule be reformulated to eliminate periods as short as three weeks between meetings and thus reduce the number of meetings for 1979 to 10 on the grounds that schedules involving three-week intervals are unnecessary and are not a good use of System resources. A possible 10-meeting schedule for 1979 is shown in column II of the attachment. All the meeting dates in this list are Tuesdays, except for July 11, a Wednesday, for reasons already noted. This schedule is essentially the same as the currently proposed 12-month schedule with the following modifications: (a) The February and July meetings have been moved ahead for the reasons indicated; (b) the January and June meetings, which would otherwise occur three weeks before the "long" meetings, have been eliminated; and (c) the May meeting has been moved one week relative to the current proposal and the August meeting has been moved ahead one week to even out inter-meeting intervals.

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We are not especially happy about the seven-week intervals resulting prior to the February and July meetings, but think we can live with them and perhaps find ways of shortening them in the years after 1979. Of course, telephone meetings can always be called if needed during the 1979 seven-week intervals.

It should be noted that because the February and July meetings will be held earlier in the month than under present procedures, the amount of economic data available for the preceding month at the time of the meeting will be smaller than is currently the case.

E. Relationship of Aggregate Targets to President's Economic Goals

The report to the Congress by the Board on the "plans and objectives" of the Board and the FOMC for the aggregates is expected to set forth, among other things, the "relationship" of these objectives to the "short-term goals set forth in the most recent Economic Report of the President."

The FEBG Act requires that the President's Economic Report set forth "numerical goals for employment and unemployment, production, real income, productivity and prices." The numerical goals for the current and the following calendar years are referred to as "short-term" goals in the FEBG Act, while the goals for the following three calendar years (i.e., through the fourth year after the year in which the report is made) are termed "medium-term goals."

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With respect to two items, unemployment and inflation, the Act itself sets forth objectives toward which the numerical goals mentioned above are expected to aim. The Act calls for reduction of the adult unemployment rate to 3 per cent and of the overall unemployment rate to 4 per cent by the fifth calendar year after the first such report (1984). It also calls for reduction of inflation in the consumer price index to not more than 3 per cent by 1984 and to zero by 1988. The Act appears to make the inflation goal subordinate to the unemployment goal since it requires that programs for reducing inflation "shall be designed so as not to impede achievement of the goals and timetables...for the reduction of unemployment." There is no reciporocal constraint imposed in the Act on policies for reducing unemployment. With respect to both employment and price objectives, the President may, if he "finds it necessary,...recommend modification of the timetable or timetables for the achievement of the goals" beginning with the second report and thereafter. Thus after the first year, dates for achievement of these goals could be extended.

Nothing in the Act requires that the aggregate objectives or any other aspect of monetary policy be specifically adjusted to the goals set forth in the economic report. Nevertheless, the fact that the Board must include in its report a discussion of the "relationship" of the aggregate targets to the President's goals could, on occasion, raise some delicate questions. The logical alternatives open with regard to the Board's report would seem to be either that the monetary

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targets are to be regarded as consistent with the President's goals or that the targets are not to be regarded as consistent with the goals. In this latter case, the goals themselves must therefore be regarded as either unattainable, undesirable, or internally inconsistent. Each voting member of the Committee will, in effect, have to decide for himself whether the alternative for which he votes is consistent with the President's goals or whether all or some subset of these goals are to be rejected as unobtainable, inconsistent, or undesirable for some other reasons.

Given the normal range of uncertainties surrounding economic projections, given the fact that the aggregate targets are stated as ranges, and given the fact that the Committee will naturally seek to promote the same desirable goals that the President will presumably enunciate in his report, we would expect that the Board would normally be able to find the Committee's ranges to be reasonably consistent with the short-term economic goals. Occasionally, however, specific exception may have to be taken to the goals in the Board's report on grounds of internal inconsistency of the short-term goals or for other reasons.

For the Committee itself, the chief practical implications of the Act with regard to the President's goals would seem to be, as noted, that the Committee should be informed about these goals prior to its February meeting to set monetary target ranges for the current calendar year. In addition, it seems clear that staff analysis prepared prior to the meeting should comment on the relationship between the President's

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goals and monetary and credit growth in the current calendar year at the February meeting and for the current and following calendar years at the July meeting.

Goals for employment and productivity clearly imply a real GNP goal and, together with the inflation goal, this in turn implies a goal for nominal GNP. Following its usual procedure, the staff could prepare projections for nominal GNP, prices, output, and employment under alternative assumptions about the growth rates of the monetary aggregates. These assumptions would include extension of the existing target rates of monetary growth as well as alternatives, probably including somewhat higher and somewhat lower rates of growth. The staff could then compare the nominal GNP growth implied arithmetically by the President's real output and price goals with the alternative nominal GNP projections generated by the alternative monetary assumptions. In its report to the FOMC, the staff would then comment on whether it believed one or more of the alternative monetary assumptions to be compatible with the President's goals, keeping in mind that the Committee sets <u>ranges</u> normally of two to two and one-half percentage points width.

It should be noted that the recommended approach to staff projections differs from a seemingly more straightforward alternative of simply having the staff estimate the numerical growth rates for the various monetary and credit measures that appear to it to be compatible with the nominal GNP growth arrived at by adding the President's

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output and inflation goals. There are two objections to such an alternative approach. First, to produce a monetary growth rate specifically projected as "compatible" with the implied nominal GNP growth suggests a degree of certainty in the projections process that does not exist. We do not think the staff projections should be set up in such a way as to provide a specific point estimate of the growth rates the staff projects as compatible with the implied nominal GNP goals. This would then put the Committee potentially in the position of rejecting a "compatible" set of growth rates as projected by its own staff. Thus, we prefer to have the staff proceed in the usual way, simply adding comments on the compatibility of the various alternative monetary growth rates posited in the projections with the implied nominal GNP goal, again keeping in mind that the Committee sets ranges rather than point objectives.

A second problem with asking the staff to move from the President's goals to a monetary growth rate projected as "compatible" is that the staff may believe the price and output (employment) goals to be themselves _in_compatible, at least for the short-term period under consideration. It would indeed not be surprising, on occasion at least, to find that the inflation objective seemed too optimistic given the real output objective and vice versa. The staff should comment to the Committee on such apparent inconsistencies whenever it believes them to exist. From the point of view of selecting "compatible" monetary targets, the point is that in the presence of such

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inconsistencies, there would not exist any one nominal GNP growth consistent with both output and price goals and, therefore, no single monetary target (or perhaps even range) consistent with both goals. Under these conditions, a monetary growth adequate to achieve the price objective might be too slow to achieve the output objective--and conversely. For this reason as well, we prefer not to have the staff attempt to project monetary growth rates "compatible" with the nominal GNP implied by adding the price and output goals.

F. Implications for Wording of Directive

The proposed changes in formulation of the long-term targets will require at least some minor changes in the wording of the directive. In its present form, the directive contains a paragraph devoted to the long-term targets. This paragraph presently consists of (1) a general statement of the objectives of policy, (2) a statement indicating that at the last meeting at which it considered long-term targets, "the Committee agreed that these objectives would be furthered by...," (3) the current long-term aggregate ranges, and (4) a statement that these ranges are subject to reconsideration at any time.

We recommend that this format be modified by four minor changes (see sample directive below): First, the current standard opening phase of the paragraph ("In light of the foregoing developments,") should be replaced with "Taking account of past and prospective developments in employment, unemployment, production, investment, real income, productivity,

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international trade, and payments and prices,...." It seems more appropriate to refer generally to past and prospective developments in the relevant economic dimensions than more narrowly to the specific recent developments mentioned in previous paragraphs, as is presently done. The list included here is the one mentioned in the FEBG Act as the relevant background for determining the "objectives and plans" with respect to the monetary aggregates.

Second, for the February to June meetings, the final sentence in the paragraph should be modified to read: "These ranges are subject to reconsideration at the July meeting of the Committee or at any time as conditions may warrant." The reason for this change is to indicate clearly that the ranges for the current calendar year may be revised in July. Thus, if the first-half actual growth appears to be running under or over the target range established for the year as a whole, it will be clear that such overruns or underruns do not necessarily imply compensating changes in the growth rate over the remainder of the year. Third, for the July to December meetings (or July to January, if a January meeting is held) the reference should be to the July meeting and to the ranges adopted at that meeting for the current calendar year. Fourth, just before the final sentence, a new phrase should be added to refer to the ranges tentatively adopted for the following year.

Sample Revised Directive
Paragraph on Aggregate Ranges

Taking account of past and prospective developments in employment, unemployment, production, investment, real

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income, productivity, international trade and payments, and prices, it is the policy of the Federal Open Market Committee to foster monetary and financial conditions that will resist inflationary pressures while encouraging continued moderate economic expansion and contributing to a sustainable pattern of international transactions.

FEBRUARY MEETING

The Committee agreed that these objectives would be furthered by growth of (specified money and credit aggregates) from the fourth quarter of 1978 to the fourth quarter of 1979 at rates within ranges of ______________________, respectively. These ranges will be reconsidered in July or at any time as conditions may warrant.

JULY MEETING

The Committee agreed that these objectives would be furthered by growth of (specified money and credit aggregates) from the fourth quarter of 1978 to the fourth quarter of 1979 at rates within ranges of ______________________________, respectively, and from the fourth quarter of 1979 to the fourth quarter of 1980 at rates within ranges of __________ ______________________, respectively. These ranges are subject to reconsideration at any time as conditions warrant.

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It should also be noted that we believe that there is no need to make explicit reference to the President's short-term numerical economic goals in the sentence describing the Committee's general economic objectives or elsewhere in the directive. The law does not require such a reference and we think it would be inappropriate to include one since the Committee is not required to take a position on the specific numerical objectives mentioned in the Economic Report and since individual Committee members may regard them as internally inconsistent, unobtainable, or otherwise inappropriate.

G. Relation of Short-term Tolerance Ranges to Long-term Targets

The short-term tolerance ranges are currently used by the FOMC as a means of triggering supplementary inter-meeting adjustments in the Federal funds rate in response to incoming data on the aggregates and to related changes in the short-term projections. The changes we propose here regarding the long-term targets in response to the FEBG Act do not themselves seem to require modification of the Committee's current procedures for setting short-term tolerance ranges. Of course, since the long-term range set in February will normally remain in place at least until late July, and perhaps through the calendar year, deviations of actual performance from targets may be more visible and thus more at the forefront of the Committee's short-term decision making than has been the case under a system where quarterly "base drift" has tended to absorb such deviations. The greater conspicuousness of

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deviations of actual data from targeted ranges may have an impact on the Committee's settings of the short-term tolerance ranges. But any such development need not imply a change in the way in which the tolerance ranges are formulated.

Nevertheless, a number of questions have been raised from time to time about the present tolerance range procedures and some alternative approaches have been proposed. In particular, the suggestion has been made that the tolerance ranges at a given meeting be defined in terms of levels representing a band around the current midpoint of the long-term target. This appears to be an appropriate occasion to review some of the issues involved in such proposals.

There are several ways in which such an approach could be implemented. For example, the ranges could be defined in terms of a band around a 13-week moving average of weekly data centered on the latest week. The Desk would then decide whether or not to adjust the funds rate--within constraints given by the Committee--by comparing the corresponding 13-week average of actual and projected data with the target band so-defined. Alternatively, a band could be defined in terms of the implied average target level for the month preceeding, the month of, and the month following a given FOMC meeting. Again, the Desk would base its decisions on an average of actual and projected levels which it would compare with the short-run tolerance range defined in terms of the three-month average level. Still another procedure would minimize the role of projections by focusing on the implied monthly target for the month of the FOMC meeting.

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All of these approaches have an understandable appeal as putting in place a mechanism that would more or less automatically move the funds rate in the appropriately corrective direction whenever actual monetary behavior deviated from the implied target path. The desirability of such a mechanism is seemingly enhanced by our experience in which actual monetary growth rates have at times persistently overshot or undershot the long-term targets--though these overruns or underruns have often been, as noted, more or less formally validated through "base drift." The desirability of an automatic mechanism is also seemingly enhanced by the fact that longer-term projections of the aggregate behavior likely to emerge with given funds rate paths is subject to large margins of error. Since the ability to project the funds rate behavior needed to achieve the long-term targets is weak, why not, it could be argued, at least assure that the funds rate will move in the right direction whenever actual deviations from objectives emerge.

Despite the attraction of these arguments, we would not recommend that the Committee tie short-run tolerance ranges in any mechanical way to monthly levels (or averages of weekly levels) implied by a band around the midpoint of the long-term target range. Instead, we believe the primary means through which the Committee should adapt its funds rate objectives to the long-term target should continue to be through the decisions made at each meeting with regard to inter-meeting funds rate objectives set in light of the past and projected performance of the aggregates. Under this approach, the tolerance range mechanism is

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used primarily for supplementary inter-meeting adjustments in the funds rate target. This approach to the problem of achieving the long-term targets has two properties that we think are desirable: (1) It acknowledges that the long-term growth ranges represent target growth rates _for the year as a whole_ and not target growth paths that it would necessarily be desirable to achieve on a month-by-month basis. (2) The approach allows the Committee to decide how rapidly it would like to reapproach within-target growth rates, once a deviation has taken place, with large adjustments in the funds rate objective set at FOMC meetings representing relatively more rapid returns to within-target behavior and more modest changes representing relatively slow returns to within-target behavior.

By contrast, we find the procedure of tying the tolerance ranges to the implied path of the long-term target excessively mechanical and subject to certain defects. For one thing it raises troublesome questions about the relationship between funds rate decisions taken directly by the Committee and funds rate moves resulting from the operation of the tolerance range mechanism. One interpretation would be that with tolerance ranges tied to the long-run target path, the Committee should not set _any_ initial funds rate objective for the Desk different from that prevailing at the time of the meeting, with the Desk adjusting the rate _only_ in response to deviations of the aggregates from their long-term paths. Such an approach appears clearly unacceptable, however. But if the Committee _does_ set an initial funds rate objective designed

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with a view to bringing the aggregates back to their long-run targets over time, then an automatic mechanism that generates further funds rate changes on top of this whenever the aggregates are currently off their long-run targets seems to imply over-compensation in the funds rate target. In short, if the Committee's initial funds rate decision is made with a view to moving back over time to the long-run target, then further inter-meeting adjustments in the funds rate should be triggered only if new evidence suggests the initial decision needs revision.

A second objection to tying the tolerance ranges to the long-term targets is that such a procedure means the funds rate will be moved whenever aggregate behavior falls outside the approved band around the long-run target path. Such movements in the funds rate would thus take place even when deviations from target were due to temporary factors that could be expected to be reversed, thus creating the need for subsequent reversal in the funds rate. In our view, short-run adjustments in the funds rate in response to movements in the aggregates that appear likely to be temporary and reversible are counter-productive.

We believe that the desire to avoid moving the funds rate in response to purely temporary developments provides a sound rational for the existing practice of setting the short-run tolerance ranges at least partly in light of the corresponding short-run projections. The evidence provided by the staff (see attachments) on balance suggests

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that while the short-term projections are subject to large margins of error, they nevertheless do provide useful information about prospective short-term movements in the aggregates: with such short-term movements reflecting temporary influences such as Treasury operations, imperfect seasonals, strikes and their aftermath, and the like. Such temporary developments, in our view, should be accommodated and should not be allowed to generate movements in the funds rate. Adjusting the tolerance ranges with an eye to the projections tends to provide some assurance that short-term funds rate movements will n ot be set off by purely short-term developments. On the other hand, substantial deviations of current and projected short-term behavior relative to the projections available at the time of the FOMC meeting _is_ likely to reflect an underlying shift in the relationships determining the funds rate path needed to achieve the long-term aggregate targets. In such cases, an inter-meeting adjustment in the funds rate _is_ appropriate and would in fact tend to be set off under the current procedures.

Obviously, the narrower the tolerance range set by the Committee for the short-term aggregates, the more likely are deviations from projections to set off funds rate movements and thus the greater is the risk of reacting to purely temporary developments. On the other hand, if the ranges are set too wide, the funds rate will adjust too sluggishly to underlying shifts. Clearly, Committee members must weigh both types of risk in deciding how wide tolerance ranges should be set. We believe that current tolerance range widths, generally set between 4

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and 6 percentage points, appear reasonable under most circumstances as long as the tolerance ranges continue to be defined as the annual rate of growth from the calendar month just past to the calendar month following the date of the Committee meeting.

We recommend, however, that the growth rate range be stated in a different way. We propose an end-point which is a three-month average, generally centered on the month of the meeting. The base for the growth rate would be the average of the previous three months. For example, the range for a meeting in November would be the growth from the July, August, September average to the October, November, December average measured at an annual rate. This approach would tend to reduce the volatility of the estimated growth rates over the policy period compared to the current procedure. Inclusion of one month's actual data in the ending period, of course, does not affect the magnitude of projection errors for the unelapsed portion of the period. But such a redefinition, by lengthening by one month the time between the midpoints of the base period and the ending period, would tend to reduce the impact of such projection errors on the estimated annualized growth rates. Moreover, the impact of the projection errors would be reduced further since the projection errors for the current and following month would be averaged in with one month of actual data. If this approach is taken the FOMC would also have to narrow the normal width of its tolerance ranges significantly if it wishes to remain as responsive as under current procedures to incoming data on the aggregates.

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Obviously, these effects are not substantive. Nevertheless, we think they would be helpful in allowing the Committee to set short-term tolerance ranges that will be closer to the long-term ranges than at present both in terms of midpoint and width. (At present, the short-term tolerance ranges tend to be substantially wider than the long-run ranges in view of the large size of projections errors when computed on a two-month basis.) We think such a development would also be useful in communicating to the Congress and the public and would tend to emphasize the relevance of the tolerance range mechanism in achieving our longer term objectives.

While generally endorsing the present procedures for setting and defining the tolerance ranges (with the exception just noted), we do recognize the need to keep the long-run objectives in mind in setting inter-meeting instructions to the Manager. As already indicated, we believe the use of fixed time periods for the long-term targets (the calendar year), with targets that are normally adjusted only once (at the July meeting), will in fact facilitate making meeting-to-meeting decisions in light of longer term performance. Clearly, at each meeting the staff will have to provide a path for the funds rate that appears likely to achieve the current calendar year target (and after July, the target for the following calendar year). These projections will provide background for the Committee's decision as to the post-meeting funds rate objective, with this objective subject to further modification by the tolerance range mechanism. If the Committee wishes

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to provide further assurance that its short-run decisions are consistent with achievement of the long-term growth ranges, it will certainly want to keep these long-term ranges in mind, in addition to the short-run staff projections, in setting the inter-meeting tolerance ranges so that both factors receive consideration.

As additional assistance to the Committee in setting its short-term objectives in light of the long-term targets, certain changes in, and additions to the format of the blue book presentation seem appropriate. First the staff should provide tables and charts tracking actual monetary growth in the calendar year to date relative to the targeted growth ranges for the year. Second, the staff should provide a table showing average growth rates over alternative numbers of months that would be required to return aggregate growth to the midpoint of the path implied by the midpoint of the target range for the current calendar year. Third, the staff should present alternative funds rate paths that would be associated with restoration of actual behavior to the long-term target path over certain reasonable alternative lengths of time, such as 6, 9, and 12 months, for example.

H. A Reserve or Base Measure as a Long-term Target

The question has recently been raised as to whether a measure of reserves or the monetary base should be added to our list of long-term targets. In our view, whatever the merits of including such a measure on another occasion, this would not be a good time to do so. First,

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the shift presently under way between demand and savings deposits owing to ATS accounts has the same adverse effects on total reserves (or the base) as a target, as it does on M-1. The shift in the demand for M-1, a shift of presently unknown magnitude, of course produces a reduction in the demand for high-reserve requirement demand deposits, and a rise in the demand for low-reserve requirement savings deposits. The result is a contraction in the amount of total reserves (or base) that is associated with given nominal income and interest rates. In other words, the same factors producing shifts of unknown magnitude in the demand for M-1 are producing similar shifts in the demand for total reserves (and the base). To try to establish and achieve a target for total reserves (or the base) under such circumstances could be expected to have unforeseeable and perhaps unwanted effects on GNP.

Apart from the special problems currently being created for a reserves (or base) target, we would tend to reject a further proliferation of long-term target measures at a time when the basic monetary measures themselves are about to be redefined. The question of a role for a reserves or base measure could best be taken up by the Committee should it reach the point of reconsidering whether to give some weight to reserves as day-to-day guides to operations.

Attachments

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ALTERNATIVE FOMC SCHEDULES -- 1979

	Previously Proposed Schedule		Proposed Modifications (10 Meetings)	
	Date	Interval (weeks)	Date	interval (weeks)
		4		
January	16			
		5		7
February	21		6	
		4		6
March	20		20	
		4		4
April	17		17	
		4		5
May	15		22	
		5		
June	19			
		4		7
July	17		11	
		5		5
August	21		14	
		4		5
September	18		18	
		4		4
October	16		16	
		5		5
November	20		20	
		4		4
December	18		18	

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Section 108. Full Employment and Balanced Growth Act of 1978 Dealing With Monetary Policy

MONETARY POLICY

SEC. 108. (a) Section 2A of the Federal Reserve Act amended by striking out the second and third sentences and inserting in lieu thereof the following: "In furtherance of the purposes of the Full Employment and Balanced Growth Act of 1978, the Board of Governors of the Federal Reserve System shall transmit to the Congress, not later than February 20 and July 20 of each year, independent written reports setting forth (1) a review and analysis of recent developments affecting economic trends in the Nation; (2) the objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth or diminution of the monetary and credit aggregate for the calendar year during which the report is transmitted, taking account of past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade and payments, and prices; and (3) the relationship of the aforesaid objectives and plans to the short-term goals set forth in the most recent Economic Report of the President pursuant to section 3(a)(2)(A) of the Employment Act of 1946 and to any short-term goals approved by the Congress. In addition, as a part of its report on July 20 of each year, the Board of Governors shall include a statement of its objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates for the calendar year following the year in which the report is submitted. The reports required under the two preceding sentences shall be transmitted to the Congress and shall be referred in the Senate to the Committee on Banking, Housing, and Urban Affairs, and in the House of Representatives to the Committee on Banking, Finance and Urban Affairs. The Board shall consult with each such Committee on the reports and, thereafter, each such Committee shall submit to its respective body a report containing its views and recommendations with respect to the Federal Reserve's intended policies. Nothing in this Act shall be interpreted to require that the objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates disclosed in the reports submitted under this section be achieved if the Board of Governors and the Federal Open Market Committee determine that they cannot or should not be achieved because of changing conditions: *Provided*, That in the subsequent consultations with, and reports to, the aforesaid Committees of the Congress pursuant to this section, the Board of Governors shall include an explanation of the reasons for any revisions to or deviations from such objectives and plans.".

(b) The amendment made by subsection (a) takes effect on January 1, 1979.