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FOMC Policy: 1970 and Beyond

IN THIS PAPER, I describe Federal Open Market Committee, or FOMC, policy of the eight months January–August 1970. And I present some guesses—based on the FRB-MIT-Penn econometric model—of real gross national product (GNP) and interest rates in 1971 for alternative future FOMC policies.

A Change in FOMC Strategy

To my mind, it is very simple to state how monetary policy is best described: by reference to the variable (an index, perhaps) that the monetary authority itself uses in defining its policy. What should be used is the control variable of the monetary authority or specifically of the FOMC. So I begin here by describing FOMC strategy and, more particularly, how it was changed in January 1970.

To all appearances, the committee's strategy remained essentially unchanged for more than three years, from September 1966, when the committee first began including a bank credit proviso clause in its directive, until December 1969.[1] The committee, meeting on the appointed date,

1. At its September 13, 1966 meeting, the FOMC adopted a directive with the following second paragraph:

"To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm but orderly conditions n the money market; *provided, however, that operations shall be modified in the light of*

would decide on target values for its money market variables: free reserves, member bank borrowings, the federal funds rate, and, on some occasions, the rate on three-month Treasury bills. It would then pass these target values along to the Manager of the Federal Reserve System's open market account. But it would normally tell him to adjust these values if he found bank credit, as measured by the so-called bank credit proxy, to be increasing more or less than had been expected.[2]

In fact, however, the manager seems never to have made large adjustments and only on rare occasion to have made small ones.[3] Of course, the committee may have been influenced in its choice of target values by changes in bank credit, whether of the remote or recent past, and may have even become, with the passage of time, more and more influenced by past changes in bank credit. Even though the manager did not make between-meeting adjustments in target values, the committee may have persisted in the inclusion of a bank credit proviso clause in order to remind itself of the importance of past changes in bank credit, and thus to ensure that the course bank credit had taken would be considered at each meeting. But whatever the explanation, for a period of more than three years ending December 1969, the committee used money market variables in defining near-term policy.

In January 1970, however, the committee evidently changed its strategy. At its January 15 meeting, it decided to use a longer time horizon. It also decided in favor of an effective proviso clause and, what is equally important, on adding a second proviso variable, the narrowly defined money stock.

The committee would go on providing the manager with starting target values for the money market variables. It would also provide him with near-term target values for the adjusted bank credit proxy and the stock of money. And the manager, unless constrained by a Treasury financing or

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unusual liquidity pressures or of any apparently significant deviations of bank credit from current expectations [emphasis supplied]."

See *Fifty-Third Annual Report, Board of Governors of the Federal Reserve System, Covering Operations for the Year 1966*, p. 179. The proviso clause is italicized. The committee began using a proviso clause in May 1966, but it first appeared in lasting form in September.

2. For a definition of the adjusted bank credit proxy, see Table 1, note *b*.

3. See Stephen H. Axilrod, "The FOMC Directive As Structured in the Late 1960's: Theory and Appraisal," Board of Governors of the Federal Reserve System (Jan. 28, 1970; mimeo.), p. 11.

the threat of a financial crisis, would in future be making such between-meeting adjustments in the target values for the money market variables as might be required to realize the target value of an index in which adjusted bank credit and the narrowly defined stock of money were equally weighted.[4]

In brief, the committee decided at its January 15 meeting that it would no longer use the funds rate, free reserves, and member bank borrowings as its intermediate target variables, or in describing its near-term policies, but instead would use adjusted bank credit and the narrowly defined stock of money.

FOMC Strategy of January–August 1970

Although the second paragraphs of the directives adopted at the meetings of January 15 and February 10 were not radically new, they did differ significantly from that of the December 16 directive, in which no mention was made of a committee desire to see modest or moderate growth in money and bank credit. And, at its March 10 meeting, the committee adopted a directive with an obviously different second paragraph, which stated the intentions clearly:

> To implement this policy, the Committee desired to see moderate growth in money and bank credit over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining money market conditions consistent with that objective.[5]

What is most important, this paragraph contains no mention of the desired state of money market conditions, and thus clearly reflects the change in strategy of January 1970.

The second paragraph of the April 7 directive is the same as that of the March 10 directive, except for a reference to a forthcoming Treasury

4. According to the policy record of the January 15 meeting, "The Committee concluded that in the conduct of open market operations increased stress should be placed on the objective of achieving modest growth in the monetary aggregates, with about equal weight being given to bank credit and the money stock." See "Record of Policy Actions of the Federal Open Market Committee," *Federal Reserve Bulletin*, Vol. 56 (April 1970), pp. 338–39. The word "increased" (rather than, say, "complete") presumably indicates that the committee was not prepared to tolerate changes of unlimited size in money market conditions.

5. "Record of Policy Actions," *Federal Reserve Bulletin*, Vol. 56 (June 1970), p. 512.

financing. That this reference was included is fortunate indeed (for the Treasury, at any rate). Had the manager not bought large quantities of bills at the end of April, the Treasury would evidently have sold very few of its notes. When the committee met on May 5, it was very much aware of what the manager had done and, more generally, of a mounting nervousness in financial markets. It gave the manager target values for the monetary aggregates, but also instructed him to do what was necessary "to moderate excessive pressures in financial markets, should they develop."[6] And in the event, the manager had to disregard his aggregate target values.[7]

At its meeting of May 26, the committee, seeing a very real threat of crisis, adopted a directive with the following second paragraph:

> To implement this policy, in view of current market uncertainties and liquidity strains, open market operations until the next meeting of the Committee shall be conducted with a view to moderating pressures on financial markets, while, to the extent compatible therewith, maintaining bank reserves and money market conditions consistent with the Committee's longer-run objectives of moderate growth in money and bank credit.[8]

At its meeting of June 23, the committee adopted a directive with a not dissimilar second paragraph. Clearly, then, near-term FOMC policies of the months May through July cannot, at least in principle, be adequately described simply by a sequence of target values of monetary aggregates, nor by a sequence of money market variables.

The instruction "moderate excessive pressures" can be interpreted as follows: Keep money market conditions from firming or, more particularly, keep the average funds rate and, if possible, the average bill rate from increasing. Each near-term policy of the months May through July should therefore in principle be described by a listing of monetary aggregate target values *and* initial values for the federal funds and Treasury bill rates. It would appear, however, that rate constraints were not binding, except through the first part of May, and that as a practical matter aggregate target values serve as a reasonable description of the policies of May through July.

On June 23 the Board of Governors announced the suspension of rate ceilings for large-denomination certificates of deposit of 30 to 89 days' ma-

6. "Record of Policy Actions," *Federal Reserve Bulletin*, Vol. 56 (August 1970), p. 632.
7. "Record of Policy Actions," *Federal Reserve Bulletin*, Vol. 56 (September 1970), p. 711.
8. *Ibid.*, p. 713.

turity. The intent was apparently to deal with the Penn Central failure. Finding it difficult, if not impossible, to issue commercial paper, corporations might be coming to their banks; and these banks, if free to pay competitive rates for 30- to 89-day money, would then be able to lend. The committee, when it met on June 23, told the manager in effect to ignore the adjusted bank credit proxy. The committee agreed that, with the suspension of rate ceilings, estimates of future changes in bank credit would be even less reliable than usual and that "more rapid growth in bank credit than contemplated earlier would not necessarily be inconsistent with [its] longer-run objective," since "to the extent that the Board's Regulation Q action resulted simply in a shift of credit flows from market to bank channels, it would not involve an increase in over-all credit flows."[9]

At its July 21 meeting, the committee decided that the threat of financial crisis had lessened and adopted a directive with a second paragraph not unlike that of April. But the manager was told essentially not to worry about the adjusted bank credit proxy at that meeting, and again at the August 18 meeting. From July through September, the committee was therefore using only one intermediate target variable—the money stock.[10]

The Pattern of Target Values

Table 1 gives quarterly committee target values for the money stock, adjusted bank credit proxy, and an index that gives equal weight to the money stock and adjusted bank credit, taken from the published policy record. As will be apparent, open market policy became more expansionary (in intent, at least) over the first eight months of 1970. The committee adopted higher target values for both aggregates at its January and February meetings and, against the background of a still more bearish eco-

9. *Ibid.*, p. 718. It is a little difficult, however, to square this statement with the imposition and maintenance of effective ceiling rates.

10. For late August and thereafter, this is not a totally accurate description. At its meeting of August 18, the committee "decided that open market operations should be directed at promoting some easing of conditions in credit markets," as well as "growth in the money stock at a rate somewhat greater than that of the second quarter." See "Record of Policy Actions," *Federal Reserve Bulletin*, Vol. 56 (November 1970), p. 820. Quite understandably, it wanted lower interest rates, both short- and long-term, and so went back to using multiple (but, regrettably, unweighted) intermediate target variables.

Table 1. Target Values of Growth in Monetary Aggregates Set by the Federal Open Market Committee, January–August 1970

Annual rates of change of averages for last month of quarter in percent

Meeting date and variable	*First quarter*	*Second quarter*	*Third quarter*
January 15			
Money stock[a]	2.0	...	...
Adjusted bank credit proxy[b]	−1.0	...	...
Index[c]	0.5	...	...
February 10			
Money stock	4.5	...	...
Adjusted bank credit proxy	0.0	...	...
Index	2.3	...	...
March 10			
Money stock	2.0	3.0	...
Adjusted bank credit proxy	0.5	5.0	...
Index	1.3	4.0	...
April 7			
Money stock	...	3.0	...
Adjusted bank credit proxy	...	5.5	...
Index	...	4.3	...
May 5			
Money stock	...	4.0	...
Adjusted bank credit proxy	...	4.0	...
Index	...	4.0	...
May 26			
Money stock	...	4.0	4.0
Adjusted bank credit proxy	...	4.0	7.0
Index	...	4.0	5.0
Money stock			
June 23	...	...	5.0
July 21	...	...	5.0
August 18	...	...	5.0[d]

Sources: "Record of Policy Actions of the Federal Open Market Committee," *Federal Reserve Bulletin*, Vol. 56 (April–November 1970).

a. Currency plus demand deposits.

b. Total member bank deposits plus Eurodollar indebtedness, affiliate-issued commercial paper indebtedness, and loans sold under repurchase agreements.

c. One-half money stock plus one-half adjusted bank credit proxy.

d. At its August 18 meeting, the FOMC also adopted a 5.0 percent target value for money stock for the fourth quarter.

nomic outlook, a higher value for the money stock target at its meetings of early May and June.

Open market policy did not, however, become steadily more expansionary. At its March meeting, the committee adopted lower target values for the first quarter for the money stock and the adjusted bank credit proxy. In February both aggregates increased less than had been expected,[11] and the committee, at its March meeting, was therefore faced with choosing in effect still easier money market conditions or adopting lower first-quarter target values for its aggregates. In fact, it adopted lower target values for the monetary aggregates. Specifically, the committee adopted target values for the money stock of 2.0 percent for the first quarter and 3.0 percent for the second quarter. If a 3.0 percent annual rate of increase was appropriate for the second quarter, why not for the first as well? Realizing a 3.0 percent annual rate of increase for the first quarter could not have required "too large" a jump in the money stock in March, except in terms of the resulting impact of easing money market conditions. The decision thus can perhaps be read as indicating that the committee retained its aversion to sharp changes in money market conditions.

The event was repeated in early May. According to the policy record, the money stock increased more in April than had been expected.[12] So at its early May meeting, the committee faced a choice between voting for firmer money market conditions and adopting a higher value for the money stock target in the second quarter. And again it changed its target values.[13]

At its March meeting, the committee may have judged that the demand for money had decreased (and would remain abnormally low through March). Such a decision would explain its lower target value for the money stock. And at its early May meeting, the committee may have decided that the demand for money had increased and that a higher target value for the second-quarter money stock was therefore appropriate. But such an interpretation contrasts with the switch in January to greater emphasis on monetary aggregates, which suggested that the committee had confidence in the stability of the demand for money.

11. "Record of Policy Actions," *Federal Reserve Bulletin*, Vol. 56 (June 1970), p. 510.

12. "Record of Policy Actions," *Federal Reserve Bulletin*, Vol. 56 (August 1970), p. 630.

13. With a financial crisis threatening, the committee decided at its early May meeting to give priority to the objective of moderating "pressures in financial markets." Introducing a money market conditions constraint, it need not, however, have changed its target value for the second-quarter money stock.

Target and Actual Values

I turn now to a comparison of actual and target values of the aggregates over the first three quarters of 1970. Target values for the second and third quarters are clear: for the second, annual rates of increase of 4 percent for the money stock and the index; and for the third, an annual rate of increase for the money stock of 5 percent. For the first quarter, I take the target values adopted by the committee on March 10, its last meeting of that period—annual rates of increase of 2.0 percent for the money stock and 1.3 percent for the index.

Target and actual values are given in Table 2.[14] In the first quarter, actual money growth (unrevised) was nearly double the committee's 2.0 percent target, although the index deviation was not so large. In the second quarter, the money stock was almost on target but the proxy, and hence the index, substantially exceeded the targeted growth. In the third quarter, the money stock (the only aggregate target variable) was again practically on target.

Table 2. Federal Open Market Committee Target Values and Actual Values, Three Quarters 1970

Annual rates of change of averages for last month of quarter in percent

	Money stock			*Adjusted bank credit proxy*		*Index*	
		Actual value					
Quarter	*Target value*	*Pre-liminary*	*Re-vised*	*Target value*	*Actual value*	*Target value*	*Actual value*
First	2.0	3.8	5.9	0.5	0.5	1.3	2.2
Second	4.0	4.2	5.8	4.0	6.5	4.0	5.4
Third	5.0	5.1	6.1	n.a.	17.2	n.a.	11.2

Sources: *Federal Reserve Bulletin*, various issues, and advance release on revised money stock series from Board of Governors of the Federal Reserve System.
n.a. Not available.

14. In late November, the Board of Governors put out a revised money stock time series for the period through mid-November 1970. Rates of change calculated from the revised series and the unrevised series differ considerably from one another (see Table 2). It seems, however, that the committee first became aware of a pending substantial revision at its September 15 meeting, so rates of change calculated from the unrevised money stock series should be used in appraising the realization of the committee's targets over the first three quarters of 1970.

During the fourth quarter, through the week ended November 18, the money stock apparently increased at an annual rate of only about 2.9 percent even though the rates on three-month bills and federal funds decreased roughly 75 basis points. The explanation for the slow growth of money could be the General Motors strike. But if so, the committee must be putting considerable weight on near-term fluctuations in money market conditions, and thus allowing the demand for money to influence the growth of the supply.

Real GNP and Interest Rates through Mid-1972

Projections of real GNP, the unemployment rate, the inflation rate, and interest rates for alternative FOMC policies are given in Table 3. There are three alternative policies representing differing growth profiles of the money stock: (1) a steady increase at a 5 percent annual rate from the fourth quarter of 1970 on; (2) an increase at a 5 percent annual rate in the fourth quarter of 1970 and at a 6 percent rate thereafter; (3) an increase at a 5 percent rate in the fourth quarter and at a 7 percent rate thereafter.

The projections allow, however, for only one fiscal policy: Federal expenditures total $215 billion and federal purchases are $99 billion in fiscal 1971; expenditures total $230 billion and purchases $103 billion in fiscal 1972.[15]

From Table 3 it appears that an extra 1 percentage point in the annual rate of growth of the money stock makes some difference, but not a great deal. These results imply that return to an unemployment rate of even 5 percent by mid-1972 could require a money stock increasing at a 9 or 10 percent annual rate, at least over the first two or three quarters of 1971, and perhaps something more than 5 percent thereafter. Of course, such a recovery could also result from a more expansionary fiscal policy or an increase, which cannot now be foreseen, in private demand for current output.

How will the committee respond? It has been roundly criticized for tolerating sharp increases in the money stock in 1967 and 1968. Then, too, the dollar assets of foreign central banks have already increased sharply and could increase further, depending in part on whether the rate of growth

15. It was assumed that the General Motors strike would end on November 15, and that there would be neither a steel strike nor an anticipatory inventory buildup.

Table 3. Projections of Selected Economic Indicators for Alternative FOMC Policies, FRB-MIT-Penn Model, 1970–72

Percent

Economic indicator and FOMC policy	*1970:4*	*1971:1*	*1971:2*	*1971:3*	*1971:4*	*1972:1*	*1972:2*
Real gross national product (annual change)							
First[a]	−1.1	3.3	1.5	2.7	3.8	4.3	5.1
Second[b]	−1.1	3.4	1.8	3.4	4.7	5.3	6.0
Third[c]	−1.1	3.5	2.2	4.1	5.6	6.3	7.1
Unemployment rate							
First	5.9	5.9	5.9	6.2	6.4	6.5	6.5
Second	5.9	5.9	5.9	6.1	6.2	6.2	6.1
Third	5.9	5.9	5.9	6.0	6.0	5.9	5.7
GNP deflator (annual change)							
First	4.4	4.2	3.2	3.5	3.0	2.6	1.9
Second	4.4	4.2	3.2	3.5	3.1	2.6	2.0
Third	4.4	4.2	3.3	3.5	3.1	2.7	2.1
Interest rates							
Treasury bills							
First	5.9	6.1	6.1	6.1	6.3	6.4	6.5
Second	5.9	5.9	5.9	5.9	6.0	6.1	6.2
Third	5.9	5.7	5.6	5.7	5.7	5.8	6.0
Corporate bonds[d]							
First	7.9	7.9	8.0	8.1	8.1	8.2	8.2
Second	7.9	7.9	7.9	8.0	8.1	8.1	8.2
Third	7.9	7.9	7.9	8.0	8.0	8.1	8.1

Source: Regression results, FRB-MIT-Penn model.

a. Money stock is increased at 5 percent annual rate 1970:4–1972:2.

b. Money stock is increased at annual rate of 5 percent in 1970:4 and 6 percent thereafter.

c. Money stock is increased at annual rate of 5 percent in 1970:4 and 7 percent thereafter.

d. Moody's index of Aaa corporate bonds.

of the European economy continues to slacken. If not, a difficult choice may lie ahead, since a much more expansionary monetary policy, possibly required for reducing the unemployment rate, could result in a considerable increase in dollar assets of foreign central banks and threaten the future of special drawing rights.

To be sure, the interest rate projections of Table 3 may be reassuring on the issue of international flows. They imply that interest rates are not going to change much no matter what the committee does. But with the bill rate already below 5.0 percent, it is not clear that these projections are credible.

Discussion

SEVERAL PARTICIPANTS COMMENTED on the very slow growth of the money stock in October and November, especially in terms of what it revealed about the key issue of Kareken's report—the Federal Reserve's relative emphasis on quantities and on market conditions.

William Poole thought short-run variations in the growth rates of money might be consistent with a policy aiming at a target path but permitting temporary aberrations from that path in order to reduce the swings in market interest rates. Perhaps the key policy variable is a path of the money stock rather than the rate of growth of money month by month. Franco Modigliani felt that the behavior of the money supply in the fourth quarter was not independent of the General Motors strike. Since transactions were reduced because of the strike, a given change in the money supply would lead to a greater decline in interest rates. Slower growth of money in the fourth quarter could be justified on those grounds. But the same reasoning would call for a more rapid expansion of money in the first quarter, when transactions should pick up. David Fand noted that total reserves and the monetary base had been growing at a substantial rate. These indicators suggest that the Federal Reserve has been more actively expansionary than the money growth rates would imply. James Tobin was concerned that the monetary strategy might produce "the worst of both worlds": The commitment to a monetary growth target may hold when otherwise the rate of growth would exceed the target; but the target rate of growth may not be realized when interest rates would fall drastically if that much money were provided. Tobin warned: "It could turn out to be an asymmetrical policy. If interest rates are declining, the Fed does not push ahead with 5 percent monetary growth. But it does not raise the 5 percent target when that policy causes rates to rise."

Daniel Brill questioned whether policy in 1970, operating under money and bank credit targets, has really been substantially different from what it would have been under the 1966–69 type of directive that incorporated money market targets and a bank credit proviso. John Kareken thought that Federal Reserve behavior had been somewhat different in 1970. David Fand reminded the panel that the Federal Reserve had permitted a contraction in money during previous recessions, even though its stance had been expansionary in terms of interest rates, free reserves, and market conditions. Although 1970 is not completely analogous to these earlier periods, it offers some evidence of progress, he suggested.