On Fed Watching

By Richard A. Debs
First Vice President, Federal Reserve Bank of New York

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Over the years, participants in the financial markets have avidly sought the touchstone of Federal Reserve policy: some single, simple, and instant financial indicator that could serve as an unfailing guide to the course of monetary policy in general, and interest rates in particular.

In the 1960's, the markets looked to the Fed's figures on net free or net borrowed reserves of commercial banks as the crucial indicator. It took some time before there was an understanding that changes in this measure, though important, could not be relied upon exclusively as the one unerring guide to monetary policy movements.

In the early years of the 1970's, the market shifted attention to the money supply, especially after the Federal Reserve made it clear that greater emphasis would be placed on the monetary aggregates as targets of policy. When the System announced in 1972 that it would experiment with the use of "reserves against private deposits", or "RPD", to guide open market operations, market observers found themselves a new favored indicator. And during all of these years, one or another interest rate came into—or receded from—popularity as the special key to credit conditions or Fed policy.

Fed watchers have been particularly interested in measures whose daily or weekly changes might yield fresh evidence on a continuing basis. Indeed, as the markets came under increasing strain this year, the search for clues became more intense—and more uncritical. During the summer, for example, the market became highly sensitive to the weekly business loan figures of New York banks reported by the Federal Reserve Bank of New York each Thursday.

During June the New York banks registered four straight large increases in commercial and industrial loans, the last of which was over $1 billion. In the following week, when any further substantial increase in loans might well have been grounds for stock market pessimism, a small gain—because it was small—was viewed so optimistically by the market that it was credited, in large part, with sending the Dow Jones up nearly 30 points. It might be useful to look more closely at this recent experience; in a sense it underscores the hazards that can befall Fed watchers.

Commercial and industrial loan demand during the first half of 1974 increased substantially, but by June it had slowed somewhat from the growth earlier in the year. At the same time, there was a more than proportionate increase in such loans at New York banks. In the first four months of 1974, almost 30 percent of the nationwide increase in commercial and industrial loans at large commercial banks occurred at the twelve weekly reporting New York banks, the balance in regional banks. From the end of April until July, there was a shift away from the regional banks to New York and Chicago banks—a shift that may have reflected uncertainties that had developed in the CD market in late spring and early summer, leading investors to seek top-quality instruments from the large money-center banks. New York's share of business loans sharply increased to 60 percent of the total. What the market did was to draw misleading conclusions by focusing on what New York banks were doing, and assuming that what happened in New York was happening nationwide.

The Fed has indeed been concerned with the rapid growth of business and other lending in 1974, but was well aware of the structural shift in lending away from regional banks to New York and Chicago. It was also cognizant that much of the lending represented a switch of borrowers from the commercial paper and bond markets to the banks, and some short-term financing of "petro" payments by oil companies. In other words, the behavior of business loans represented some special factors superimposed on the reactions of borrowers as they came under increasing monetary restraint. We did not expect—and did not seek—signs of policy success in a three- or four-week period; and we certainly would not reconsider a policy posture on the basis of one week, or one month even, of comprehensive data, to say nothing of a single indicator for a single week. If one is going to focus on business loans (and I am not counseling that this be done to the exclusion of other factors) a Fed watcher would much better serve his interest if he focused more carefully on the Federal Reserve's weekly report covering the 330 large commercial banks around the country, which account for over 70 percent of all business loans. Even though these figures are reported one week later than those of New York, their comprehensive coverage makes them a superior indicator of trends in business lending than the New York figures.

Clearly, the market has often misread the System's response to unfolding developments and often has overreacted to its own convictions. The Federal Reserve response is, of course, dictated by its public responsibility for monetary policy and for helping to promote a healthy economy. If Fed watching is to be successful from your point of view, you should have a good understanding of our motives and methods, and of the linkage between central bank actions and the credit markets. Let me, then, turn to what the Federal Reserve does respond to, and how it responds, as it carries out monetary policy.

As you undoubtedly know, the Federal Reserve Bank of New York carries out on behalf of the System the directives issued monthly by the Federal Open Market Committee (FOMC), the key policy-making group in the System. The Committee, chaired by Arthur Burns, is composed of the seven Governors of the Federal Reserve Board and five Reserve Bank presidents, four of whom serve for only one year and then rotate with the other Reserve Bank presidents. Alfred Hayes, President of the New York Reserve Bank, is Vice Chairman and a permanent member. As First Vice President of the New York Fed, I serve as an alternate member. Alan Holmes, Senior Vice President of the New York Fed, is the Manager of the System Open Market Account and runs the Trading Desk at the New York Bank.

The FOMC sets goals for monetary and bank credit conditions a number of months ahead and indicates how the Trading Desk should respond to new information on such conditions in the period between meetings. Typically, the FOMC specifies its monetary aggregate targets as ranges of tolerance covering rates of growth for a two-month period. These ranges of tolerance are selected to be consistent with longer run financial objectives expressed as growth rates for a period of six months or so. The Committee also specifies a range for the Federal funds rate (the day-to-day interest cost of reserves borrowed by banks from each other) until the next meeting.

The two-month targets and guidelines decided at each FOMC meeting are published, together with the general policy directive to the New York Federal Reserve Bank, with a three-month lag. Despite the lag, every serious Fed watcher reads these records carefully because they provide insight into how the FOMC views the economy and clues to how the Committee may respond to economic developments.

Greater emphasis has been placed in recent years by the Committee on the monetary aggregates—principally M_1, which is currency and demand deposits in public hands. Nevertheless, the Federal Reserve continues to be vitally interested in how interest rates and credit markets behave, especially when coping with domestic and international financial difficulties.

The central bank cannot hit the monetary aggregate targets directly. The direct influence we have is on the cost and availability of bank reserves to commercial banks. Through purchases and sales of securities in the open market, the Federal Reserve can add to or subtract from the level of bank reserves, and thus the base supporting member bank deposits which constitute the major portion of M_1 and the other monetary aggregates.

However, even while pursuing longer run policy targets, the System must also cope with strong and often unpredictable short-run influences on reserves. These include Federal Reserve credit advanced in the check collection process, called "float", currency in circulation, and the Treasury balance at the Federal Reserve, all of which can vary substantially from week to week. And because of changes in these market factors, the underlying trend of financial developments may be obscured in the short run. Another problem for the Account Manager is that the information on credit outstanding and money supply at nonmember banks is not as comprehensive or as timely as it should be.

In order to implement the FOMC's instructions on a day-to-day basis, the Trading Desk at the Federal Reserve Bank of New York provides reserves which will keep the Federal funds rate, member bank borrowings, and net borrowed reserves within general objectives. Over the interval of several weeks between meetings of the Federal Open Market Committee, new data each week on reserve and money aggregates permit new estimates to be made of monthly growth rates. These are compared with the ranges set by the Committee. If we are coming out within the desired ranges, then there is no reason to change the day-to-day reserve conditions that we had been aiming for previously. But if the estimated growth rates in the aggregates push up to, or beyond, the outer limits set by the Committee, then the Desk will make some adjustments in its attitude toward reserve provision. Typically, the Desk will provide nonborrowed reserves grudgingly if the reserve and money aggregates are growing more rapidly than desired, or more willingly if the aggregates are growing too slowly. The Desk effectively monitors any such short-term adjustments by shading the funds rates, bank borrowings, and net borrowed reserve measures. These adjustments are not entirely mechanical, however, and can be and have been modified by interim Committee reviews between regular meetings of the Committee.

Thus, sophisticated market observers have watched carefully the growth rates of the reserve and money supply aggregates, the Desk's management of the Federal funds rates, the level of member bank borrowings, and net borrowed positions. An increase in money growth above longer term trends has been interpreted as a harbinger of even higher interest rates. In the first place, careful observers have understood that a rapid growth of money and credit implies inflation; in such circumstances, lenders demand and get higher interest rates—the so-called inflationary premium—in order to protect themselves against having to lend expensive dollars and be repaid in cheap ones. Second, as the Fed has adopted a more resolute stance against inflation, an increase in money growth over an extended period, above what was deemed to be the money supply target, has also raised the expectation that the Federal Reserve would act to offset such growth, inducing—at least in the short run—a rise in interest rates. In such circumstances, astute observers have looked for a rise in the Federal funds rate as one sign confirming that the FOMC has directed the Desk to manage bank reserves more strictly.

The day-to-day management of bank reserves must take into account that there is a long and variable lag from policy actions on bank reserves to the monetary aggregates. While the Federal Reserve can directly control the reserve base with some accuracy, it cannot exert direct control over the use of reserves by banks and the public's preferences for different types of deposits. Thus when banks vary the amount of their excess reserves, or the public shifts its deposit preferences in response to such things as the interest rate structure or transactions needs, the money supply can be subject to considerable variation on a week-to-week, month-to-month, and even quarter-to-quarter basis.

Because the demand for money can be highly volatile in the short run, it is neither desirable nor possible to plot a predetermined short-term course for money supply growth. For if we did try to control rigidly the growth of the reserve base—say on a week-to-week or even a month-to-month basis—shifting demand for money would produce excessive interest rate fluctuations which would have highly destabilizing effects on financial markets.

In addition, short-run fluctuations in the money supply have little or no significant impact on the economy. Fluctuations within a half-year period seem to have little or no discernible effect, and our research suggests that, even if M_1 growth somewhat overshot the desired growth path for as long as six months, the ultimate economic effects would be minor if money growth during the following six months slowed enough to compensate.

These factors suggest the appropriateness of a longer time frame for the execution of Federal Reserve policy. In some ways, the nation's economy can be viewed as a giant ocean liner and its policy instruments as the controls. The controls are set broadly to bring the ship to its destination, and though there may be adjustments for currents or storms, the course is not changed from hour to hour. Nor is any captain foolish enough to think that he can turn the ship around sharply, as if it were a speedboat.

The credit and stock markets, by contrast, change their courses frequently. The day-to-day volatility of interest rates and share prices reflect primarily the volatility of the markets' expectations about profits, interest rates, and the prices of the securities themselves. At times as monetary policy is perceived as leaning toward a different posture—let us say toward ease—the markets may respond, sometimes with great exaggeration. Market participants, perhaps misreading a shading of policy for a major shift, rush to capitalize on what they fear may be only a fleeting opportunity for profit. The initial rise in prices may stimulate bullish expectations on the part of market bystanders who join in, reinforcing the buying pressure. Lord Keynes has pungently described the psychology of the financial speculator as one "who tries to guess better than the crowd how the crowd will behave".

Thus, I warn you to be careful not to read Fed intentions into short-run changes in securities prices and interest rates; you may be staring into the mirror of your own expectations. Even in the Fed funds and Treasury bill markets, in which the Federal Reserve does indeed have substantial influence, the volatile expectations of participants at times play a substantial role in determining the level of rates.

Against this background, it might be useful to turn for a few minutes to the current economic situation.

Needless to say, the most overriding factor in today's economic environment is inflation. Indeed, inflation isn't limited to our shores, it's worldwide. In the past year, United States consumer prices have risen nearly 12 percent. The take-home pay of the typical worker has declined over 5 percent in real terms during the same period. And wholesale prices have gone up over 20 percent.

A major reason for its current virulence was the dovetailing of very high levels of demand among the major industrial nations during 1972 and 1973, especially for industrial materials.

The decline in the value of the dollar in foreign exchange markets made our own situation acute because the prices we pay for imported materials, as well as for finished goods, rose. And a cheaper dollar made our exports increase sharply, which put further pressure on our already strained industrial capacity.

Aggravating the price structure were worldwide shortfalls in agricultural production in 1972, which caused food prices to rise in 1973. In addition, since last fall there has been the staggering rise in the price of all petroleum products, as oil-producing countries restricted their shipments and boosted prices. And last spring, many wages and prices rose as direct controls were phased out. More recently, there has been a further upward push in agricultural prices due to drought conditions in our Midwest.

I don't have to tell this group about what inflation has done to financial markets. Interest rates have increased sharply in 1974 and some firms have had difficulty raising funds—to put it mildly. The equity markets have been buffeted, with stock prices reaching a twelve-year low. And high market rates caused net deposit outflows from thrift institutions, with the result that residential building starts are now averaging more than one-third below what they were last year.

The distorting effects of inflation have complicated business-investment decision making, as profit figures have not reflected the fact that inventories and plant and equipment must be replenished at substantially higher cost. Consumer reaction to inflation has manifested itself in lowered confidence and, in turn, in sluggish spending. The result has been a diminution of overall economic activity, although there are still shortages in key areas such as steel, aluminum, fertilizers, and other petrochemicals.

The gross national product (GNP) in real terms declined in the first half of this year. This decline cannot be attributed entirely to a weakening in demand. There were supply and technical factors at work as well.

In the first quarter, the energy shortage acted as a drag on GNP. And the change in real GNP in the second quarter would have been positive, instead of negative, had it not been for the partial take-over of Aramco by the Saudis. The resultant decline in Aramco's profits is recorded as a decline in net exports and thus a decline in GNP.

Economic activity in the third quarter is sluggish, judging from the evidence. For example, industrial production, a broad-gauge indicator, has stayed about unchanged in recent months.

Yet, despite the slackening of real economic activity, the number one problem facing us today is inflation, not unemployment. Fortunately, the level of unemployment so far has not risen significantly.

The Federal Reserve has had to bear the brunt of the battle against inflation. Unfortunately, the Federal budget remains in deficit. The nine-year inflation we have undergone can in no small measure be ascribed to a highly expansive fiscal policy, which occurred during a period when the economy's resources were being used rather intensively. And I have to add that monetary policy was by no means faultless during this period.

Last fiscal year's $3.5 billion deficit seemed modest. But if the spending of Government-sponsored agencies and other outlays that did not show up in the regular budget were included, that deficit was over $20 billion, exactly the opposite of what was fiscally required. Needless to say, the budget for fiscal 1975, with an expected deficit of over $11 billion, is unsatisfactory. President Ford's dedication to greater fiscal discipline is most welcome news, as was his initiative in organizing and participating in a series of conferences focusing on inflation. It is heartening to see a spreading conviction on the part of the American public that the taming of inflation is an objective of the highest priority, that requires a determined commitment by us all.

In addition to fiscal restraint, there will have to be, of course, a sustained period of monetary restraint to reduce inflationary pressure and wring out inflationary expectations. Such a policy will contribute to a slowing in the rate of economic growth for a while and undoubtedly cause some hardships, such as rising unemployment, a weak housing sector, and continued pressures in financial markets. In the interest of social equity, we cannot let any one group or economic sector suffer disproportionately in the anti-inflationary battle. For example, it would be desirable, as Chairman Burns has suggested, to be prepared to limit the extent of unemployment by establishing a Government program of public-service employment should the unemployment rate rise above 6 percent.

With respect to financial pressures, the Federal Reserve is keenly aware of its responsibilities as lender of last resort. We are prepared to meet those responsibilities as we have done in the past, whether difficulties arise in the banking system, as they did this year in the case of Franklin National Bank, or in the commercial paper market, as in 1970. Also, as you may know, the Fed has the authority to lend directly to institutions other than banks, including thrift institutions, and for a number of years has had contingency arrangements for supporting member banks which might extend credit to a thrift institution suffering unusual liquidity pressures.

At the present time, other financial intermediaries serving real estate markets, as well as corporations—such as utilities—heavily dependent on capital market financing, have also come under great pressure. In the present period, for example, the cash flow of utilities has been squeezed between rising costs, especially for fuel, and controlled prices.

We in the System have been very much concerned with the effects of these liquidity strains, and have kept ourselves closely informed of developing problems. In particular, we have been in close touch with the banking community regarding potential problem areas. In this connection, I might say that the commercial banking system has been fulfilling its responsibilities in these circumstances, and has been extending credit to firms subject to such liquidity strains, particularly in those cases where the failure to obtain the necessary financing could have adverse repercussions in the financial markets. In this respect, the banking system has been playing an important role in helping to avert potentially serious problems in the financial sector of the economy.

In general, I believe that a course of fiscal and monetary restraint is the necessary precondition to achieving price stability. Such policies, however, are not sufficient in themselves in our present circumstances. They would be aided, for example, if we could eliminate institutional rigidities, some of which have been built in by government, that shackle competitive price and wage determination. Reexamination of antitrust laws and building codes to encourage more competition, and the modification of minimum wage laws as they affect teen-agers are a few examples that come to mind.

Restraint by business and labor in setting prices and bargaining for wages would also help importantly. While wage and price controls would be counterproductive, it would be useful to reestablish guideposts, to give publicity to fair standards, that might help end the self-defeating alternation of wages-pushing-prices-pushing-wages.

I know the markets would welcome some masterstroke of policy, and each statement by a policy maker that fails to suggest a fresh new initiative has been met with visible disappointment. However, it is unrealistic to expect a rapid resolution of a problem that has been rooted so deeply for so long.

A protracted period of moderate fiscal and monetary restraint should not be considered bearish for the credit and equity markets. As I suggested earlier, one of the major factors contributing to high interest rates is the expectation that inflation will continue. Once the markets are convinced of the long-range commitment of policy makers to responsible restraint, and once the markets see hard evidence of fiscal resolve to support monetary policy, inflationary expectations should recede and set the stage for a decline in interest rates and the recovery of financial markets. I might add that, while realities of the 1975 Federal budget may well preclude large spending cuts, expectations in the markets should respond favorably even to moderate reductions if they testify to the dedication of the Congress and the Administration.

The abatement of inflationary expectations would be most welcome—not only for this group as participants in the business and financial community, but for us all, and our families, as citizens. It would mark meaningful progress in our long struggle to arrest what is now recognized as public enemy number one—a deeply entrenched and recalcitrant inflation which, if not brought under control, can cause serious damage to the fabric of our society. Let's hope that we will see such progress over the coming year.