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PART II

The Recognition Pattern of the Federal Open Market Committee

by C. ELTON HINSHAW

1

Introduction

This study describes and evaluates the Federal Open Market Committee's performance in anticipating and recognizing seven post-World War II cyclical turns, and relates the FOMC's policy actions to its views of economic conditions in the vicinity of these turns. One aspect of the controversy concerning the efficacy of countercyclical monetary policy has been the Federal Reserve's promptness or lag in recognizing the need for action when a peak or trough in general business occurs. Two previous studies assessing the Federal Reserve System's ability to recognize business cycle turning points reached conflicting conclusions. For the cyclical turns since the 1951 Accord, Kareken and Solow estimated the recognition lag—the period between the turn and the Federal Reserve's recognition of it—to be approximately 8.5 months at peaks and three months at troughs.[1] Brunner and Meltzer disagreed. They concluded that:

"In current academic parlance, the 'inside lag' of monetary policy appears to be extremely short. On two of the three occasions when the economy turned toward recession, the 'recognition lag' was negative; when the economy turned toward recovery, the 'recognition lag' was longer, averaging 3 to 4 months." [2]

[1] John Kareken and Robert M. Solow, "Lags in Monetary Policy," in *Stabilization Policies,* Englewood Cliffs, N. J., 1963, p. 70. The total lag of monetary policy can conveniently be divided into an inside, an intermediate, and an outside lag. The inside lag is usually defined as the period between the need for action and the taking of action, and can conceptually be partitioned into a recognition lag (the period between the need for action and its recognition) and the decision or action lag (the period between recognition and the taking of action). Since the Federal Reserve has the power to act when the need is recognized, Kareken and Solow assumed that the decision lag was zero or negligible and that the inside lag was essentially a recognition lag.

The intermediate lag is defined as the period between the taking of action and the financial effects of the action, and the outside lag as the period between the financial impact and its effect on real production and employment. See *ibid.,* pp. 3 and 62.

[2] Karl Brunner and A. H. Meltzer, *The Federal Reserve's Attachment to the*

Both studies determined the Federal Reserve's recognition lag by comparing the National Bureau of Economic Research (NBER) dates of business cycle turns with dates of "policy change." [3] The maximum amount of earning assets that member banks as a group could hold was used by Kareken and Solow as their indicator of modification in monetary policy; the lag in the change in trend of this policy index behind the NBER business cycle dates was their measure of the recognition lag. Brunner and Meltzer inferred recognition by comparing the NBER dates with a score assigned to the Federal Reserve's actions. Using a scale ranging from +1 (decisive easing) to −1 (decisive tightening), they each independently scored the FOMC's actions as given in the "Record of Policy Actions," a section in the Federal Reserve Board's *Annual Reports*. They then compared scores and arrived at a consensus score which presumably reflected the Committee's view of current and expected economic conditions. After comparing their scores of the Committee's actions with the dates of cyclical turns, they concluded that "the System's post-Accord record of recognizing and acting at turning points can only be regarded as splendid." [4]

Since these studies were completed, the Federal Open Market Committee's minutes for 1936–60 [5] have become available, and it is now possible to ascertain directly what the Committee thought about current and future economic conditions for seven of the postwar turns. Attempting to assess the Committee's ability to recognize cyclical turns by inference from policy changes alone can be misleading. Only if the FOMC reversed the direction of policy solely upon anticipation or recognition of peaks or troughs would this approach yield satisfactory results. If the Committee changes policy for other reasons, as it did in

Free Reserve Concept, Subcommittee on Domestic Finance, House of Representatives, 88th Congress, 2d Sess., Washington, 1964, p. 50.

[3] The NBER chronology of business cycle dates provides a record of cyclical turns that shows the month in which the peak or trough is judged to have occurred. See Table II-1 for the NBER reference cycle dates for the peaks and troughs covered in this study.

[4] *Ibid.,* p. 50. The "Accord" referred to is the Treasury-Federal Reserve Accord of 1951.

[5] Federal Open Market Committee, *Minutes of the Committee, 1936–60, and Its Executive Committee, 1936–55,* The National Archives, Washington, 1964. (Hereafter referred to as *Minutes.*) Prior to 1947, meetings of the Committee were so infrequent and discussions of economic conditions so sparse that an adequate comparison between the 1937–38 turns and the postwar turns could not be made. Consequently the study is limited to the 1947–60 period.

the 1947–60 period,[6] the question arises as to whether such action is in response to an expected (or recognized) turning point or for some other purpose (i.e., "disorderly markets," balance of payments problems, etc.). The Committee's minutes are the best source of this information. A reading of these minutes shows that a modification of the previous findings is in order. The minutes yield additional information about the Committee's ability to recognize cyclical turns and, in combination with its actions, yield additional insight into decisions concerning monetary policy.

Chapter 2 describes the method used to evaluate the Committee's forecasts. Chapter 3 reviews chronologically the FOMC's view of economic conditions in the vicinity of the seven postwar turns covered by its minutes and compares its ability to recognize peaks and troughs with that of the business analysts studied by Fels. Chapter 4 relates the Committee's forecasts and views of current economic conditions to the policy decisions which it made during the periods surrounding cyclical turns. And the impatient reader can turn to Chapter 5 for the conclusions.

2

Procedure

In his study of the problem of forecasting and recognizing business cycle peaks and troughs, Fels found "there is a pattern in reports on the business outlook in the vicinity of cyclical peaks and troughs. As time goes by, analysts become increasingly aware of first the possibility, then the probability, and finally the certainty of a turning point." [7]

[6] Brunner and Meltzer recorded eighty-seven changes in policy during the years 1947–60. See their *An Alternative Approach to the Monetary Mechanism*, Subcommittee on Domestic Finance, House of Representatives, 88th Congress, 2d Sess., Washington, 1964, pp. 119–124.

[7] Rendigs Fels, "The Recognition Patterns of Business Analysts," the companion piece in this volume. Fels studied the forecasts of ten publications made in the vicinity of the eight turning points since World War II. Only eight of the publi-