BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date July 21, 1937.

To Chairman Eccles

Subject: The Objectives of Monetary Policy

From Lauchlin Currie
LBC.

The attached statement is substantially the same as my mimeographed statement dated July 19. It contains textual revisions and I suggest you read it in place of the mimeographed copy. I am working on a short statement along the lines you indicated this morning.

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July 21, 1937
Lauchlin Currie
Confidential

THE OBJECTIVES OF MONETARY POLICY

Background

The Board of Governors is a public body, exercising powers delegated to it by the Congress. The ends toward which these powers are to be exercised are indicated in the Federal Reserve Act in very broad and general terms. Thus, open market operations are to be carried out "with a view to accommodating commerce and business, and with regard to their bearing upon the general credit situation of the country". (Section 12a, 3). Reserve requirements may be altered "in order to prevent injurious credit expansion or contraction". (Section 19 (6)). These terms of reference are so broad as to be susceptible of many varying interpretations.

That more specific objectives have not been incorporated in the law is doubtless attributable to the gradual evolution in ideas concerning the nature and purpose of the Federal Reserve Board and Federal Reserve Banks. At the time of the formation of the System neither the theory nor the practice of central banking for purposes other than the maintenance of the monetary standard had been much developed. The United States appeared definitely committed to the maintenance of the semi-automatic gold standard. The motivating force behind banking reform therefore was not dissatisfaction with the monetary standard, but the desire to prevent periodic panics and banking collapses from which the country then suffered. The prevailing view was that an emergency and seasonal loaning agency was

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required. This is indicated in the Preamble to the Federal Reserve Act, which states that it is "an Act to provide for the establishment of Federal Reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes".

In the post-war period disturbed conditions abroad and the large movements of gold forced the System to exercise a measure of discretionary control in an attempt to prevent or mitigate wide fluctuations in our economic life. With the breakdown of the existing gold standard in the depression, devaluation in 1934, and the subsequent large accretions to the monetary gold stock, it became apparent that monetary management would be necessary for an indefinite period in the future. Increased powers and responsibilities were conferred on the Board of Governors of the Federal Reserve System.

The Board of Governors in its policies seeks, so far as it is within its power, to promote conditions conducive to the restoration and maintenance of as full employment as possible, under conditions of general stability.

A necessary element in the pursuit of this objective is the maintenance of a sound banking system, through which monetary control operates, and the System has always exerted what influence it could bring to bear in this direction.

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While the Board is convinced that its objective of promoting conditions conducive to the maximum sustainable employment of our human and material productive resources is the end towards which Congress wishes it to exercise its influence, it would, nevertheless, welcome less ambiguous terms of reference than are at present incorporated in the law. In 1935 Governor Eccles suggested a more specific statement of objectives, which was accepted by the House of Representatives in the Banking Bill of 1935. It was not, however, accepted by the Senate. In view of the continued introduction of bills containing statements of objectives, the Board has recently reviewed the whole matter.

Choice of Objectives

In making a statement of objectives the distinction should be drawn between an objective and a formula, or means of achieving that objective. Monetary management is an art rather than an exact science. It involves forecasting and dealing with intangibles and hence there must be scope for judgment and discretion. The limitations on the effectiveness of monetary policy must be kept in mind. The System must not be held accountable for developments under the control of other agencies, nor for developments which no one can control. Monetary factors are only one of the many sets of forces affecting business activity, and even in the monetary sphere the Treasury is responsible for the exercise of very important powers.

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With these factors in mind, the Board has considered carefully the most frequently proposed objective, which has to do with the stabilization of prices in one form or another. While it is heartily in accord with what it conceives to be the underlying purpose of this mandate, namely, the lessening of booms and depressions and the increase of the national output and well-being, it nevertheless feels that this mandate states a formula rather than an objective, that it does not leave sufficient scope for discretion and judgment, and that it exaggerates the effectiveness of monetary policy.

The stabilization of prices is rarely proposed as an end in itself. The great majority of those who advocate price stabilization do so in the conviction that the attainment of this objective would mean also the attainment of what they really desire, - the maximum sustainable utilization of our human and material productive resources. They observe that wide fluctuations in employment and production are accompanied by fluctuations in the price level and, hence, come to the not unnatural conclusion that if the latter is prevented the former will not occur.

There is some correspondence between fluctuations in the wholesale price level and fluctuations in employment and production. But the correspondence is not close enough to make it wise to substitute a rigid formula for discretion and judgment in determining monetary policy. Situations have occurred and may occur again in which undesirable conditions are developing while the average price level remains stable. There have been occasions in which a large volume of unemployment existed along with stable prices. There are situations in which the maintenance or

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restoration of full employment under stable conditions is possible only with an advance in prices. There may even be occasions when a mild recession in prices in reflection of technological improvements or of bumper crops is desirable.

The possible weakness of price stability as a guide to policy may be illustrated by a rise in the index attributable to an advance in agricultural prices. If this rise should be associated with short world crops in conjunction with a bountiful harvest in this country, and full employment prevails, it might prove justifiable to institute a policy of monetary restraint to prevent excessive stimulation of domestic activity. If, on the other hand, prices rose because there had been a crop failure in this country, it might prove undesirable to adopt restrictive measures. The combination of a crop failure and a restrictive monetary policy might bring on a general business recession.

Another reason why discretion and judgment in interpreting price movements are necessary is the fact that an increasingly large portion of our price structure is inflexible or "administered". This is true not only of public utility and freight rates, but also of very many manufactured goods. If the demand for such goods and services falls off, or if labor-saving technological improvements cut the costs of such goods and services, their prices may not be reduced and unemployment may increase. In these circumstances it could be argued that, despite the stability of prices, a policy of monetary ease designed

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to promote an expansion of incomes, demands, and hence increased employment, would be warranted.

Some monetary writers believe that over a period of time the general average of prices should tend gently downward in reflection of technological improvements and reduced costs. Others feel that increasing efficiency should be reflected in higher wages, rather than in reduced prices. Still others take the view that the pressure for wage advances will be so great, and the opportunities for profitable investment will be so limited, that an adequate volume of capital expenditures to maintain full employment will be compatible only with a mild upward secular trend of prices. In view of the wide differences of opinion on this matter, and the impossibility of forecasting at this time the desirable trend for prices to pursue over a period of years, the Board feels that it would be a mistake to set up as a guide for policy the stabilization of any price index, even tho limits within which it might fluctuate were permitted.

Still other objections to price stability as a guide for policy are that it exaggerates the importance of monetary factors, places an undue responsibility on the Board, and tends to direct attention away from the real objective in the furtherance of which the Government as a whole should be directly concerned.

It has been demonstrated on numberless occasions that there is no direct nor proportional relationship between changes in the volume of money and changes in the price level. Variations in the rate of

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spending of money or, what is substantially the same thing, in the demand for goods, are of greater importance in affecting prices, production and employment than variations in the supply of money itself. Through the effect of variations in the supply of money on interest rates, the monetary authority may exercise some degree of influence on the rate of spending for capital investment, but this influence may be completely offset by other factors.

When the problem is stated in this way the limitations on the effectiveness of monetary policy become apparent. The attainment of maximum sustainable production requires a careful adjustment of the flow of community incomes and expenditures to the productive capacity of the nation. It is obvious that on many occasions the action of the government with reference to its taxation and spending policies has far more influence on the demand for goods and the general price level than have the policies of the Federal Reserve System.

To expose the Board to the charge of failure to accomplish something which it is not within its ability to accomplish would be obviously unjust. This, however, is a minor consideration in comparison with the harm that would result from popular and official acceptance of the idea that attainment of a greater measure of business stability is the concern exclusively of the Federal Reserve System, or that it could be attained through the action of the System alone. The only hope of even a fair measure of success in attaining this objective lies in the skillful coordination of all the powers and policies of the government, non-monetary as well as monetary.

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For these reasons the Board believes that it would be unwise to state the monetary objectives in terms of price stability. While recognizing the undesirability of wide fluctuations in the general price level the Board does not feel that price stability can be safely used as an exclusive guide for policy. It does not leave sufficient scope for discretion and judgment in meeting the ever-changing business situation and it tends to defeat its purpose by directing attention away from the fundamental objective of relatively full employment of our productive resources. The Board would much prefer to have attention focused on this fundamental objective, which is the chief economic problem of the day, and to have it emphasized that its solution is the concern not alone of the Federal Reserve System but of the Government of the United States as a whole.

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