MONETARY POLICY AND THE FEDERAL RESERVE SYSTEM

by
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Mr. Chairman, ladies and gentlemen, I appreciate the introduction that the chairman has given me and the kind words that Ray Gidney, my associate, said about me yesterday. I couldn't help being reminded of what happened in Spartanburg, South Carolina, when I was doing service down there in the early days of the war. They tell a story of a very delightful spinster whom they called Aunt Minnie down there and rumor got around town that she was going to get married. The local paper assigned the reporter to cover this story. He went to her and said, "Aunt Minnie, I understand that you are about to be married." And she grinned all over, looked him right in the eye and said, "Well, I certainly appreciate the compliment, but I can deny it officially."

Whenever I come to a meeting of this sort, I always ask myself why I'm here. In this particular instance I have several good reasons for being here. The first one is that the current administration of the Federal Reserve Board is actively associated with the Pacific Northwest. My first visit in office was to attend the dedication of the Portland branch of the Federal Reserve Bank of San Francisco; and at that time I got a line on Abbot Mills, who, as many of you know, now serves with me on the Board of Governors in Washington. I know he would want me to extend to all of his many friends in this area his greetings and to assure them that he is still thinking about the Pacific Northwest, even though he is working faithfully in Washington. I have another reason for being here and that is the cordial and aggressive and patient and persistent letter writing of Joel Ferris and Dean Lee who I could obviously see were not going to take "no"; so I might just as well relax and come. But despite these first two good reasons, I have a really sincere interest in this type of meeting. Because I honestly believe that the hope of our future lies in the development and encouragement of meetings of this type, I have argued this question with many people who say, "No, that's just a useful opportunity to meet a few people and hear a few funny stories. It doesn't really accomplish anything." But I'm convinced that the essence of democracy comes out of a meeting of this sort and that ideas can and do rule the world and that our only purpose in a meeting of this sort is to have an idea occasionally that we can develop. We're now in process of developing what is the modus operandi of the society that we live in, and without meetings of this sort I don't believe that we can effectively fulfill our function. So you can see that my objectives are good. I fear that I will not attain any of them but I thought that this morning I would just make a few dabs on the canvas, let you fill in the details and hope that you will think that there is some rhyme and reason in the portrait that comes out.

What I really want to talk about, of course, is monetary policy. But monetary policy has to be put in its proper setting. I recall being in London in 1947 when a friend of mine invited me to a very pleasant dinner with Professor Einaudi, who was in a short period of time to become the President of Italy. Professor Einaudi was a student of economics, and in my opinion a great economist. He held forth at some length after dinner on the fact that monetary and credit policy had disappeared from Europe but that it was on its way back and that in due course it would reassert itself. And then he said, "We are going to face a period when people will recognize that monetary and credit policy has a role. They will think that it can produce miracles, and they will expect it to do more than it can, and we may be back right where we started from." Well, I've thought about that evening a great deal in the years that have followed and perhaps as you will recall there was a movement from the left to the right.

Why do people move to the right? Because they like the right better than the left? Oh, no. They move that way because the left wasn't working and the left wouldn't work unless you gave up certain freedoms and certain prerogatives and certain rights that most of us cherish as fundamental to our liberty, itself. And so you saw a process, which began in Europe, starting with Belgium and moving on around the circuit till it got to Italy. And as it played its part in Italy (and I think it played it very effectively and very efficiently there), you heard people say, "Why it will even solve the population problem." Of course, it can't do anything like that; but it did produce stability and it did produce a lira that was worth something.

We saw ourselves emerging from the war period in Europe with all of the old principles buried under the belief that these were perhaps new times and the war conditions could continue forever. And so we have heard and listened to a great body of sincere, often opinionated thought, to the effect that exchange rates didn't have any place in the picture any more; that, after all, the control system of the Bank of England was such that it was virtually fool proof, and that if the controls were not adequate they could be improved. I remember a friend of mine in the Bank of England talking for three hours about how effective the exchange controls of the Bank of England were and a few years later I lived to hear him say that they were so completely ineffective that they were virtually hopeless. During that period the British pound was clearly overvalued. The treasury was able to maintain that position for the pound by insisting upon the fact that production and employment would suffer if there was any devaluation of the currency. Yet the value was out of line and at some point everyone knew that the sellers' market would disappear, the buyers' market would begin to return, world supply conditions would change, and the pound would have to face up to the problem. In one way or the other, either the British could take steps internally, which would be very painful to take politically, or they would have to face up to devaluing the pound. And you all know what they did. Exchange rates do count.

I enjoyed thoroughly the panel on livestock and meat last night. It's completely over my head. I don't know a thing about livestock or meat; but I enjoyed it because of the principles that I saw being discussed there. Of the speakers last night, all of them, three of them used the phrase directly and all of them skirted around it; one of them, Mr. Bolte, referred to it positively and said, "The law of supply and demand you would have with you always." I don't think you can ever get away from it. I think I am quoting Mr. Bolte almost exactly as I heard him. There are just a few simple principles in economics and business and yet they have been obscured by dozens of books and dozens of articles that seem to ignore what to me is the distinguishing mark of the free country. If you will take John Maynard Keynes' "Treatise on Money" and read the two volumes carefully you will find practically no reference to how money can be used to dam up or alter or change the course of values, and yet that is a treatise on money.

Money is right at the heart and center of a flexible society. I want to talk just a little bit about how we got the Federal Reserve System as an evolutionary matter. The most misunderstood concept, it seems to me, in American thought is the rule of the free market. People think in terms of extremes. Everything is completely free or it's completely controlled. Very few people seem to see it as an evolutionary process. We have concepts upon which our society rests. We have a concept of private property, of free enterprise, of the profit motive; those concepts are certainly not the same as they were at the time that the Pilgrims landed on Plymouth Rock.

They've been modified continuously in the course of the history of this country around one central point--the greatest good for the greatest number.

Our forefathers had come to this country for freedom, primarily, and they had seen that heritage abused by kings and despots abroad. They had seen particular abuse around the money power. Therefore, when the First Bank of the United States was established you find a great effort being put into preventing the government from having any say whatever in the bank. Gradually, as time went on the Second Bank of the United States was developed. You see some recognition that the public interest did play a part. The greatest good for the greatest number was sought; and you see that principle evolving up through a free market concept. By the late eighties you were beginning to have money panics in this country, money crises that were identified with the enormous growth and development of this country. We had what we call scattered reserves and inelastic currency. Reserves in banks tended to disappear when they were most needed and currency tended to become scarce when it was most needed. Obviously we wanted just the reverse.

By 1907 it was clear that the country was not going to put up with that free market concept. The country just wasn't going to have its business upset and dismantled from period to period by money crises. And so with some reluctance, but certainly with vision, under the new freedom of Woodrow Wilson we established a managed currency. But the goal was to safeguard it, in every way we humanly could, from becoming a device in Washington which would be either controlled by the private interests, on the one hand, or the political interests on the other hand. All of you in this room are familiar with the system that was worked out. I placed the emphasis in our title on the word system, Federal Reserve System--twelve banks, twenty-four branches, throughout the country.with the national governing board in Washington, not like the Bank of England, or the Bank of France, or the Bank of Italy, with one central bank and a number of branches throughout the country. I'm not criticizing their setup but I think ours is more adaptable to a country of the width and breadth of ours.

Therefore, we had in this system a means of keeping in touch with this very sensitive device for regulating the supply of money. Why do we want to regulate the supply of money? Every modern and progressive country at some point in its development has to have a central bank. Ours is a decentralized centralized bank where we endeavor to work through the grass roots.

Some people say it is a cumbersome system. Certainly it is not as easy to operate as if it were a one-man operation and certainly it isn't as easy for the political forces of the country to operate as if it were subordinate to the treasury or part of the executive branch of the government per se. These safeguards were placed around this system because there is deep down in the American, probably more so than in any other living people today, a fear of phony money. While we've not experienced that fear in the sense that Europeans have--for inflation has run riot with their currency and destroyed the very fabric of their society--nevertheless, the American people react to a fear of phony money. Mr. Bryan, as you remember, ran three times on a platform of "Sixteen to One." He was not entirely wrong. I hope nobody will misunderstand me when I say that. His speech, "The Cross of Gold," is, I think, a classic, and I don't think there's ever been any intention on the part of the body politic in this country for us to crucify our people on a cross of gold.

I think that money should be our servant and not our master, but nevertheless it must be surrounded by an understanding that its integrity depends upon its administration, particularly when it's a managed currency free from recontrol of the private interest on the one side and of the political interest on the other side. That is the institutional concept of the Federal Reserve, and having said that, I want to qualify it by saying that I am not trying to hold forth this morning that the Federal Reserve System is perfect. It certainly isn't. It will need to be changed and modified from time to time. But its role, essentially, is to see that we have a money supply which is neither so large that it will induce inflationary pressures nor so small that it will stifle initiative and growth. That is exactly what we've been trying to do in the past three years in administering the System. We have operated against both inflation and now against the forces of deflation. We have to lean against the wind in both directions.

Now I think of the money supply as a stream or a river. I like to see a little ripple in it--in the river. I don't want it to overflow its banks and cause difficulty surrounding it. I also don't want it to dry up, and I think that it can be adjusted in terms of a market concept. When we gave this authority to manage the currency to the Federal Reserve System, some people think that was the end of the free market concept. It is my conviction that it was not the end; it was a modification of it and fundamentally we still feel that by and large, under our system of government, and, with our democratic institutions, that the greatest good for the greatest number will be achieved by permitting the maximum play of the market that can be permitted without dismantling society itself.

That is what we were facing when we came to the Treasury-Federal Reserve accord. In 1951 it was necessary to restore to the market for government securities some of the flexibility which has been denied by the government for a period of roughly ten years. In restoring it, people told us that we were to face disaster and you had all of the stories of what would happen to the bond account of the various banks. Few people seem to realize that a government security is absolutely the soundest security that there is in a country like this. So far as its maturity is concerned and the payment of its interest, you will never have to worry. The only risk in the government securities lies in depreciation of the currency, and that has been lost sight of for a period of time.

Why did we at this particular time enter into an agreement with the Treasury that we would unrig this market in order to minimize monetization of the debt and at the same time to make it possible for the Treasury to get the money that it requires to operate? That's in essence what the Treasury-Federal Reserve accord was. We did it because at this particular juncture the law of supply and demand had caught up with us once again. The latent inflation had been there since war when, as we have always done in a war period, we inflated in preference to levying income taxes. Inflation was part of the by-product of war and it all began to head up in order to maintain a two and a half per cent rate--or whatever rate you wanted to maintain--on government securities. It wasn't a case of buying just a few million dollars worth of bonds, it was the case of opening up the printing press and buying billions of dollars of government securities and, at that juncture, with the law of supply and demand operating again we decided to return to basic principles.

Now, some people said, as they did with exchange rates, that interest rates don't make any difference. And if they do make any difference, you'd have to make such a large adjustment in the interest rate that it would just disrupt the whole society. You'd have to go up to six per cent or seven per cent or eight per cent. When the decision to unpeg the government securities market was made that was generally the sort of talk that was going on. A very modest adjustment in interest rates produced a very dramatic effect. Government securities ceased to be interest-bearing money almost immediately. The credit mechanism began once again to be a governor, one of the governors on the fly wheel of economy, and the process of evaluation of portfolio, the process of determining whether you'd rather make this mortgage, which might be relatively dubious, or take a loss on this security, began to operate. Not for one minute am I trying to attribute all of the stabilizing effect to monetary policy. But that it was an influence very few people today will deny and we began to see our inflationary spree come under control.

At this juncture I just want to review what has been happening in monetary policy recently. You've seen a dramatic shift from restrictive policy to what we call a policy of active ease. How did that come about? The reason we were worried about the inflation, and the only reason for worrying about an inflation, is that it always leads to deflation. As I pointed out, you can't alter the course of the law of supply and demand; you can do a lot of things to it, but it will always be with you, just as is the law of gravity. At some point you have to face up to it. Now, we have been struggling with that. We were making an adjustment and we found that interest rates did play some part. We began to get some stability in our economy and by the middle of 1952 I think it was apparent to most people that the purchasing power of the currency was gradually settling down and that you were no longer faced with extreme inflation.

Then came Mr. Eisenhower's election. After his election, there was a resurgence of confidence in business. Nothing that I'm saying is in any way political. I'm just trying to analyze what was happening; and there was a great expansion of plant and equipment on the theory that we had a business administration friendly to business. Therefore, we found ourselves faced in the early part of 1953 with what some people have described as a bubble on top of a boom. Some of us on the Board and some in the System felt that this could be a soap bubble. If it burst it would cause us a great deal more trouble when the inevitable reaction came than if we could keep it somewhat under wraps. Therefore, we followed a restrictive monetary policy through the latter part of 1952 and more aggressively so in the early part of 1953, and we saw the wave of inflation come to a halt. We didn't know precisely when it came to a halt, but the problem was bank reserves.

Now what were we going to do with that situation? I have said frequently in public appearances that in the spring of 1953 we miscalculated the degree of tightness that came into the money market. I don't think we miscalculated for technical reasons. I think our technical judgment was quite accurate. But you have an important factor in psychology which is the imponderable which you have to deal with in monetary policy. When I took this job as Chairman of the Board, like any responsible individual I tried to evaluate my qualifications, if any. I must say that they were not very impressive--certainly not to me. But I felt that there must be some principles that we could work with and the only thing that I got courage from, as I thought of my own qualifications and of the problem, was the fact that I had been in and around and on the fringes of money and banking and credit for twenty-five years and I knew just enough about it to know how very little I did know about it. I appreciate to some extent (and the more I've been in office, the more I've tried to keep my perspective on this basis) how easy it is to think we can get a simple formula; that we can get some program that will solve the problem. There is no field of endeavor in which more people develop into what I call, if you'll pardon me, the crackpots, than in this field of monetary management. The only individual that I've come to distrust in this particular area is the individual who's certain he has the answer.

When you are gauging the psychology of a lot of people, you are dealing with a great many imponderables and we find that the expectations of people are the most difficult thing to assess. The money supply was quite adequate, in my judgment, in the spring of 1953, until the expectations of the people regarding the Federal Reserve concept of a free market and the administration intentions with respect to interest rates on treasury securities just carried people away. There developed a conviction that there was no need to invest now, because, after all, you would be able to get six per cent on government securities in no time and the Federal Reserve was not going to supply any reserves to the market. It was just going to abdicate so far as supplying and absorbing reserves was concerned. It was going back to a pre-Federal Reserve period. It is not particularly unusual for people to arrive at that sort of a thought when we have gone through a period of war, the economic consequences of war and preparedness for war; and the ordinary principles have been obscured by the necessity for emergency action. You've come out of the period when patriotism has been the main key for keeping inflation under control and once you get a little easier situation and begin to rely more on the private segments of the economy and less on the government expenditure for your welfare and well-being it is perfectly natural for that reaction to take place. But, nevertheless, it went further than any of us could have anticipated and, I think, at that point we probably suffer from a conjunction of circumstances, some of them beyond our control, some of them within our control; but our judgment wasn't equal to it. In a country as large as this for a short period of time money became not tight, which is perfectly proper, but virtually unavailable for a limited period of time and that contributed to a certain amount of difficulty. We reversed that policy very promptly. We reversed it by approaching the problem in these four ways. We would take the period May 1 till December 1 and we would make a projection of what this money stream ought to be if it were continued normally (not with a view to either tightening the money market or easing the money market) with a view to permitting the market forces to determine rates. That seems to be very difficult for a lot of people, particularly bankers, to see because they think that you ought to adjust and the Federal Reserve can just control this. I think it's helpful to try to interpret what the Federal Reserve is going to do, but if the Federal Reserve is operating in the way it seems to me it ought to operate, which is on the assumption that by and large the play of the market will be more effective in achieving these results than will the Board of Directors of any given company or any given cabinet official, or the Federal Reserve Board in Washington, then you can see what the main objective of policy should be.

We estimated that there would be required for this money stream between two and a half and three and a half billion dollars at the end of the year. That figure will never be precise. We arrived at it by looking at the needs of the Treasury. We always have to look at the needs of the Treasury. The Federal Reserve is not set up to control the appropriation machinery of the Congress. We're set up to help the government finance itself. We can talk about balanced budgets and I can have strong views as an individual, but I have no authority, as I see in my office, to try to abrogate the decisions of the Congress with respect to appropriations. What we have to do is to try to help to finance it in the soundest way possible. The Treasury at that juncture, and it was a new Treasury team, was wrestling with a difficult problem. How much could it cut expenditures? What was it going to need in the way of new money? All during that spring about as devoted and intelligent a group of men as we've ever had in Washington wrestled with that problem seriously day in and day out and their views changed to the tune of five or six billion dollars frequently. Money management isn't easy when you're having to shift five or six billion dollars in your figures. It wasn't until the latter part of May that we had a pretty clear indication that the Treasury was going to need in the neighborhood of six billion dollars of new money and that it could achieve the balance that it was talking about. This is no criticism of the Treasury, but it took that length of time for them to come to a crystal clear appreciation of what the problem was and for us to fit our policy into it. That was one of the factors that we took into account.

Then we always are there to meet the seasonal requirements of business. How are you going to gauge those? It's very difficult. We're working on it now at the Board. I've been trying to get individuals around the country to give me their own projections. They're all helpful. What will be the demand for credit on the seasonal basis for the balance of this year? I cite the fact that last year the projections and the estimates of everyone from our Federal Advisory Council, the best that the statisticians of the Federal Reserve Board had, the best talent we could get through the community, were just about a hundred per cent off. The estimate, in New York City alone, of the clearing house banks was that the demand for credit in addition to their normal demand on the seasonal basis between the fifteenth of May and the fifteenth of October would be in excess of a billion dollars. Actually there was a decline in that period of two hundred and fifty million dollars; so they were off a billion, two hundred and fifty million dollars. Is there any wonder that interest rates went down? We added to that money stream some figure for growth in the economy. That's been misinterpreted by a good many people so I welcome the opportunity to mention it here. We added in this projection three per cent and it leaked to the press as these things always do. Therefore, people said we were now going to go on adding three per cent for forever to the money supply, that this was a type of perpetual inflation. There was no intention whatever to do that, but we did think that it was reasonable to assume with a gross national product at the level at which it was, and business activity at the level at which it was, that there should be some growth factor and we took for this particular period three per cent.

You have to evaluate not only volumes of money, of course, but velocity of money. That is just as important a factor as volume. The quantitative theory of money has to be kept along side the qualitative theory of money if it's to have any use and validity in an economy of the type of ours. And then on top of these three projections of the needs of the Treasury, the growth requirements of the economy, and the seasonal requirements, we have to look at the psychological factors. While I am on the psychological factors, as I have already hinted, I don't think we did very well in any period there. You have a problem of re-education in terms of the free market concept going on. By and large if we had been successful--completely successful--in this projection, interest rates would have risen if business had improved, interest rates would have stayed about stable, if business had stayed about stable, and interest rates would have gone down if business declined. Business was declining all through this period and interest rates were also declining. Now you come to the other side of the picture and there you have more difficulty because monetary policy cannot create prosperity. Monetary policy can assist, it can be helpful. You've heard the old song, you can pull a string, but you can't push it. You can't make a man borrow money if he doesn't think he can make a profit on it. You can only adjust your money supply in such a way that you give the maximum assistance to prosperity, the sustained prosperity that is the objective of all of us. I have used an illustration frequently of the role we can play by saying that in terms of the baseball season which is now starting, we can see that the bases are in good shape, that the balls and bats are all right, that we have a good umpire and referee (and we don't want too many umpires and referees out there) and we can be on the bench and we can cheer for the prosperity team. But we can't get out in the field and play. In our system we're not expected to get out in the field and play and if the motor people, for example, have difficulties with selling, certainly the Federal Reserve Board is no place to come, if you judge by me, for assistance. In the first place, I don't know anything about the motor industry, probably never will know very much about it. And no one must get the idea that the Federal Reserve Board is ever going to be manned with people who will be authorities on business and finance and every aspect of business. It's going to be manned with people who, if they stick to their own knitting, and have some appreciation of these fundamental concepts can be of inestimable,I may say invaluable, assistance to the business and the banking community.

Now, at the risk of being too repetitious, I want to just repeat that this concept of the free market is related to the modifications that have gone on in the earliest days of this country--private property, free competitive enterprise and the profit motive, operating in the market place in ways that will achieve the maximum good for society. At some point in this picture, and with this I close, we come to what I do not apologize for calling the American Way of Life. We come to an understanding that we have certain basic principles which, operated within the framework of common sense and character, can propel our economy as no other economy has been propelled; which can make possible the endless stream of jeeps that we sent to Russia during the war which was the marvel and the admiration of the Russians. We have in this American Way of Life not a Fourth of July oration, not something we wave the flag about, here and there, but we have a progressive point of view, a progressive philosophy, and when we talk about the American Way of Life, we have to realize that it can't be defined. I came under the influence of a very brilliant but facetious professor who used to make fun of the American Way of Life, because he said it's just a Fourth of July oration; nobody can definite it, nobody knows what it is. It took me twenty years of business experience to find out how wrong he was, how completely off base in my judgment, he was, because the glory of the American Way is that we can't define it. It's a continuous progressive way of life. In it is the recognition of the importance of sound currency, and the recognition that money and credit, if we are to have competition and freedom in our society, must be flexible.

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