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Southwestern Graduate School of Banking
Southern Methodist University
Dallas, Texas
July 17, 1962

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FEDERAL RESERVE POLICY

I am to talk to you tonight under the title "Federal Reserve Policy". I construe that title broadly and intend to discuss not only the record of recent monetary policy but to attempt to set it into perspective. To accomplish that end I shall discuss the characteristics and objectives of monetary policy, the structure of central banking in the United States, and some broad economic policy problems which monetary policy must take into account.

Let me begin by making three general observations which may seem overly obvious to you but which seem to me, all too often, to be forgotten, overlooked, or simply not recognized.

My first observation has to do with monetary theory--or perhaps I should say theories. There are a number of theories of interest rate determination which center on different, though not necessarily mutually exclusive, aspects of the process through which rates are set. Some theories stress supply and demand for loanable funds, some stress cash balances and liquidity demands, some stress the savings-investment process. What I want to stress is that elements of all these theories seem to account for interest rate movements at particular circumstances of time and place and under particular institutional characteristics of the economy.

Monetary policy therefore has to be made on a pragmatic basis and cannot be tied to a particular theory. This should not be taken to mean that there is no conceptual framework for monetary policy but it should be taken to mean that central bankers cannot be guided exclusively by any one or an unchanging mixture of such factors as: the state of liquidity, the level of cash balances, the money supply, the volume of savings, the amount of investment, or the demand for

loans. Central banking thus remains more art than science, a fact that has brought forth criticism that it is really more mystique than method, that its impact and its results are uncertain and that its practitioners are committed to saying little because they know little to say.

Actually, of course, the fact that central banking is more art than science hardly makes it unique in the field of economic, political, or social policy. And the fact that precise determination of the effects of credit cost versus credit availability, of changes in the money supply versus changes in liquidity and velocity, is not possible does not mean that the general linkage between monetary policy action and economic response is impossible to discern. Quite obviously, central banking action affects bank reserves; such reserves form the basis of the money supply and underpin commercial bank loans and investments; changes in these affect spending and saving. Questions of "how much," "how fast" and so on can be answered reasonably well at a particular point in time - they merely are not, yet at least, susceptible to formula treatment.

Just to leave this point on a more positive note, I should give you in broad outline a central banking approach to monetary theory. Over the long pull, the demand for real investment must be matched by the supply of real savings if we are to have high employment and a growing economy operating at or about at its current capacity. This is true because economic resources are scarce and in a capacity operation resources going for investment purposes have to be taken from consumption purposes and saving represents withholding of spending from consumption.

Created money or credit, then, can be no more than a relatively short-run substitute for savings in financing investment. It can bridge temporarily gaps between the flow of current savings and needed investment when real resources are available because the economy is operating below capacity. It can aid in smoothing the resource allocation process even under an economy operating at capacity. And since a growing economy needs an expanding supply of credit, the supply of credit and the supply of money need to grow also.

Both credit supply and money supply (cash and demand deposits) should not grow too rapidly for the economy to absorb. The money supply itself cannot be made to exceed the amount of cash balances the public is willing to hold at an appropriate rate of turnover. The greater the amount of other liquid assets the smaller the money supply may be to operate a given level of economic activity. Interest rates are a reflection of the interplay of demand-supply forces in the savings-investment process and are regarded more as an essential allocation factor in the market than as a deliberate goal of monetary policy.

My second observation has to do with the character of monetary policy. It is usually characterized as a "general" or "overall" economic control in contrast to a "direct" or "selective" one. Actually monetary policy has and is supposed to have a selective impact on the economy. The real points of difference between "general" and "selective" monetary control are that in the former case selectivity is exercised through the market mechanism rather than through fiat and that, in theory and actuality, it runs generally in favor of the efficient and against the marginal user of credit rather than against particular people or activities. In our type of economy, or in any type for that matter, economy of resource use is desirable since resources are limited.

The real questions here are whether the market mechanism does a better economic allocation job than would a non-market device and/or whether the economic, social, and political costs are too great to allow it to work. On the first point, the historical record seems to be on the side of using the market mechanism. On the second point, the question of undesirable costs resolves itself mainly into one concerning undue discrimination against one or more segments of the political economy. Here the evidence is mixed but, on balance, seems to indicate no undue discrimination. Certainly it does not prove discrimination.

My third observation has to do with the efficacy of monetary policy. Monetary policy is not an all-powerful economic stabilization device, and good

monetary policy does not automatically guarantee full employment, good growth rates, and price stability. Monetary policy is important, however, and bad policy probably can almost guarantee against long-term maintenance of growth, high employment, and price stability.

This point about the utility of monetary policy is particularly frustrating to central bankers. One group of critics contends that any deviations in prices, increases in unemployment, slowing down of growth or falls in level of activity are direct consequences of the failure of monetary policy to be carried out properly. Another group, and sometimes the critics belong to both groups at the same time, argues that because in the past decade prices have risen, because unemployment is higher, because our growth rate apparently laps the Russian rate, that monetary policy is useless and that there is no point in relying upon it at all as a stabilization device.

My colleague at Atlanta, Malcolm Bryan, once used a graphic analogy to express a central banker's feeling on this point by comparing monetary policy with a wife who was beautiful and affectionate, a good cook, a brilliant conversationalist, a fine mother and a talented pianist, but who was sued for divorce because she was physically unable to move the piano around the room.

To conclude my observations on this point, I should note the record of history, and most strikingly, the record of recent history abroad would seem to demonstrate almost beyond challenge that sound, courageous, and well-timed monetary policy action, coupled with similar fiscal policy action, can and has contributed to high rates of real growth with reasonable price stability.

Now let me summarize briefly the central points of these three observations. The first dealt with the formulation of monetary policy and concluded that it was not, and probably could not be, an exact science. Rather it is an art, carried forward by judgments of reasonably competent and experienced men who spend their full time at the job. The second dealt with the character of monetary policy and concluded that the judgments of these practicing central bankers could

be pushed only so far and probably could not be substituted completely and efficiently for the market mechanism. The third dealt with the utility of monetary policy and concluded that it was of considerable importance but was not a panacea.

Federal Reserve Structure and Objectives

I turn now to consideration of certain aspects of the structure, objectives and operational policies of central banking in the United States. The structure of the central bank is important because it may help or hinder the formulation and execution of monetary policy. The central bank's place in government, its relation to government and to the private sector of the economy are aspects of its structure. I do not intend to go into detail about Federal Reserve System organization; the major point I want to make is that it is an unusual blend of public and private, of central and regional characteristics. Given that the central function of a central bank is the formulation and execution of credit policy, that central function in the Federal Reserve System by statute is controlled in part by the Board of Governors, in part by the Reserve banks, and in part by a combination of Board and banks.

The System's structure has changed somewhat since its establishment but it is still fair to characterize it as a blend of public and private, central and regional. It is important to recognize that this blend came about partly by design and partly by political compromise. Broadly speaking the System was deliberately planned as a central bank with strong regional characteristics while its so-called "quasi-public" or "quasi-private" structure was the product of political compromise.

A half century ago the United States was as big geographically as it is now; it was a whole composed of many regions which generally exhibited fairly strong differences in kinds of economic activity, in rates of growth and in money market characteristics. Thus a regionally structured central bank seemed eminently logical for the United States, albeit unusual when viewed against central banks in other countries.

The public-private structuring was a product of various factors and was a compromise. The new central bank was to be a "bankers' bank", therefore the private bankers insisted upon a voice in its affairs. At the same time it would perform public functions, therefore the public should have a voice in its affairs. The points pro and con were many and varied but the net result was an organization structured along both public and private lines.

Obviously time brings about many changes and some observers hold that the structure of the System today, while it has changed somewhat so as to accommodate itself to changing conditions, needs to be changed more radically. Briefly the argument runs that regional differences today are far less significant than they were, that monetary policy has to be national in scope, and that there is no logical reason for a central bank which is in fact a public institution to retain vestiges of private organizational structure. The most complete specifications for accomplishing these ends are to be found in the report of the Commission on Money and Credit (a group of distinguished private citizens, bankers, businessmen, economists, and labor leaders) issued in the spring of 1961. Among the more important recommendations concerning Federal Reserve organization and structure are these: consolidate all credit policy powers in the Board of Governors, make the terms of the Chairman and Vice Chairman coterminous with that of the President, have the President set up an advisory board (a national economic council) to assist in coordination of economic policies, retire the capital stock now held by member banks in the Federal Reserve Banks, and make all insured banks members.

In commenting on these recommendations I want to make three points very clear. First, I speak of them as an individual and not as a spokesman for the System. Second, I want to discuss them in the terms I have used before, central and regional, public and private. Third, I am not commenting on the Commission's report in general, and therefore what I have to say should not be taken either as generally critical or generally favorable to the report as a whole.

First, let me say that I have some feeling that the Commission was overly influenced by three misconceptions: (1) the need to tidy up the organization chart aspects of an institution that is functioning reasonably well, (2) the feeling that the public character of the central bank should be more clearly indicated, and (3) the belief that regionalism is no longer very important. I want to comment on these in reverse order.

In my judgment we still have important regional differences with respect to type, level and rate of growth of economic activity. While there is no question that many of the aspects of regional money markets have disappeared or moderated appreciably, there are still some differences evident in interest rates in certain markets, in seasonal and cyclical credit demands, and in impact of monetary policy. Thus while I agree that monetary policy now is and should be national in scope, I feel that the whole is still the sum of its parts and that regional differences should be taken into account in formulating a national monetary policy. Therefore, I conclude that the regional character of the System remains important and should be preserved. Certainly I see no advantage gained in eliminating or weakening that regional character.

I find it difficult to comprehend the Commission's view of the System's public and private characteristics. There is no question as to it being an institution with public responsibilities. In the twenty years I have spent in the System, I find no significant misunderstanding of that fact on the part of presidents, directors or bankers. Each member of the Open Market Committee, be he Board member or President, takes the same oath of office. There are differences of opinion among Open Market Committee members but they rarely, if ever, coalesce around the President members as a group or the Board members as a group. Splits normally find both Presidents and Board members on each side.

It seems to me that the Commission's vision was obscured by glasses which saw "public" and "private" mainly in terms of procedure of appointment to office rather than in terms of function and performance. As a matter of form,

I would have no real objection to Reserve bank presidents being appointed in the same way as are Board members, but I doubt that they would be, by that fact alone, either more competent or more aware of their public responsibilities.

Finally, I see no persuasive reason to do what I have called "tidy up the organization chart" just to make it look better. The fact that member bank stock holdings in a Reserve bank do not confer the normal rights of stock ownership on the member is reasonably well understood now, if it ever was misunderstood. Why should we change a practice of 50 years standing merely because it looks illogical on an organization chart? I do not regard this as a matter of great importance either way. In contrast to this point, however, I believe it would be useful to make the terms of Chairman and Vice Chairman of the Board of Governors coterminous with that of the President. I think this was Congressional intention and that over the years the schedule merely got out of phase. The realities of the situation are that no chairman could serve effectively, or would serve, if he were completely out of sympathy with an administration; this might as well be recognized by law. I believe it significant that this point, plus higher salaries for Board members, were the only Commission recommendations with respect to System organization taken up by the President in his suggestions to Congress for action.

We now turn from the structure of central banking to its objectives. Central banking objectives fall into three broad classes - ultimate, intermediate, and proximate. First we shall deal with the ultimate objectives. In one form or another, these have been given in official Federal Reserve publications about as follows: The Federal Reserve System attempts to operate so as to promote or contribute to high employment and production, a rising standard of living, and stable prices. In a paper submitted to the Commission on Money and Credit, the goal of monetary policy was given as "to provide maximum assistance toward promoting long-term growth and containing cyclical swings in economic activity within reasonable bounds, while permitting adjustments which are required to

preserve the dynamic character of our economy."

Three comments might be made about these ultimate objectives. First is the fact that monetary policy formulation and execution is a continuous process, and continuous review of developments provides the basis for continuous consideration of policy. The processes and procedures through which policy is executed in the short run are and have to be far more definite and precise than the broad goals but always have to be associated with them.

Second is the question of direct linkage between specific policy action and ultimate economic response. No one can say with certainty that specific central banking action leads to ultimate economic response in precisely such a way or such an amount. The drive shaft between central banking action and ultimate goal is too long and is linked to too many gears of indeterminate speed. Nor can anyone state with precision what would have happened absent the central bank action or with a different action. But here again the indicated direction of central bank action is fairly clear, and the continuous review process makes it possible to change the speed and pressure of such action as the course of developments in the ultimate goals is observed.

Third is the point that the ultimate goals may not always be compatible. In one sense, this is true; in another sense it is completely misleading. When we deal with politico-socio-economic affairs, we almost always have conflicts. Guns or butter, individual freedom or service to the state, low borrowing costs or high rewards to savers are easy examples. The strength of a dynamic and democratic system lies in its ability to make adjustments that permit optimum attainment of the goals of a free society. So to say that the ultimate goals of central banking are not compatible is to state the obvious but without any understanding of our society.

Ideally, we want to attain all of the ultimate goals, and no one is more important than another, nor are they separable in the long run. In the short run, lack of compatibility may exist quite often but also quite often does

not exist at all. For example, at the moment, policy emphasis naturally is colored by relatively high unemployment levels rather than by preoccupation with rising prices, because the former exists and the latter is absent.

From consideration of ultimate objectives, let us move all the way back to proximate objectives before discussing the intermediate class. These proximate objectives are those most directly controlled or influenced by central banking policy actions. In this group I put total reserves and net free reserves (both positive and negative). While many people would disagree, I also put here short-term interest rates and the general level and configuration of the interest rate curve.

Net free or net borrowed reserves are within fairly direct control of the Federal Reserve, although the control is less direct than it is with total reserves. By definition, free reserves (positive or negative) are excess reserves minus borrowings. While the System can control total reserves and can limit borrowings, it cannot directly control excess reserves nor make banks borrow. Thus, if the System wants to attain a given level of net free or net borrowed reserves, it cannot completely determine total reserves or borrowings, and, conversely, if it seeks to attain a given level of total reserves, it cannot completely determine net free or net borrowed reserves. From a practical standpoint, however, this arithmetic fact does not reduce System control over free or net borrowed reserves to any significant degree.

Far more controversial as proximate objectives are short-term rates and the general configuration of the interest rate curve. The controversy turns partly on the point of propriety of interest rates being an objective at all, partly on the point of propriety as to their being a proximate objective, and partly on the point that pursuit of interest rate objectives makes reserve volume (total or free) less susceptible of direct central bank control.

In giving you a central banking approach to monetary theory, I noted that interest rates are regarded more as an essential allocative factor in the

market than as a deliberate goal of monetary policy. By classifying short rates and general rate pattern as proximate objectives of central banking, I obviously qualify the above statement. Just where does that leave us?

The statement means to me that a central bank should not seek either an arbitrary, non-market determined level or pattern of rates nor attempt to rigidly peg such a pattern. Obviously, however, central bank policy action with respect to reserves has direct influence on interest rates if supply-demand relationships have any meaning. Therefore, central bank policy implicitly has some interest rate goals in mind. In point of fact, current monetary policy has fairly specific goals in mind for short-term Treasury bill rates.

The distinction I am trying to draw here is a subtle one. In my view, proper central bank action does not involve imposing the central banks' view of an appropriate interest rate structure upon the money and credit markets without any regard for reserve volume objectives. It may be quite proper central bank policy to have a view as to what interest rates are likely to be as reserves are added or subtracted and to use both short-term rates and general rate pattern as goals along with reserve volume goals. And furthermore, it may be quite proper central bank action to pursue an interest rate goal somewhat more diligently than a reserve volume goal at a particular conjuncture of circumstances.

Now I see this kind of approach as being not only different in degree but in kind from rate pegging as was done in World War II. It is different because it seeks to not dominate the rate structure at all costs and it is different because the rate structure, and even a specific short-term rate, would not be viewed in absolute terms but rather in terms of maximums and minimums which themselves may fluctuate. Thus, a goal for short-term bill rates of, say 2 3/4 to 3 per cent, is quite different in both degree and kind from a goal of 3/8 per cent with no plus or minus allowance. And when a goal of a certain level and pattern of rates obviously is being resisted by market forces after operations in reserve volume seem fully adequate, proper central bank policy would reconsider

and probably change that goal, which approach is something far different in both degree and kind from a rigidly pegged market.

The point as to whether interest rates should be classed as proximate or intermediate objectives is difficult to resolve. From the above discussion, it is obvious that interest rates are not quite as proximate as reserve volume. My own feeling is that they are more proximate than intermediate, but I would not push this point too hard. It may well be that short-term rates should be regarded as proximate objectives, and the general rate pattern as an intermediate objective.

The point about possible conflict between proximate objectives of reserve volume and interest rates has been covered in one sense in the above discussion. As is true of ultimate objectives, there may be conflicts between proximate objectives. Part of the art of central banking is the resolution of such conflicts and as a practical matter the proximate objective conflicts can be and are resolved without too much difficulty.

We can now move back, more or less halfway toward the ultimate objectives, to consider the intermediate class. These have to do with spending and consumption, saving and investment, and thus include the volume of credit, the liquidity of the banking system and the economy as a whole, and the money supply.

My comments on the intermediate objectives can be quite brief. The linkage between Federal Reserve policy actions, the response of those factors in the proximate objective area, and the secondary response of the factors in the intermediate objective area are seen with reasonable clarity, as I observed earlier. Strictly speaking, Federal Reserve control over intermediate objectives does not exist, but practically Federal Reserve influence does, even though the degree of influence varies with time, place, and circumstance and is not precise not definite.

While the linkage between proximate and intermediate objectives is not precise and definite, it is far more so than the linkage between intermediate and ultimate. Federal Reserve policy strongly influences total bank deposits

and bank loans and investments. Its influence is somewhat less definite on money supply and general liquidity but is apparent. When funds flow into ultimate particular uses, however, they are beyond central bank control - which I believe is as it should be.

Review of Past Policy

For the balance of this talk I will deal mainly with the monetary policy record. First, I believe it will be useful to review in capsule form monetary policy over the past two decades, beginning with the entry of the United States into World War II.

In December 1941, the Federal Reserve announced that it would "use its powers to assure that an ample supply of funds is available at all times for the war effort, and .... exert its influence toward maintaining conditions in the United States Government security market that are satisfactory from the standpoint of the Government's requirements."

These purposes were accomplished. There is no point now in discussing whether too much war finance was provided by money creation and not enough by taxation or borrowing of savings or whether the pegged interest rate pattern was too low, too tilted or generally inadvisable. But there is point to underlining two facts which tend to be forgotten as the years pass. First, the System's operations resulted in huge purchases of Government securities and consequent huge additions to bank reserves and the money supply. Second, the Government securities market became artificial; normal price risks disappeared and long-term bonds became as liquid as short-term bills, almost becoming interest-bearing cash. The pegged rate structure meant, of course, that the System had no control over the supply of reserves; holders of securities could liquidate them in an assured market at no penalty.

In the five years following the end of World War II the dangerous monetary situation that prevailed at war's end was relieved in large part.

Unfortunately, a good share of the relief took the form of letting price increases lift the value of output into better balance with the swollen money supply as the inflation repressed during the war broke out into the open. Fortunately, the Treasury surplus moderated the adjustment but even so it was severe. During the period, monetary policy, with the aid of debt management, gradually and cautiously moved toward a base of greater operating freedom.

March 1951 saw the Treasury-Federal Reserve Accord, which is generally taken to mark the beginning of a flexible monetary policy. Actually, much of 1951 should be viewed as an adjustment period during which the pegs were pulled out but support operations continued on a declining scale. Monetary policy itself held mostly constant, partly in keeping with the adjustment period arrangement, partly because economic and credit conditions were propitious for such policy.

By 1952 it was possible for monetary policy to move more flexibly and, in a broad sense, it has been employed flexibly ever since. Generally speaking, I believe that the record since that time has been fairly good with policy shifts from ease to restraint or from restraint to ease being reasonably timely, adequate, and effective. In my own judgment, the major exception to this statement came as a result of overstaying a policy of ease in the upswing following the 1953-54 recession. Subsequent moves to restraint perhaps could have been more gentle had it not seemed necessary to recapture quickly control that had been let slip for too long.

A few figures will serve to illustrate the flexible character of monetary policy in the ten years 1952 through 1961. The Open Market Committee held 135 meetings in that period. Broadly speaking, policy changes may be viewed as being of two degrees of strength - major and minor. The major shifts have been marked generally by changes in the wording of the directive (more precisely in the b clause of the directive) given by the Open Market Committee to the Account Management. Minor shifts have been marked by what I call "shades" in the instructions given the Account Management within the framework of the directive. For

example, a directive may call for restraint but a "shaded" instruction may call for meeting seasonal needs. Careful reading of the published policy record indicates these "shades". In the ten years, there were 30 changes in directive and 49 "shades" in the instructions.

In addition to these indications of flexible open market policy, the other tools of credit policy also were used flexibly. There were 7 changes (all reductions) in reserve requirements (including here the steps taken to free vault cash for reserve credit), 7 changes (4 increases and 3 reductions) in margin requirements and 21 changes (13 increases and 8 reductions) in the discount rate in the ten-year period.

A somewhat more detailed examination of monetary policy over the past two and one-half years illustrates perhaps more graphically than the mere recital of number of policy changes what flexible monetary policy means.

Let us briefly get the underlying economic facts in mind first. You will recall that 1960 opened with a spate of rosy economic forecasts about the Soaring Sixties. It soon became apparent that there would not be much soaring done in 1960 and before the year got very far along the question was not whether the economy would expand but whether it would contract, and, if so, how much. Actually 1960 turned out to be a year which averaged higher in economic activity than 1959, but one where the broad measures of activity tilted slightly downward after the first quarter and into the first quarter of 1961. Subsequently there was a fairly rapid run-up in those broad activity indicators through the balance of 1961 and this has continued, with somewhat diminished force through the first half of 1962.

A few figures may be helpful here. The Gross National Product was running at an average rate of $506 billion in the second quarter of 1960, about $18 billion more than in the fourth quarter of 1959. By the first quarter of 1961 it had fallen to $501 billion (down about $5 billion). By the close of 1961 it had risen to $542 billion and currently is estimated at about $556 billion -

up about 11 per cent from the recession trough. The index of industrial production went from a high of 111 in January, 1960, to a low of 102 in February, 1961 and subsequently has risen to about 117. The unemployment rate was about 5 per cent in the first half of 1960, ran up to almost 7 per cent by the close of the year and hung there until late in 1961 when it began to drop. It is currently 5.5 per cent and thus still is higher than it was at the beginning of the brief recession of 1960-61. Prices have shown little change over the entire period.

I should call your attention to two points here. First, I hope you note that I have portrayed the course of economic activity in measures that conform pretty well to what I have called the ultimate objectives of monetary policy. Second, it is important to note that in terms of annual averages production and income in 1960 showed more gain from 1959 than they did in 1961 against 1960. And as noted, unemployment stayed high in 1961 and still is high, while prices have been stable.

One further factor needs to be noted before we look at the record of policy in the past two and one-half years and it is a very important factor - our international balance of payments position. It had worsened in 1959 and in 1960 got steadily worse until we faced a real crisis at the close of that year and in early 1961. The situation has bettered appreciably since that time but the problem is still with us and probably will be for some time to come.

Now as to actual policy. Early in 1960, when it became apparent that the strong expansion forecasts were wrong, the System began to ease credit policy and that easing action became more pronounced as the year advanced. At the same time the balance of payments position made it necessary to use some new techniques so that our interest rate structure would not fall so far as to accentuate outflows of funds abroad and make our balance of payments worse.

From late March, 1961 through July, open market operations added $1.4 billion, net, to the System portfolio, which purchases offset a $500 million increase of currency in circulation and gold outflow, permitted a reduction of

$300 million in member bank borrowing and made possible a $600 million increase in member bank reserves. In early June and in August discount rates were reduced, by 1/2 percentage point each time, thereby lowering the cost of borrowing from the Federal Reserve Banks from 4 to 3 per cent. In August and November, reserve requirement changes principally affecting vault cash, had the effect of releasing $2 billion in reserve funds. Net purchases of securities in open market operations provided another $800 million reserves in the second half of the year.

For 1960 as a whole, member bank reserve positions improved net by more than $1 billion, from net borrowed reserves of more than $400 million in December, 1959 to net free reserves of about $650 million in December, 1960.

Note that System policy actions aimed at the proximate objective of monetary policy. They were designed to provide adequate ease in terms of reserve supply but within a framework of competitive world interest rates. Thus the release of vault cash late in the year and provision of reserves through open market purchases of securities other than bills helped keep some direct pressure off short-term rates.

In 1961 System policy continued to be one of adequate ease with attention paid to short-term rates. With resources underemployed, with no apparent dangers of price inflation, and with a continued, although somewhat easier, balance of payments problem, that policy seemed to be clearly indicated. At the close of the year came amendment of Regulation Q which permitted banks to pay higher rates on savings and time deposits effective January 1, 1962. This has helped keep and attract funds which might otherwise have gone abroad.

In terms of proximate objectives, what were the results of policy over the two and one-half year period? Total reserves were increased by about $1.2 billion net, rising more rapidly in 1961 than in 1960. Free reserves moved from a minus $400 to $500 million to a plus of equal amount, reaching that level in 1960 and holding there throughout 1961 and well into 1962. Member bank

borrowing dropped from $900 million at the close of 1959 to less than $100 million at the close of 1960, and has stayed low ever since. Short-term rates which were very high at the end of 1959 went down to about 2 1/4 per cent by the end of 1960, came up to around 2 3/4 per cent in 1961, and recently have moved close to 3 per cent.

In terms of the intermediate objectives, total bank credit rose $10 billion in 1960, another $15 billion in 1961, and has increased further in 1962. Loans rose 6 per cent in both 1960 and 1961. Total deposits (the broad money supply) grew by 4.5 per cent in 1960 and by more than 8 per cent in 1961. They have expanded further, on a seasonally adjusted basis, so far this year. Loan-deposit ratios dropped indicating a rise in bank liquidity, but did not drop so far as to indicate over-liquidity.

Current and Prospective Policy

To conclude this talk let me comment briefly on current policy and prospective policy problems. There is not much I can say about either. Current policy is formulated against the observable background of some slack in the economy and a continuation of the balance of payments problem. Thus it remains basically easy, basically the same as it has been in recent months, with perhaps a bit more emphasis on short-term rates. And on this point I should note that one very important factor in keeping short-term rates from slipping down has been Treasury debt management policy which has increased the supply of short-term securities.

Future policy, of course, will be formulated against actual performance of the economy. A flexible monetary policy is supposed to flex when conditions change. The policy makers hope their prescience and their ability will combine to have it flex in the right direction at the right time.

I should, however, comment on one specific point because it is quite important from the standpoint of the course of future monetary policy. There

is apparently considerable support for a tax cut both on the grounds that the economy could use one to advantage currently and that taxes are too high in general and may be inhibiting growth. Some supporters of a tax cut argue that we should change the "mix" of our fiscal-monetary policy prescription so as to have looser budgets and tighter money. Such a "mix", they say, would not only stimulate the domestic economy but would help our balance of payments problem by leading to more competitive (higher) interest rates here.

My purpose in mentioning this is not to support or oppose a tax cut but merely to note that if one takes place it may well change the conditions for monetary policy. A tax cut financed through real savings could lead to a different kind of monetary policy than one financed through the banking system. But regardless of how it is financed it will be a factor for monetary policy to consider.

Thus I close this talk on an indefinite note which underlines the points with which I opened it. Monetary policy is not a science, it is an art. Its practitioners have by necessity moved from the classical and romantic periods to the more modern schools. They have not yet, however, become surrealists or abstractionists. I hope they never do because, above all else, central banking art is and has to be realistic if it is to endure.