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ADAPTATION FROM CONVICTION NOT TO PRESSURE

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By Karl R. Bopp

Central banks have long been known as "lenders of last resort." This occasion, however, may be the first -- and perhaps the last! -- time that a central banker is called on as a speaker of last resort.

When Hampton Randolph asked me last Saturday to stand by because Ambassador Romulo might not be able to be here, he said that I could repeat to you the talk I gave less than a week ago to the New Jersey Bankers Association. That was a tempting solution because it would have been easy. The easy solution, however, is not always the best one. For reasons that will become clear, I did not consider it to be the best solution in this case. So, I simply cancelled my plans for the weekend and wrote a sequel.

The topic of my New Jersey talk was "The Tradition to Adapt." In broadest terms, the burden of my message was that our enterprise system must shed the rigidities of thought and action with which it has become encrusted if we are to remain free. The title however, was chosen with specific reference to the Federal Reserve System. I tried to indicate that the Federal Open Market Committee authorized transactions in long-term government securities which were inaugurated on February 20 as a means of "contributing to domestic recovery and simultaneously strengthening our international payments position." I rationalized the decision in these words:

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> "The purpose was to make reserves available to promote domestic recovery without depressing short-term rates which would aggravate our balance of payments difficulties. The action was in the tradition of the Federal Reserve System which is to adapt its policies and techniques to current developments."

The key sentence satisfied a rule of rhetoric by tying the substance of the talk to the title.

I recall vividly inserting a paragraph at this point to avoid misinterpretation. That paragraph reads:

> "The change in technique most emphatically does not mean that the System is once again going to peg prices and maintain an inflexible pattern of yields. We have had sufficient experience with pegs to know that they aggravate rather than mitigate the swings in the business cycle. We know also that a booming economy, with seemingly insatiable demands for credit, will force interest rates up. We observe this not only in our own history but also and particularly during the past few years in other industrially developed countries, notably Western Germany."

As one who had been a restive participant in a junior capacity, I spoke with feeling as well as with reason about the System's experience with the pegs.

I regret that this specific reference did not convey the basic point that I was trying to establish. That basic principle is that although the System has done its best to develop a tradition of keeping abreast with modern thought and of adapting itself to economic developments, it also has convictions, based on experience, and does not follow every Pied Piper who happens to have an inspiration as to what we should do. We have tried to develop an open mind not a drafty one.

That I failed to make this clear was indicated in several conversations I had after the talk. The point that was made to me could be expressed in these words: "We appreciate the great pressures to which you are subjected and can understand why you feel you must adapt yourself to them." The

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implication was clear that they meant not the pressure of economic developments that I had analyzed in the talk but rather pressure from powerful individuals and interests.

It is my considered conviction that the moment the System yields to such pressures will mark the beginning of the end of the System as we know it. After all the Congress in creating the System established elaborate safeguards to assure that this would not happen. Congress created an organization that would not be controlled for partisan political purposes by the administration in power nor by private interests, especially the so-called financial interests. It made the System responsible to the Congress rather than to the President and created a rather complex organization in which Government representatives would have final authority but in which private individuals would make a contribution.

At the apex of the structure is the Board of Governors of the Federal Reserve System. It consists of seven members appointed by the President by and with the advice and consent of the Senate for fourteen-year terms. The long terms are specifically designed to insulate the Board from the day-to-day pressures of partisan politics. In the unlikely event that private interests would attempt to seize control of the System, it is perfectly clear that the Board, selected by the Government, has the power to enforce its will. A united Board has authority over all our policy instruments. It has exclusive control over the reserve requirements of member banks and over margin requirements for purchasing or carrying listed securities, the sole selective instrument of credit control. It reviews and <u>determines</u> rates of discount established by the directors of the Reserve Banks. Its members comprise a majority of the Federal Open Market Committee which determines Open Market operations.

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The Board of Governors not only exercises general supervision over the Reserve Banks but also has power to remove any officer or director of any Federal Reserve Bank. It may ignore the advice of the Federal Advisory Council. Within these limits, Congress felt that private interests could make a valuable contribution to monetary policy.

The Federal Reserve Banks are organized to blend public and private influences. Each of the twelve Federal Reserve Banks is supervised and controlled by a board of nine directors. Class A are chosen by and are representative of the member banks. Class B are chosen by the member banks and are engaged in commerce, agriculture, or some other industrial pursuit and may not be bankers. To diffuse power, it is also provided that member banks be grouped for purposes of electing directors into three groups: large, medium, and small. Each group of member banks elects one Class A and one Class B director. Finally, the Class C directors are appointed by the Board of Governors. The Board of Governors designates one Class C member as chairman and another as deputy chairman of the board of directors.

The general idea was that in establishing discount rates or the cost of credit, the board of directors should have the views of lenders (Class A) and of borrowers (Class B) with a public group (Class C) to resolve any differences that might develop. I might say that my experience at the Federal Reserve Bank of Philadelphia is that directors do not consider themselves as representative of any particular interest. I have known Class B directors to move an increase in the rate, even on occasion when the mover's firm had a security flotation in the offing. Similarly, Class A directors have made a motion to reduce the rate. Action on the rate is preceded by a review of economic developments presented by our vice president in charge of research. He, in turn, has consulted with his staff, which

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includes professionally trained economists and statisticians. Most of you have come to know the quality of some of these men from our field meetings and from our monthly review. We are the original source of significant economic data. Directors express their judgments on developments. A motion on the rate is made with reference to the total situation, not as a reflection of a narrow point of view. Ordinarily, though not invariably, of course, votes on the rate have been unanimous. I mention this so that you may have some feel of the spirit that motivates a Federal Reserve Bank.

I should like now to sketch for you what I conceive to be the primary function of the Federal Reserve System in our society. I shall be very general at the outset.

The basic economic goal of every Government is the maximum utilization of its human and other resources. Societies differ, however, with respect to the relationships that they feel should exist between the Government and the individual and, consequently, on how specific goals are to be determined and achieved.

In dictatorships the State is supreme and the individual is subservient to it. Essentially, the leaders decide who is to produce how much of what goods and services and for whom. They determine the division of time into work and leisure, the allocation of resources to investment and to consumption.

In democracies the State is the servant of the people. Through secret ballots, the electorate determine generally what role they want their Governments to play -- and it may be considerable. Within the limits thus established, each individual decides his own priorities as to specific goals.

The difference in basic philosophies is reflected in the differing role that money plays in the two systems. In choosing among alternative goals

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and alternative ways of achieving them, even a dictatorship is concerned with costs. Since the factors of production -- land, labor, capital -- are not directly commensurate, some unit of account is needed. Money serves this purpose, even in a dictatorship. It also performs some auxiliary function of allocations within the limits determined by the general economic plan.

In democracies, on the other hand, money is the basic instrument of economic freedom through which individuals make their preferences known. Within very wide limits, each individual has freedom to choose how he will earn his money income. Through the democratic process of the secret ballot, citizens elect representatives to determine how much shall be allocated to what specific common purposes through the Government and how these purchases shall be financed by specific taxes and borrowing. Again, within wide limits, the individual is free to spend the remainder of his money income as he sees fit. He may also borrow to supplement his income, may save for the future, and may sell some assets and buy others as he sees fit to secure a maximum of welfare. This is a continuous process. Decisions of today are not only influenced by those of the past but condition the choices of the future. For example, the young couple that decided they could afford to live in a new housing development because their income could meet existing taxes, interest, amortization, insurance, and other scheduled payments, now find they really had obligated themselves for new sewers, schools, roads, and so many other community necessities, as well as the unanticipated private expenditures that are required to live as they had expected. The decisions that individuals make, direct the use of resources to those purposes for which they spend money and away from those for which they do not. We live in a profit and loss economy, as the Rambler and Edsel cars clearly demonstrated.

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Democratic societies want their economic system to achieve maximum utilization of resources while maintaining a maximum of individual economic freedom. Unfortunately, there is no inherent reason why the total of all the individual decisions to buy or sell, to borrow or lend, to consume or invest, to hoard or spend will add up to the exact amounts that are needed to utilize available resources.

What is desired is some mechanism that will induce individuals of their own volition to adjust their behavior so as to produce the desired total result. The Federal Reserve System is a vital part of this mechanism. It is, however, by no means the only part. Before I discuss monetary policy, therefore, I should like merely to mention briefly the other major parts. First, we need competitive and functioning markets. Second, we need appropriate fiscal policies. Last year Governments at all levels purchased about 20 per cent of our entire output. How much and what is bought as well as the source of the funds obviously have far-reaching effects on the level and composition of total output. Third, we need appropriate management of the debt.

Appropriate wage-price actions, and fiscal and debt management policies contribute to stable economic growth. Inappropriate policies in these areas aggravate inflation or deflation and impede stable growth. The monetary authorities, unfortunately, cannot operate on the assumption that appropriate policies in all these areas will be followed at all times. We must deal with developments as we find them and not as they might be.

It is easy enough to describe in very general terms the basic purposes of a flexible monetary policy. If governments, corporations, and individuals try to purchase more goods and services than can be produced at existing prices, their efforts will tend not to increase production but

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prices. It would be appropriate, therefore, to make credit more expensive and more difficult to secure. Although the public would react by using its cash more efficiently, it also would be induced to postpone some of its purchases and thus remove the inflationary pressure. If, on the other hand, the public is not buying as much as can be produced at existing prices, easier and cheaper credit would tend to induce the public to step-up its purchases and thus restore production and employment to capacity.

Even this highly simplified model indicates that monetary policy, which is designed to serve the long-run interest of the public, must move against short-run swings of sentiment, restraining when sentiment is too exuberant and encouraging when it is too pessimistic; hence, the money managers cannot expect to be popular.

The real world, of course, is not so simple as the sketch I have given. Those who have been concerned with monetary policy have been interested in having it promote a number of specific goals. Among the more important of these are full employment, a stable level of prices, convertibility, and adequate growth. It is reasonable to suppose that frequently -- perhaps even generally -- a single monetary policy of ease or restraint would promote all of these goals. In other words, declining employment and output are frequently associated with a declining price level and increases in the nation's monetary reserves, and all point to a monetary policy of ease.

Frequently, however, is not often enough. Central bankers face tough choices when the several objectives point to conflicting policies. That is precisely what has happened during the past year when the decline in output and an increase in unemployment was associated with an adverse balance of payments and a large outflow of gold. It was to resolve this

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dilemma that the Federal Open Market Committee authorized transactions in longer-term Government securities that I mentioned at the outset. The decision was in keeping with our tradition to adapt to economic developments in the real world.

As to the future, the destiny of the System in the long run depends on the quality of our monetary policy. A central bank can remain independent within Government not as a matter of right or of law but only as it maintains the confidence of the public. Such confidence in turn can be maintained only if we demonstrate two basic qualities: an open mind so that we can devise techniques appropriate to ever-changing economic developments and a tough skin so that we do not yield to outside pressures whatever their sources.

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