CONTEMPORARY MONETARY POLICY

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Monetary policy is a subject often discussed in terms of a mechanical relationship between goods and money. Prices in the market place are the tangible expression of this relationship. Money is a medium created by or under governmental authority. On the other hand, goods represent a conglomerate output of millions of authorities, primarily private. Accordingly, it would seem entirely logical for government to exercise its central power to adjust the supply of money to the supply of goods.

Such a theory appeals strongly to our sense of an ideal world, for if adjustment of the money supply to the supply of goods were effectively made, certain desirable results would surely follow. Prices on average would be more stable. And if average prices were more stable, markets would become more clearly definable, and uncertainties of production would be lessened. In turn, these developments would likely be reflected in a greater over-all economic and social stability.

This is very attractive doctrine, and in a good many economics textbooks it is elucidated with clarity and persuasion. In final essence, the monetary problem is made one of properly organized government. What is needed to control the issuance or creation of money is merely that government should establish some agency--for instance, a central banking system--equipped with a panoply of discretionary powers. Administered by men of "ability and wisdom," this agency can surely regulate the supply of money in the interest of a sustained high level of employment, production, and trade at stable market values.

The problem of monetary policy is not quite as simple as appealing dogma would make it. To begin with the money supply is a kind of amorphous mass, and not a quantity of readily identifiable and additive items. Witness the recent spectacle of a prominent monetary controller finding little change in the money supply over the past year while an equally prominent financier found a substantial increase during the same period.

We have currency money issued by the Treasury and by the Federal Reserve Banks, and we have the demand deposit money created by the commercial banks. We have a large additional amount of liquid assets in the form of time deposits and savings accounts, building and loan shares, and the cash value of insurance policies convertible into other money at par and virtually on demand. We have an even larger volume of liquid assets in the form of Government securities, readily exchangeable into money at par, by redemption or sale. We have still other assets that are very high in liquidity, and therefore in nature close to money. Some of our money, moreover, when lodged in the reserves of Federal Reserve Banks and commercial banks, possesses the property of multiplying through loans and investments into still more money.

Then there is the fact that Government credit plays so large a part as asset backing for the money supply. This makes public confidence in the whole monetary mechanism heavily dependent on public confidence in

Government credit. I might observe in passing that this particular condition is primarily the result of having financed a recent and very costly war.

This is not all. A sizeable part of outstanding money balances and a sizeable segment of outstanding Government debt is regarded by holders as temporary lodgment of value--that is, is held for reasons of short- or longer-term liquidity. At the holder's volition, the money at rest may be reactivated or the Government securities in temporary holdings may be converted into money. The result is that active money flows in the economy, and indeed the total money supply, are subject to change by the independent decisions of many individual and institutional holders.

Added to the feature of money elasticity through credit extension, the independent influence on monetary conditions of liquid asset holders has important consequences. It means that, in addition to a governmentally established authority, we have many private monetary authorities of lesser or greater importance. It further means that public monetary policy today, at least in its short-run aspects, is very much a game of offsetting effects on money flows and the money supply of decisions by the numerous private monetary authorities. A corollary implication is that public monetary policy is in part a game of avoiding undesirable effects of actions on private monetary decisions.

Governing our existing complex mechanism of money and near money, we have an equally intricate framework of law and public supervision. Our money and related financing agencies, moreover, have developed their own special patterns of operation. Monetary policy has also to be shaped in the light of these institutional elements.

The impression obtained from even casual observation of the structural features of our present money system is plainly not one of simplicity; it is anything else, depending on one's sense of proportion. No set rules or principles for the conduct of public monetary policy in these circumstances is easily formulated and agreed upon.

Besides its frustrations on account of a highly complex money structure, monetary policy has a thorny path to follow because of the nature of modern money creation and extinguishment. Major changes in the economy's money flows and in its money supply are heavily dependent on certain strategic forces, such as the Treasury's surplus or deficit, capital formation by private business, consumer expenditures for durable goods and housing, and international trade. These forces in turn have many aspects and the money authority must respond to them as best it can by influencing the terms and conditions on which new money, through credit extension, is made available to borrowers.

Government surplus, for example, serves as an aid to restrictive monetary policy, since it may be used to offset or temper expansive monetary factors. Government deficit, on the other hand, works to handicap restrictive policy. In fact, unless savings of the public are available in adequate amounts for the purchase of Government securities, Government deficit tends to bring about monetary expansion, whether desired or not, and the known weapons of monetary policy, at least those that may be applied under such conditions, are only capable of offsetting in part the inflationary effects.

The volume of business capital formation is affected by current expectations of future business activity, and investment plans are subject to commitment, alteration, or withdrawal as the economic outlook changes, despite the wishes or the instruments of the monetary policy makers. Consumer durable goods demands stem from wants that are now deeply imbedded in the American standard of life, and the matter of interest rates in the nation's money market has less effect on the strength of these demands than the monetary authorities might desire. The state of international trade is a reflection of world political tensions as well as the product of reciprocal needs between nations for goods and services, and monetary policy can do little but absorb its current impact.

In portraying public monetary policy in its contemporary setting as an involved compound of many elements, it is not my purpose to despair over its role or its prospects. Rather the objective is merely to stress that to have constructive policy by the public monetary authorities under postwar conditions requires a comprehension and understanding on their part that is indeed profound. It is also reasonably obvious, I think, that a good dose of flexibility in weapon and action is a further essential element of policy.

In this kind of monetary situation, the adequacy and adaptability of policy instruments is a very critical issue. It need be no matter of surprise that contemporary monetary controversy takes so much the form of "there is not enough available power" and "monetary policy is not making use of the power it has." Each of the present instruments of monetary policy, and some of them are relatively new as monetary history goes, was evolved to meet some particular type of monetary problem. Once firmly established in the armory of policy weapons, these instruments have been retained for future use. But monetary conditions change and policy weapons lose their applicability and effectiveness, or they reach the limit of use permitted by statute or technical circumstances.

We may illustrate some important changes since prewar times by reference to the so-called traditional instruments of central bank monetary policy. Because of large holdings of short-term Government securities, acquired through the processes of war finance, commercial banks no longer have extensive need for borrowing funds from the Federal Reserve Banks. Reserve Bank discount rates, as a result, do not have the same effects on the cost of credit in the money markets as they did, say in the 'twenties.

Again, because of the largest outstanding public debt in our history and the wide distribution of its ownership, open market operations today are more devoted to assuring stable market values on this debt than as a companion weapon to discount rates in regulating the cost and supply of credit funds, and thereby of changes in the money supply. This fact is much deplored by some, but the very size of the public debt makes confidence in its market value a keystone of stable financial organization. Postwar financial experience has shown a residual buyer in the market to be an important reinforcement of needed confidence.

Lastly, power to vary reserve requirements of Federal Reserve Banks, while a very effective weapon, has been unavailable during most of the postwar period because of practical exhaustion of statutory discretion on the upward side. Additional power was belatedly granted by

Congress to the monetary authorities only last summer, and, as you know, use has already been made of it--with some constructive results it may be added.

During the postwar period, the monetary problem in this country as well as other countries may be described in a word as "redundancy of money and other liquid assets." This redundancy of liquid assets has largely represented expansion of public debt to finance war. Correction of redundancy, therefore, has been contingent mainly on retirement of Government debt. Confronted with this situation, monetary policy has been obliged to recognize the facts, make the most of whatever weapons could be used--without disrupting confidence in Government credit--to restrain additional monetary expansion from private credit demands, and urge the immediate primacy of fiscal surpluses in restraining inevitable inflationary pressures. To speak more bluntly, monetary policy has had to take a secondary position in coping with the economy's financial problems in the wake of war.

This position of monetary policy has not been viewed with complete satisfaction by some nostalgic observers, impatient to see free enterprise economy restored promptly to its prewar pattern of functioning. These individuals apparently believe that the record would have been better if monetary policy shortly or even later after hostilities had sent market interest rates in "hot," or at least "orderly," pursuit of expected profit rates and the marginal propensity to consume--until some natural, in any case, noninflationary equilibrium point were found between the three.

Whatever merits this subtle economic theory may have, its application in a wholly abnormal situation has appealed to the monetary authorities as a highly risky experiment. Considering the unparalled public debt of 250 billion dollars which monetary policy has had to assume some part in managing, there is assuredly something to be said in favor of the position they have taken, namely, that postwar inflationary forces have not been amenable to treatment by traditional policy prescription.

While monetary policy may be said to have groped its way in this recent period of transition from war, it cannot be accused of dormancy. Monetary policy, within statutory limitations, has vigorously used its relatively modern accessories--control over stock market credit and control over consumer instalment credit. It has used moderately its influence over short-term interest rates. Its authority to conduct open market operations resulted on at least one occasion in a rude shock to long-term investors and it has prevented disruptive financial conditions from developing as a result of widely fluctuating Government security prices and shaken confidence in public credit. It has applied with greater aggressiveness than the banking community has desired available statutory authority to regulate member bank reserve requirements. Finally, it has used its informational resources to inform the Congress and the public of the nature of the postwar monetary problem, and to urge both the first importance of a strong fiscal policy and the need for a basic strengthening of available monetary powers. These measures have admittedly not been enough to prevent a considerable postwar inflation, but it may be that history will accord them a more than incidental role as restraining elements in the inflation process taken as a whole.

Our postwar monetary problem continues to be a critical public issue. The supply of money and other liquid assets is still disproportionately large in relation to current output and incomes, even at present price levels, and in relation also to foreseeable economic needs. This supply has the potential, moreover, of further vast expansion. Restoration of an effective authority for its control is essential if the widely accepted objective of economic stability at the highest sustainable levels of production and employment is ever to become, for the present generation, an attainable goal.