

Perspective On Monetary Policy

Remarks by

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When I was first invited to take on this assignment, I was asked to "just tell them what monetary policy is all about." More than 30 years ago, when I worked at the Federal Reserve Bank of Richmond, I could have done this with rather more self-assurance than I feel tonight.

In taking a "tell it like it is" approach, I am reminded of one of former Chairman Martin's stories about himself. It seems that when he was at the New York Stock Exchange back in the 1940's he exercised regularly at a well-known nearby gymnasium run by a man named "Gunboat" Smith. One day "Gunboat" was bemoaning the fact that one of his preliminary fighters in a charity fight that evening at Madison Square Garden had had to drop out and he asked Mr. Martin if he would substitute. The Chairman thought about it awhile and, as he puts it, decided that "after all, life was just a series of experiences." So he accepted the engagement. It seems, however, that word got around the street and that night a crowd from the Exchange showed up at the fight. Mr. Martin relates that he managed to get through three rounds, although when he looked over at the other man and saw him glowering all he could do was smile back because he wasn't mad at anyone! At any rate, at the end of the fight the referee lifted Mr. Martin's arm too, called it a draw, and the men from the Exchange climbed into the ring and carried our former chairman off on their shoulders.

This story typifies not only Mr. Martin's attitude toward life but illustrates why he was so well suited to manage monetary policy. His ability to treat each experience as it came along stood him in good stead. For if I am to "tell it like it is," I would have to

say that monetary policy is a series of individual experiences that often bear little resemblance to each other or to the textbook descriptions. This does not mean that monetary policy is simply pragmatic but rather that each of the experiences in the monetary area represents something different in terms of problems and policies. For example, right now we are confronted with a slowing economy, an illiquid banking system, strong capital demands and business spending, continued inflationary expectations and upward cost-price pressures. And all these developments are taking place against the background of an Administration dedicated to braking inflation without a recession. Small wonder so many people would like to substitute a fixed rule for discretionary action with respect to monetary policy.

Fact and Fancy in the Policy Process

And just how far we sometimes are from the textbook descriptions is easily illustrated. In Chandler's excellent Money and Banking text—and the same is true of the present edition of our own Federal Reserve *Purposes and Functions*—there is no mention, in the discussion of the instruments of credit policy, of the Regulation Q ceilings on interest rates which were an integral—some think too much so—part of the Federal Reserve restraint policies of 1968-69. Even the rather pleasant picture of considered coordination, in some stuffy sanctum, of the use of monetary policy instruments as described in the textbooks sometimes may be somewhat at variance with the real world. Take the case of the decrease in the discount rate in August 1968. When I was at the Federal Reserve Bank of Richmond, I lectured very learnedly, or so I thought, to similar seminars year

after year about the discount rate as a tool of monetary policy. But this 1968 decrease in the discount rate, first proposed by the Directors of the Federal Reserve of Minneapolis, is illustrative of the mixture of fact and fancy that we often encounter regarding the instruments of credit policy.

Looking back, in July of 1968 questions were being raised within System counsels whether, in light of the passage of the tax surcharge, monetary policy should not flex with the change in fiscal policy and become somewhat easier. The staffs at the Board and the Reserve Banks—like economists generally—were talking about impending recession and some perhaps even used the term “overkill.” Members of the Board also were talking about the desirability of flexing, and some were expressing a sympathetic view toward a reduction in the discount rate of as much as one-half per cent.

The meeting of the Board of Directors of the Federal Reserve Bank of Minneapolis took place in Rapid City, South Dakota on August 15, 1968. Once a year the Minneapolis Directors meet outside of Minneapolis as part of their attempt to familiarize themselves with the entire Ninth District. I was an invited guest at this particular meeting. At breakfast that morning in the hotel we were made honorary citizens of Rapid City by the Mayor, who then rushed off to lead the Annual Rodeo parade which passed just outside the windows of the same hotel room where the Board of Directors was meeting. Against the background of bands playing, and with the feeling of being almost part of the parade, the arguments pro and con as to a discount rate change were presented. The principal argument for a change of one-half per cent, presented by President Gatusha, was the prospective impact of the surcharge and the general outlook for fiscal restraint. The principal argument against this change was the lack of tangible evidence of a slowdown and some skepticism as to the actual achievement of fiscal restraint. After debate—interrupted at one point by the discovery that a newspaperman had strayed into our midst to take a picture—the Directors compromised on a one-quarter per cent change and forwarded this action to the Board in Washington for approval.

The “Politicization” of Monetary Policy

Obviously this was a highly unusual meeting but the story illustrates two points about the nature of monetary policy. First, it illustrates the sort of differing experience in real life that frequently confronts monetary policy, not only in terms of economic considerations but also with respect to the institutional setting for decision-making. Second, it also

illustrates what I would call the “politicization of monetary policy”—a process that I have witnessed at firsthand over the last three decades. By “politicization” I mean in the broader sense of involvement in the crucial issues of the day—just as you and your fellow faculty colleagues have undergone “politicization”—as well as in the narrower sense of necessarily meshing with governmental policy generally. I could further illustrate this with another experience, namely, the change in the discount rate in December 1965. I do not need to elaborate on that episode, which involved eventual confrontation with the President, because the FOMC minutes covering that period have been released and are part of the public record. Again, acting in part out of a skepticism as to the adequacy, present and prospective, of fiscal restraint—a skepticism that in retrospect proved all too well founded—monetary policy began to move toward restraint, culminating in the so-called crunch in financial markets in August 1966. But, as the record shows, that first move was deliberately delayed in an attempt at coordination within the prevailing political milieu.

Thus, as I view the role of monetary policy it has been called upon, in an increasingly political environment, to bear much too much of the burden of stabilization policies generally—a burden that has led to inequities in impact on sections and sectors of the economy, such as the housing industry. This does not absolve us in the Federal Reserve of our responsibility to do what we can in the interest of sustainable economic growth but underscores the need to do so with a recognition of the limitations on our own role. One of the principal gaps that I encounter in descriptions of monetary policy is the inadequate recognition of its practical relationship to fiscal policy. The role of monetary policy must be viewed in the context of the appropriate mix of monetary and fiscal policy and all too often this has not been done, either by academicians or practitioners. We need to rely less on monetary policy and to find ways to innovate in the use of fiscal policy.

Again, as I view the role of monetary policy, too often we have ignored, or insufficiently examined, the role of interest rate ceilings in policy and both the short- and long-run implications of using ceilings as the cutting edge of monetary policy. The story of monetary policy in 1969 is a story of the how and why of interest rate ceilings and of bank efforts to find other sources of funds to substitute for the massive disintermediation which, combined with the strength of credit demands, brought their liquidity positions to record lows. Time and again in meet-

ings in Europe of central bank governors of leading Western European countries I was taken to task for the effects our Regulation Q ceilings were having on supplies and rates of Eurodollars—at the same time they were praising our general restraint policy without recognizing fully that the rate ceilings were serving to make effective that restraint.

The Monetary Aggregates as Policy Guides

A related area in any overview of monetary policy and its role is the role of monetary aggregates. As is evident in the public record of monetary policy actions, increased attention has been given in formulating monetary policy to variations in the monetary aggregates. Just as we are all Keynesians in the sense of using Keynes' analytical apparatus apart from his policy applications so, too, I suppose we are all more or less Friedmanesque in looking at the monetary aggregates while rejecting his single-sided applications.

When I was at the Richmond Federal Reserve Bank Eddie Wayne¹ sometimes accused me—unjustly of course—of using the phrase “as has been so well stated before” to refer back to a memorandum or speech of my own. But not to disappoint those who took him seriously, I will refer you back to a talk which I made at Dartmouth last October dealing with the monetarists' position. In brief, my own position—which you will be surprised to learn has not changed since last October—is that I do not accept the Friedman thesis that money (or monetary policy) alone matters and that we can prevent undesirable fluctuations in GNP simply by keeping the money supply—however defined—growing at a relatively stable rate. I concede—and in fact our own FRB-MIT model and related studies show—that monetary policy, despite significant lags in effects, does appear to be an important, effective component of our economic stabilization programs. But I see no reason to swallow whole the simple causal relationship posited by the Friedmanites. And I think it is important, even vital, to know how the conversion of money into demands takes place and with what sectoral effects—rather than to ignore the conversion process.

More important, I see no reason—and our FRB-MIT model clearly supports this view—to dismiss fiscal policy as an important tool of stabilization policy. The monetarists' dismissal of fiscal policy is, I think, not justified. In fact, as I have indicated tonight, my own approach would be the contrary—namely to innovate *more* with fiscal policy and

rely *less* on monetary policy. As to the kinds of innovations I have in mind, without being too specific, I think they fall in two categories: one, standby powers granted to the President to make temporary changes; two, some easier, and possibly more automatic, Congressional procedures to make tax changes in response to Administration requests related to cyclical developments.

And from my own point of view as a policymaker, I do not think we can simply rise above definitional problems in trying to use money supply as a target of monetary policy. Not only do the monetarists have to make up their minds as to which money supply variable should guide us: M_1 , the money supply narrowly defined as currency and bank deposits; M_2 , adding time deposits; or with other adjustments such as taking account of large denomination CD's. Policymakers also need to know what variable they are talking about even in giving greater, without exclusive, emphasis to the monetary aggregates. The Council of Economic Advisers in their recent annual economic report make a plea for monetary policy to concentrate more on the steadiness of the main monetary aggregates such as the supply of money, of money plus time deposits, and of total bank credit. Then they add: “This still leaves questions of policy to be resolved when these aggregates are tending to move in different directions, or at different rates of change, as they often do.” When I came across this caveat, I immediately thought of a meeting of the FOMC—not too long ago—in which the Manager of the System Open Market Account, trying to respond to some members' admonitions to watch the monetary aggregates more closely, pointed out that one measure was rising rapidly, the other declining. He asked, “How do I weigh them?” And quick as a flash the answer came back, “Equally!”

People, Events, and the Policy Process

Finally, and perhaps reflecting the bias of my own long career in the System, I find it difficult to put monetary policy in perspective without reference to people and events. For certainly monetary policy has over the years also reflected leadership within the System as well as the circumstances surrounding it. In the formative years of the System, through the 1920's, it was Benjamin Strong who left his imprint on the System and its policies. In the period of monetary reconstruction following World War I, he was mainly responsible for the System coming of age and assuming its rightful place in the panoply of central banks around the world. Then, during the recession years of the 1930's, and throughout the war and postwar years of the 1940's, Marriner

¹EDITOR'S NOTE: Edward A. Wayne was President of the Federal Reserve Bank of Richmond from March 1961 to April 1968.

Eccles did much to change both the locus of power within the System and the kinds of monetary policies adopted by the System. And, for my part, without any reflection on such stalwarts as Allan Sproul, Karl Bopp, or my Richmond associates, I would characterize the 1950's and 1960's as the "Martin Era" both in terms of the institutional and monetary policy facets of the System.

Taking first an inward look at the institutional aspects, what hath the Martin Era wrought? As I have seen it over the years—and my own service with the Fed precedes that of our former Chairman by more than a decade—several things stand out. First, I do not think it is simply trite or a cliché to say that Chairman Martin in a very real way made the word "System" in Federal Reserve System a meaningful one. I have observed his contribution in this respect at firsthand, a contribution not only in terms of the role of the Presidents and Directors of the Federal Reserve Banks, but also with regard to the character and meetings of the Federal Open Market Committee. I well remember driving back from an FOMC meeting to Richmond one day with then President Hugh Leach²—a man not given to excessive words—who spoke at some length about the differences that Chairman Martin had brought about in making it possible for the Federal Reserve Presidents to contribute in the formulation of policy. Among other things, he said that it was a great contrast from prior times, when their views had remained largely unexpressed, to the present practice where each President freely and regularly presents his own views. In the earlier days the Federal Open Market Committee met only four times a year while in between there were bi-weekly meetings of an Executive Committee. I attended those meetings, too, with Hugh Leach because at that time the state of transportation dictated that the two Reserve Bank Presidents, joining the Chairman of the Federal Reserve Board and two other Governors in making up the Executive Committee, come from New York and Richmond. Be that as it may, Chairman Martin brought about the present practice of regular meetings of the Federal Open Market Committee every three or four weeks with all the Presidents attending and presenting their views. (Unless a vote is taken I never can remember which Presidents are on or off the statutory Committee.)

Recently, a newspaperman asked me whether this change was good or bad. My answer was that it is a good thing and has served to strengthen the System. Specifically, for example—and as this group

knows from my remarks I am no monetarist—at each of the meetings now Darryl Francis, President of the Federal Reserve Bank of St. Louis, gives a full presentation of a monetarist's position on current policy and, while he has few if any adherents, I think it is a healthy thing to have other views such as his expressed. For I do not think all wisdom resides in the Board. On this same score, the Reserve Bank Presidents, who are closest to major industries or segments of the economy, can bring to bear an intelligence system—sort of an early warning radar system—of impending developments that relate to policy. In the same way, I think Chairman Martin revitalized the Reserve Banks' Directorships and by his efforts—and he frequently indicated to us that he spent more than a third of his time on the composition of the Reserve Banks' Boards of Directors and particularly their Board Chairmen—brought forward men who could make a contribution to the effective functioning of the Federal Reserve as a System.

The Board of Governors in the Martin Era

Second, on the institutional side, over and above the System's external relationships, Chairman Martin made a real contribution to the Board's internal arrangements, making it more of a working whole with respect to both the staff and the members of the Board. At the time Chairman Martin came in, the staff was clearly dominated by one or two and while I have always had every respect for their intellects, which is why they dominated, we now have in my judgment a much better balanced arrangement with the staff forming a more cohesive force in assisting the entire Board. Similarly, with respect to the Board itself, by contrast with the pre-Martin days when Board members carved up little bailiwicks of their own, we had under Martin daily Board meetings and all decisions have been basically the business of every Board member.

Third, on the institutional side of things, Chairman Martin was zealous to preserve the System's independence, but independence in the proper sense of the term, namely within, not from, the Government. His efforts in bringing about the Treasury-Federal Reserve Accord obviously come to mind. But as all of you know, the popular notion in the press that the Board sits in splendid isolation from the rest of Government simply is not true. In serving five Presidents, Chairman Martin reflected a constant awareness of the political realities and of the System's image. At firsthand, I observed his influence on at least two of those Presidents, an influence that was earned by his judgment and in-

²EDITOR'S NOTE: Hugh Leach was President of the Federal Reserve Bank of Richmond from March 1936 to March 1961.

tegrity. But while he advised and counseled with the Presidents and Secretaries of the Treasury, he never allowed the System to become simply another part of the Executive Branch of Government, either by personally attending Cabinet meetings or otherwise committing the Board in his consultations.

Turning to the monetary policy aspects of the Martin Era, my own judgment as to the record is that it has been a remarkable one, particularly in terms of the timing and direction of monetary policy. As far as Chairman Martin's role is concerned, I think this reflected both the extraordinary sources of information which he enjoyed at all levels here and abroad plus his own exceptional intuition and judgment. He has a great sense of humor and an inquiring mind and always asked questions of his contacts wherever they might be. I am reminded here of the recent experience he had on coming out of his apartment on 5th Avenue in New York to find a crowd of marchers moving down the street in the same direction he was going and carrying placards labeled "Ho Chi Minh" and shouting "Ho Chi Minh." The Chairman fell in step with one of the participants and asked, "Are you for him or against him?" Receiving no response he continued walking with the group until he reached his destination.

Again, recently one of the journalists with a national weekly magazine asked me: "In view of your judgment about the success of Martin's policies how do you defend against the charge of errors, including the error in 1968?" My answer is that of course there were errors—which Chairman Martin too has cheerfully conceded—but, as I have already indicated, I believe they reflected for the most part the inadequacies of fiscal policy and overreliance on monetary policy. We have simply tried to do too much with monetary policy.

As to 1968, specifically, I think that Chairman Martin's, and the System's, errors on the side of ease reflected two things: *first*, an overestimate by our own staff—along with economists everywhere else in Washington or wherever—of the immediacy and extent of the impact of the surcharge and, *second*, Chairman Martin's own feeling that having been in the forefront of the battle to get the surcharge in place (and I credit his efforts along with Secretary Fowler's dogged determination with winning that battle) the System would be in a better posture, its image would be better, if it evidenced some flexibility and meshed with fiscal policy. Again this illustrates the "politicization" I referred to earlier.

But the chief characteristic of the Martin Era from the policy standpoint was that the policy pro-

cess was not a one-man operation. His leadership reflected his personality and integrity. He constantly led by indirection, subtly and in a low key way, never pressing his own views. And I would be remiss if, in this connection, I failed to mention that he was a superb Chairman, *qua* Chairman; and this brought a continuity and coherence to policy decisions. His technique in chairing was really remarkable—for example, at the conclusion of a meeting of the FOMC in which everyone had been all over the lot, Chairman Martin would simply smile and say, "Well, Gentlemen, this is an easy meeting—we are all really not very far apart" and so on. And suddenly one found a unanimous or near-unanimous decision had emerged.

The Economy at the End of the Martin Era

As to where we find ourselves domestically at the end of the Martin Era, I know Chairman Martin was not happy with his legacy. At the farewell dinner which the President had in his honor at the White House a few weeks ago, Chairman Martin spoke with considerable feeling as to how he wished he could leave saying that inflation was under control but in his view it was not—we still had too much of it around us and in expectations.

The immediate Martin legacy on the international side of things is a much brighter picture, at least with respect to the international monetary system. Here Chairman Martin's efforts over the years led to the developments culminating in 1969—developments which were brought to fruition this past year due in no small part to Undersecretary of the Treasury Voleker's negotiating skill. First of all, I regard it as significant progress for the international monetary system that we now have in being, and in prospect, substantial amounts of Special Drawing Rights that should enable a better functioning of the adjustment process and serve generally to strengthen the system. Here Chairman Martin's wise counsel was always available to Secretary Fowler—he was at the Secretary's right hand in the meetings of the Group of Ten Finance Ministers and Central Bank Governors—in London, in Stockholm, in Rio and elsewhere, and supported the Treasury's efforts throughout.

Second, I give Chairman Martin much credit for the establishment of the two-tier gold system which has demonstrated its durability, despite its critics who looked for an early demise, and which has now been reinforced and generalized by the agreement with regard to South African gold production. The Chairman called and chaired the meeting in Washington in March 1968 and without his skill in chair-

ing that group I am not sure we would have seen the emergence of the two-tier system.

Last, but not least, we have had a significant realignment of exchange rates, again serving to strengthen the functioning of the international payments system. Here, too, Chairman Martin was in the forefront of the efforts to bring about the much needed realignment, especially in the case of the West German mark. I am not entirely sure how to evaluate his contribution because at the famous Bonn Conference in November 1968 when the central bankers were asked out of the meeting we ended up playing ping-pong at two in the morning! But his friendship and close contact with President Blessing of the Bundesbank surely did not impede the final resolution to revalue.

As I conclude these comments about Chairman Martin's leadership, I will only add that I do not know what Bill Martin will be doing now that he has left the System, although he has mentioned going on a couple of Boards of Directors. But I am reminded of the story about one of his experiences when he was first in the service, in training during World War II. As you know he left his job as head of the New York Stock Exchange and enlisted as a private. The other trainees were not quite sure how to treat him; some may have resented him. But, as I understand it, one day when he was slated for K.P. duty he took over for another trainee who was ill, and yet another who had cut his hand, and ended up with about eighteen hours straight of K.P. duty. The next day one of the trainees asked him to hitchhike into Columbia with him and Bill agreed. As they stood there thumbing a ride the other trainee turned to Bill Martin and said, "You know, you're not such a bad fellow after all. When you get out of the service I don't think you'll really have any trouble getting a job at Bickfords."

The Current Economic and Financial Milieu

I have dwelled at some length on the personal side of the System monetary policy equation. But the other side—the circumstances surrounding monetary policy—also cannot be omitted if one is to obtain a practical perspective on the role of monetary policy. And here, perhaps, the current setting well illustrates the problems and perplexities that confront monetary policy and monetary policymakers as we enter a period of new leadership under Chairman Burns.

As we look at the financial picture at the moment, we see financial markets still under pressure as evidenced by relatively high interest rates and by a general squeeze on liquidity positions of key financial institutions, particularly bank and nonbank

thrift institutions. Despite some slight drop in market yields, rates payable under Regulation Q limits on time and savings deposits at banks are still relatively unattractive to savers. The recent action by the Board raising the Regulation Q ceilings may help to stem the recent heavy shifting out of large negotiable certificates of deposit. However, with their liquidity squeezed, with deposit outflows sizable, and nondeposit sources limited, bank lending terms and conditions are still relatively stringent. These tight credit conditions have been accompanied in the latter part of 1969 and early 1970 by a decline in stock prices. And thus far in 1970, liquidity positions have remained under pressure although interest rates have declined somewhat, particularly in the Treasury bill area.

The credit tightness which I have described, in combination with some degree of fiscal restraint, resulted in little economic growth in the fourth quarter of 1969 and prospects for little growth in the period immediately ahead. Virtually every large sector of demand has shown declining strength. Almost everywhere one looks, whether toward industrial production, or retail sales—particularly new car sales—or outlays by state and local governments, or residential construction, or defense spending by the Federal Government, the picture is one of an economy that is slowing down. With respect to monetary policy, the impact has been most marked in reduced residential construction activity and curtailment of state and local government spending. But there has also been weakness in consumer markets, especially in durables, which is clearly a significant factor in the slower growth of demand and activity. Perhaps the only exception to this evidence of slowing has been business fixed investment, which has continued on an expansive path despite the tight financial markets.

Although economic activity has slackened and the labor market appears less taut, prices have continued to increase at a rapid rate. Over the last three months of the year, wholesale and consumer prices rose at annual rates of about 5 and 6 per cent, respectively. While current weaker demand may moderate price increases somewhat over coming months, cost pressures—particularly in view of collective bargaining ahead—seem likely to persist. On the international front, while the international monetary system seems stronger, little progress has been made toward a sustainable equilibrium in our balance of payments.

The Current Policy Problem

The tendencies in the economy evident in late 1969 and early 1970, therefore, suggest two principal

problems facing public policy, including monetary policy, over the balance of the year. First, aggregate demands for goods and services appear to be abating, and output is declining; thus, one problem is to avert a cumulative decline in demands and output that would assume the characteristics of a significant recession. Second, price increases have been continuing at an unsatisfactory rate. Thus another problem is to bring the rate of price increase within acceptable bounds so as to avoid distortions in the domestic economy and a consequent inequitable reduction in the real incomes of those whose money incomes adjust only sluggishly, if at all, to price increases.

Under the circumstances, an effective strategy for monetary policy involves the delicate task of attempting to keep the economic readjustment now in process from cumulating while at the same time ensuring that reasonable price stability is restored so as to lay the basis for sustainable long-term growth. Such a desirable outcome may not be completely within the control of monetary, or other public, policies during the current year. A certain amount of momentum has been built into economic developments as a result of past public policies and of business and labor wage-price policies. Moreover, the reactions of consumers and businessmen are not completely predictable. To a degree their behavior is independent of monetary policy, depending on such developments as the appeal of new products or technological innovations. But also to the degree that their actions do depend on money and credit conditions, their response to monetary policy can and has varied from period to period, depending on such elements as profit prospects and inflationary expectations.

While 1970 is filled with uncertainties, it is possible that it may prove to be a watershed year in the

fight against inflation. This will depend in part on restraint on the part of labor and management with respect to wage and price policies. It will also depend on prudent restraint in public policies, both fiscal and monetary. In 1969, the principal aim of policy was to cool down demands for goods and services, but in 1970 demand conditions may well prove to be such that the earlier restraint can gradually be lessened. On the other hand, the need to encourage sustainable long-run economic growth, requiring as it does an abatement of inflationary expectations and an environment of overall price stability, suggests that any major shift in monetary policy could be counterproductive. While the broad outlines of a potential monetary approach could be sketched this early in the year, as we are trying to do within the necessarily confidential confines of our own policy group, any approach we sketch can only be tentative. The timing and magnitude of monetary moves will have to be, as I suggested in opening these remarks tonight, dependent on events as they unfold.

As I look ahead at the possible monetary policy course, and the role of monetary policy in the period ahead, I am reminded of the colloquy in Chairman Burns' testimony to the House Banking and Currency Committee just two weeks ago. Mr. Hanna of the Committee addressed the following question to Chairman Burns: "Now that the President has submitted his budget, the tax bill has passed, what do you say about the prospects of changing your policies?" To which Chairman Burns with his customary dry wit replied, "Monetary policy is something that is constantly under review by the Federal Reserve Board, and I assure you the coming week will be no exception." I assure you that the same statement can be made about monetary policy and its role for a considerably longer period ahead.