For release upon delivery
Thursday, February 20, 1975
4:00 p.m., E.S.T.

MONETARY POLICY

AS A "SOCIAL" SCIENCE

Remarks by

Robert C. Holland, Member

Board of Governors of the Federal Reserve System

in the

Distinguished Lecture Series

The Ohio State University

Columbus, Ohio
February 20, 1975

Our current economic dilemma has focussed widespread and searching attention on economic stabilization policies--what they are, what they should have been, and what they ought to be.

This kind of intensive examination of the subject is altogether right and proper. I appreciate the chance to return to the comparatively reflective atmosphere of the campus to discuss with you today that particular economic stabilization policy about which I know most, namely, monetary policy. I firmly believe that exchanges of views between scholars and practitioners can sharpen the insights of both.

Monetary policy falls into that category of knowledge labeled "social science." When I was a student on campus, professors of the physical sciences were self-assured enough to use the term, "social science," as an occasionally satirical expression, being quick to point out its vagueness, imprecision, and lack of empirically validated theories. The basic reason for such imperfections, of course, is that the social sciences deal with people, and people simply are not as precise, as predictable, or as rational as machines.

The intervening years have done a good deal to narrow this particular contrast in our branches of learning. Social sciences in general, and economics in particular, have striven for more quantitative formulation and validation of ideas. The physical sciences, meanwhile, have found that many of what were thought to be fixed parameters were but human conventions, soon to be overturned by the onrush of new findings. All branches of science are encompassed in an observation by the late Dr. Jacob Bronowski, the renowned British scientist who created the remarkable television series, "The Ascent of Man":

> "Science is a very human form of knowledge. Every judgment of science stands on the edge of error and is personal. There cannot be a decent science without humanity."

Those words are both humbling and comforting for a person who is trying to apply scientific theory to life.

Monetary theory has made great strides in the last three decades. Much of that advance has been based on abstractions, statistical and theoretical. Implicit in the equations and models that populate current monetary literature is a kind of idealization of the people involved --both the people who make policy and the people who are affected by it. Careful econometric analysis of past experience has done much to improve our ability to perceive underlying tendencies in aggregate economic behavior, but it has also tended to play down the variability of individual instances around those tendencies.

Those variations are people-caused. They are inevitable in the world in which we live. If they are not recognized and taken account of, more than theories will be disrupted.

I would like to call your attention today to three particular ways in which human nature and human variability condition monetary policy. The first involves the varying effects that a given monetary policy can produce. Those effects are partly a product of people's attitudes, and such attitudes are not the same from person to person or from one episode to the next.

History is dotted with dramatic examples of great shifts in people's economic reactions, especially around the outbreak or cessation of wars. Less sweeping changes, however, take place continually. They are very much conditioned by changing public moods--of confidence, of uncertainty, or of caution.

For example, last fall, the people of this country turned unusually cautious. Businesses and individuals alike cut back on their spending sharply. The dimensions of that cutback outstripped anything foreseen by the stable of the nation's greatest economists gathered at the Summit Conference on Inflation last September.

From a monetary point of view, that spending cutback translated into a reduced transactions demand for money--especially demand deposits--but an enhanced precautionary demand for liquidity, including repayment of short-term debts and accumulation of interest-bearing deposits. Monetary policy has had to adapt to these changes, with no certain foreknowledge of whether or when they would take place, how big they would prove to be, or how long they would last.

In the face of these developments, the Federal Reserve has taken a number of easing steps, not only in its open market operations, but also with its other instruments--discount rates and reserve requirements--which sometimes touch people's attitudes more directly. Because we found commercial banks liquidity-conscious in this new atmosphere, we pumped out nonborrowed reserves at a rapid rate, enough to enable member banks to repay virtually all their indebtedness at the discount windows. That has been a kind of stock-adjustment process for banks that has extended almost up to today. Now we have the banking system better positioned to finance the transition from recession to recovery; and if all goes well, such financing will not bulge so large as to fuel a resurgence of inflation.

A second very human dimension of monetary policy consists of the people who make it. I believe that, on average over the decades, key Federal Reserve officials have been of as fine a quality as one could find in any major branch of public service. But at his best, man has his weaknesses. There can be days when one or another of us seated around that Board table can be distracted, short-sighted, or incomplete in his analysis, and our decision can suffer accordingly. Occasionally, we can be so immersed in the spirit of the times that we can be tardy in recognizing a new trend that is emerging.

As an extreme example, let me point to the woeful monetary policy of the years 1929-1933. Federal Reserve policy of that era has been maligned by monetarists and Keynesians alike, with the benefit of hindsight. But one ought to remember that such monetary policy was in accord with the theories and policies then being espoused by most of the leading economists of that day.

I could also pick one of our biggest mistakes of recent years, in 1968. When a long-delayed one-year tax increase was passed in that summer, I believe the majority of economic and financial experts felt that a somewhat more accommodative monetary policy was called for. To be sure, there was a minority, including persons now inside the Federal Reserve as well as in academia, who perceived the situation more accurately. But the Federal Reserve, sharing the consensus view, provided enough reserves to support a generous monetary expansion for some months before recognizing the excessive vigor of underlying demands and the need to move toward monetary restraint.

I have no doubt that other years can be shown to contain monetary errors as well. As long as God keeps making mankind as He does, these human errors in policy-making will occur. Our recourse is to try to minimize them, to correct them quickly, to learn from them.

A third human factor conditioning monetary policy is the basic set of values of our citizenry. To be sure, the Federal Reserve is insulated from short-run pressures to change its policy by a variety of protective arrangements, some provided deliberately by law and others resulting from the very indirect effects of its operations. This protection permits monetary policy to pursue even a course with highly unpopular side effects for some period of time. Often it can be essential for the Federal Reserve to do just that, for some of the good effects of a policy--such as slowing down price increases--can materialize only with considerable lags, while the intervening adjustment period can bring such unpopular consequences as high interest rates and curtailed availability of loans.

Over the longer run, however, I think it is crucial for the public to come to accept the basic objectives at which a particular monetary policy is aimed, and to develop some appreciation that policy is working to achieve those objectives. To state the converse, I doubt that the Federal Reserve could or would pursue a very unpopular set of fundamental objectives year after year.

If there are changes in public attitudes toward the relative merits of various basic economic objectives, then the feasible scope for monetary policy is shifted correspondingly. For example, it seems clear to me that public concern over inflation has mounted within the last two years, both absolutely and relative to the importance attached to other economic objectives such as full employment. Consequently, I believe it has been both possible and proper for monetary policy to have placed greater emphasis on fighting inflation during much of this interval. I hope and expect that the longer-run benefits of that policy emphasis will accrue to the American people for years to come. Now, of course, recessionary forces have developed in the economy that are being resisted by appropriately eased monetary conditions, but it will be important to carry through this latter task in ways that do not create a new wave of inflation.

This view of the scope for monetary policy makes it incumbent upon the central bank to distinguish what it thinks is "right" from what it thinks is simply "tolerable." It also makes it important for the central bank to have a good system for gathering nationwide information on emerging economic developments and basic attitudinal changes. Fortunately, the regional design of the Federal Reserve System lends itself well to this purpose. A premium is also placed on improving the public's grasp of the fundamental economic issues facing the country. The great state universities are in a unique position to further this objective, and I applaud the innovative programs in this field being undertaken here at Ohio State and at some of your sister institutions. We in the Federal Reserve have also been trying to commit a respectable fraction of our people's time to the cause of economic education.

Ultimately, I believe, the American public will tolerate only those monetary policies whose broad results are regarded as compatible with the nation's basic economic goals. In a sense, this means that central banking is, to steal a phrase, "the art of the possible." A good many monetarists may scowl at what I have just said, but I think Thomas Jefferson would smile.

This afternoon I have concentrated my remarks on what might be called the human side of central banking. This is, of course, only a part of the picture. It is not a perspective which I regard as antagonistic to highly quantified analysis of past and projected monetary behavior. Such analysis can distill average economic tendencies in a more disciplined way than any other approach economists have yet developed. Policy-makers, however, need to take account of both average tendencies or relationships and the human deviations therefrom. Distinguishing the one from the other, and adapting policy in appropriate ways to each, is part of what makes central banking an art as well as a science.

This is the spirit in which I believe monetary policy ought to be approached, whether by a policy-maker or by an academic analyst. In this spirit, I hope and expect that we can all contribute to better policy tomorrow.