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"Sputnik and Monetary Policy"

Six months have gone by since mankind entered the space age - if I may date the beginning of that age from the successful Russian launching of an earth satellite. During this period in which human beings have put five artificial satellites into orbit around our planet, we have all witnessed, and participated in, a surge of public interest in various aspects of outer space.

It is instructive to look back to October 1957 and to recall the nature of the reactions in the United States to Sputnik I. Suddenly everyone began to look skyward, endeavoring to see the strange new object. There was a spate of newspaper articles and much conversation about the scientific properties of an orbiting satellite. Strange technical terms like "re-entry problem" and "final stage engine" came to acquire familiarity, even in the centermost part of the country, my home town, Broken Bow, Nebraska.

In addition to the reactions of awe and curiosity, there were two other types of reaction of which we ought to take note. In some cases there was near-panic based upon fear of the unknown and of newly-demonstrated Russian prowess. In this atmosphere, a story spread to the effect that the Russians were about to send an object to the moon in order to imprint upon it a red star in celebration of the 40th anniversary of the Russian Revolution.

The other type of reaction to Sputnik that is relevant to my subject today was the wave of self-criticism that swept over our nation. We suddenly became aware of a neglect of basic research, the niggardly level of teachers' salaries, the importance of scientific education (albeit with too much emphasis on quantity rather than quality), and even the contribution of eggheads to our national well-being.

What has all this to do with banking and with monetary policy? I think there is a useful analogy between the reactions to Sputnik in the past six months and to the active use of monetary policy in the past six years. Admittedly, monetary policy cannot compete, in terms of dramatic impact, with earth satellites. Nevertheless, within its own orbit, monetary policy has been the subject of a surge of public interest, intermixed with misunderstanding and exaggeration as to both its capabilities and its limitations.

This should not be surprising. The revival of monetary policy that has occurred in the United States and in many other countries, as a means of maintaining order in economic developments, is comparatively recent. Only after a generation of oblivion, during depression and war, has monetary policy come again to be used as a tool of government policy in pursuit of the goals of economic growth and price stability.

The revival of monetary policy began in the early 1950's in consequence of the inflationary pressures that accompanied the Korean War. In the United States, the wartime policy of central bank support in the market for government securities (that is, "pegging" operations) was ended in March 1951 with the Treasury/Federal Reserve accord. Prior to that time, we had monetary policy - but of the wrong sort. And other policies had to be used to combat an inflation that was actually nourished by monetary policies. Since that time, monetary policy has been used <u>deliberately</u> and <u>actively</u> to combat both inflation and recession.

Indicative of revived interest, the amount of space devoted to monetary problems in the newspapers has increased many-fold in recent years. Technical terms like "discount rate" and "net borrowed reserves" have acquired a surprisingly widespread usage.

In addition, there has been, as in the case of space matters, a considerable amount of headline-making and exaggeration regarding the effects and potency of monetary policy. Some observers have implied that monetary policy is capable of controlling every wiggle in the economy if only it is administered wisely. The Federal Reserve Board and the Open Market Committee have been pictured as a group of all-powerful men who hold in the palms of their hands the economic destinies of every American. For example, after consumers purchased a record number of automobiles in 1955 and decided to buy fewer cars in 1956, monetary policy was blamed by some observers for this cutback in buying.

I have no desire to minimize the influence of monetary policy, for it does affect the lives and welfare not only of Americans but also other people all over the world. But just as in the case of Sputnik, judgments with respect to it should be made on the basis of knowledge and balanced appraisal.

I am not complaining about the tendency for public opinion to swing to extremes in its initial reactions to a new development. It is one of the great virtues of a democracy that public opinion can and does well up on occasion - compelling legislators and government officials to consider new ideas and to re-examine old ones. One of the characteristics of countries that are not democratic is the apathy and ineffectiveness of public opinion.

I am merely trying to emphasize that effective and influential judgments with respect to monetary policy, or our policy regarding missiles and preparedness for the space age, must be based on information and analysis, not on imagination or superstition. The Federal Reserve endeavors continuously to re-appraise both the situation which it is trying to influence and the instruments with which it operates. It assembles and distributes a considerable amount of information on the subject. It welcomes investigation and study of the workings of monetary policy by any person or group, by Congressional committees, or private foundations. Out of these various efforts can come two related results of great value: (1) a better-informed public, and (2) a wiser use of monetary policy.

Government policies in general and monetary policy in particular depend on an informed public opinion for their full effectiveness. This does not mean, of course, that every citizen needs to become a monetary expert. The United States is capable of pursuing a wise policy with respect to missiles and other aspects of space without each citizen becoming an expert in physics. But a general knowledge of capabilities and limitations, of objectives and obstacles, helps the citizen to acquire the perspective to understand and evaluate events as they occur and governmental decisions as they are made. However, the attainment of an informed public opinion is not easy - many difficulties stand in the way. Let me present one or two of these in the area of monetary policy.

As you are well aware, monetary policy in the United States has evolved through several phases since its revival in 1951. These phases reflected the movement of the business cycle over the years and the effort of the Federal Reserve to lean against the winds of inflation and recession. Following the recession of 1953-54, our economy entered upon a boom of rather striking proportions. As the boom progressed in '55, '56, and early '57, total demands for goods, for labor, and for capital pressed hard against availabilities. In such a situation, the law of supply and demand is as inexorable as the law of gravity. When demand tends to outrun supply, prices rise.

The purpose of monetary policy during that period was to restrain demands - in so far as monetary measures could restrain them - in accordance with the capacity of the economy to supply the goods and services that were in demand.

As we all know, prices did rise between 1955 and 1957 in spite of the Federal Reserve policy of credit restraint. Perhaps the degree of restraint was inadequate, but does this mean that monetary policy was ineffective?

One can easily imagine the boom of 1955-57 ending not with a whimper but with a crash. That is, instead of the boom spending itself in a gradual downslide with (we hope) a relatively moderate and short period of adjustment, creeping inflation could have shifted to a gallop and culminated in a speculative orgy followed by an abrupt collapse and a long and hard period of adjustment. That this did not happen can, I think, be attributed at least in part to the steady restraint that was maintained on the expansion of bank credit.

The business cycle has a momentum and a rhythm of its own, growing out of the aggregate of millions of private decisions to expand productive capacity, to consume, and to save. Monetary policy can indirectly influence these decisions (and hence the economy), but it certainly cannot control them. For example, we can regulate fairly well the actual volume of money in the economy, but we cannot control its velocity; that is, the rate at which people use it. And everyone knows a ten dollar bill spent twice represents more purchasing power than the same bill spent once in the same period of time.

The role of stabilization policies is simply to try to temper cyclical movements in economic activity by discouraging spending when aggregate demands are growing more rapidly than the capacity to produce, and by encouraging spending when total demands are falling short of productive capacity.

In this field, the timing of policy-implementing actions, as well as their direction and magnitude, is of crucial importance. If the timing is poor, it is possible for monetary policy to accentuate rather than offset cyclical tendencies. But the fact that a policy of restraint precedes a downturn in economic activity is not by itself a demonstration that timing was wrong.

The question whether or not restrictive monetary policy overstayed the boom in 1957 will be the subject of discussion for a long time. I have no desire to be dogmatic on the question. We at the Federal Reserve do not claim to be supermen or to have an infallible crystal ball. We do not even agree unanimously at all times; rather we operate on the basis that the majority view is more likely to be "right" over the long pull than the view of any one of us.

It is not to be expected that all the policy-makers of the Federal Reserve will always view the state of the economy in the same light or always agree completely on the steps which should be taken in our effort to keep it on a reasonably even keel. Hence, the policies which are adopted are in reality a synthesis of our views and may not be in complete accord with the judgments of any one of us. But the policy, once adopted, is a Federal Reserve policy for which all of us bear equal responsibility.

The policy in the summer and early fall of 1957 was merely to continue the degree of restraint that had been in effect for some time in an effort to contain the forces of creeping inflation that had emerged with the investment boom. That these forces were still affecting views and actions in the summer of 1957 is evidenced by the sharp rise in prices of stocks, which in July provided yields below those on high-grade bonds. When it became evident in the autumn, after the psychological public reactions to Sputnik, that the upward impetus of the boom had weakened, Federal Reserve policy was modified. It can be as cogently argued that the change in policy was too early as that it was too late. But no one can know what the result would have been if a different policy had been followed.

The experience in the autumn and winter provides another example of incomplete public understanding of monetary policy. Since mid-October, when Federal Reserve policy changed direction, there has been a series of measures designed, among other things, to increase the availability and lower the cost of bank reserves. Open market operations, as well as slackening credit demands, began to lessen the pressure on reserves. In November discount rates at Reserve Banks were lowered, and again in January and March. There were reductions in reserve requirements in February and March.

For several months after mid-October there were frequent and widespread reports in the press that Federal Reserve actions had been confined to psychological moves. It was pointed out that open market purchases were no greater in the fall of 1957 than a year earlier and therefore, it was claimed, reserves were not being eased. This may be true in part, but only in part. One must look at the results. The means are not all-important. There are often several ways to skin a cat.

With the demand for bank credit declining in late 1957, pressure on bank reserves would have eased to some degree without any action by the Federal Reserve. But in addition, reserves <u>were</u> supplied through open market operations. This easing of reserve positions elicited a remarkably prompt and positive response. Bank loans which had declined contrary to usual seasonal tendencies in October and November, showed a greater than seasonal increase in December. Although business loans declined sharply early in 1958, bank credit in the aggregate increased substantially at a time when a seasonal decline is customary. Banks put a large part of the additional reserves to use by buying securities and making loans on securities.

This action by the banks, together with the psychological reaction of the investment community, caused a dramatic change in the market for new security issues from a state of congestion to one of remarkable fluidity. New issues of securities have been floated in record volume at higher prices and lower yields than those prevailing last autumn.

That the pressure on banks was eased considerably (whatever the cause), notwithstanding the accelerated expansion in their total loans and investments, is indicated by the fact that member banks reduced their borrowings at Reserve Banks from a level of about $1 billion in late summer to less than $200 million recently. Whereas, in late summer the "net <u>borrowed</u> reserves" averaged about $700 million, recently there have been "net <u>free</u> reserves" ranging in the neighborhood of $500 million, a difference of $1,200 million, which is not exactly small change. And as you know, the yield on U. S. government bills - which some people look upon as a bellwether - dropped from 3-5/8 per cent last fall to less than 1-1/4 per cent in recent weeks, an unprecedented drop.

Federal Reserve operations simply cannot be understood except against a background of knowledge of the developing situation in the money markets and in the economy generally. In regulating the availability and cost of member bank reserves, the Federal Reserve naturally takes into account the effect on reserves of those influences outside its control, for example, (1) float, (2) gold inflow and outflow, and (3) currency demands. With the effects from these factors in mind, the central bank endeavors to serve as a balance wheel - tipping the over-all change in reserves in the desired direction.

Since Christmas, these "outside-our-control" factors have, as they usually do at this season, supplied additional reserves to the banks. Federal Reserve operations have absorbed a smaller portion of these additional reserves than they usually do. Some observers noting this, but failing to take into consideration the volume of reserves supplied from other sources, and the extent to which credit expansion has put freed reserves to use, have erroneously drawn the conclusion that Federal Reserve action has been slight.

The difficulty of analyzing Federal Reserve policy is compounded by the fact that even its formulators may be motivated by different reasons. Take, for example, changes in discount rates. Some changes in rates represent not a change in policy - or even a change in intensity of restraint or ease - but simply an effort to adapt rates to market conditions in order to maintain an existing policy.

However, at times some policy-makers may favor a reduced discount rate as an "easing" operation which they think is needed to stimulate further extension of bank credit. Others may favor the same action, not for that reason, but for the purpose of taking advantage of the existing economic climate to move into a <u>position</u> from which future developments can be better combatted. To them it may seem that in attempting to deal with a foreseeable inflationary danger, it will be easier to start from a low discount rate position than from a high one. The same is true of reserve requirements. Consequently, it is desirable, they may think, to move discount rates and reserve requirements down, when that can be done without reviving latent sparks of inflation, in order to improve the effective position of monetary policy. <u>Position</u> can be as important in central banking operations as it is in football, in chess, or in business.

These are some of the major factors, varying in significance as they do from time to time, of which one must be aware in order to understand monetary policy and to appraise the way in which the central banking system operates in trying to do its part in keeping the vessel of the American economy in the deep-water channel - and in a modern industrial society it is a narrow and tortuous channel, indeed.

Without belittling the complexities or the achievements of the physical sciences, I truly believe the problems of the world in economics and government are more difficult. The reason for this is that chemical and physical problems are subject to experimentation under controlled conditions, which is exactly what the free world does not want in the area of economics and government. In those areas, the facts are constantly changing; we can know only a fraction of the relevant circumstances and must guess about the others as well as we can. In short, the conditions surrounding modern man, particularly in such areas as business, and finance, and government, can be dealt with successfully only through an extraordinary combination of information, initiative and integrity, courage and judgment. Many men have one or two of these qualities in exceptional measure; very few have all of them. Nevertheless, the system we have created unavoidably places a heavy duty on each of us to perform his job as wisely and as conscientiously as he can. And this duty demands constant study - constant effort to keep up to date on the new information and new ideas in one's own area of competence and responsibility.

This is, of course, the basic principle on which this Conference is founded. The responsibility of people whose work deals with money and banking is especially heavy because ours is a money and banking economy and the machine could break down very quickly and very badly if the lubricant of finance failed to circulate properly. It is encouraging to observe the increasing realization of our responsibility, and our efforts to discharge it effectively. That realization is exemplified in meetings like this, in which each of us attempts to broaden his knowledge of facts and ideas, his capacity to form the judgments and make the decisions that his job demands, and thereby to make a useful and creditable contribution toward keeping in efficient operation the powerful and productive machinery of the American economic system.

Now for a word with respect to my personal view of the American economy: One cannot return, as I have just done, from a tour of the Far East, where the economic problems dwarf our own, without being impressed anew by the vastness of our natural resources, the initiative and imagination of our people, and the dynamic strength of our economy. We have our problems: unemployment (which none of us wants or accepts complacently), reduced business activity, and even an increase in business failures. We have had a recession. But we have not had deflation; few sellers have yet felt obliged to reduce prices in order to sell goods or services.

At the same time, we do have a tremendous volume of stored-up purchasing power and a country full of people anxious to improve their housing and transportation facilities and their standard of living generally. Consumption has been in excess of production and inventories are rapidly falling to minimum working levels. We have a backlog of needs for public facilities. Research and new processes are constantly developing more efficient machines and methods of production and new products that require capital investment.

As I see the picture, there is nothing wrong with the great economic machine of this country that cannot be easily and readily corrected by reasonable price adjustments, a wise utilization of available monetary and fiscal tools, and a proper _frame of mind_.

In a dynamic, flexible, free enterprise economy, we are bound to have ups and downs, despite governmental efforts to moderate them. I would hope that the American frame of mind is such, or will rapidly become such, that we will be able to take the ups and downs, not complacently, but in stride and without panic. I am not willing to believe that we became so soft during the "ups" of '56 and '57 that we will panic with the "down" of '58 and swallow temporary palliatives that are not in our long-run best interests. In other words, let us by all means deal with the recession with appropriate monetary and fiscal measures, but let us also keep in mind the danger that some momentarily attractive remedies could create serious inflationary problems for us in the future.

Let me conclude with a plea for continued critical examination and appraisal of monetary policy against the backdrop of past, prevailing, and prospective economic conditions. In central banking, as in science and every other field, significant opinion must be informed opinion.