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CONTEMPORARY MONETARY POLICY AND ECONOMIC STABILITY

Those who have the task of making policy decisions sometimes admonish the academic economist to avoid theorizing in a vacuum. However that may be, the policy maker himself must beware of making decisions in a theoretical vacuum. Absorbed as he must be in day-to-day operations, the policy maker can easily lose perspective. If he fails to relate each new problem to what has gone before and to what may come after, the result will be inferior policy.

Let me take this opportunity to heed my own warning and review contemporary monetary policy broadly in the light of experience in this country with both theory and practice. In so doing, I realize that I may not say anything new. But my purpose is to provide perspective for consideration of more immediate monetary issues, which I shall come to in my second lecture and in the seminar between the two lectures.

Gold Standard Background of Modern Monetary Policy

Our conception of the responsibilities of monetary policy has been continuously evolving and broadening for the last half century or so. During the nineteenth century and the early years of the twentieth century, the theory of the gold standard dominated most thinking about monetary affairs. This theory was preoccupied with the rigid stabilization of the international exchanges, rather than with the internal stability of the nations adhering to the gold standard. The domestic money supply of individual nations was thus assumed to be determined automatically by international market forces and the responsibilities of monetary policy were relatively meager.

Under established gold standard rules, monetary or central banking policy was regarded as largely passive. The primary function accorded the monetary authorities was to facilitate the smooth operation of the gold standard mechanism and the rules for action were simple and unambiguous. A net inflow of gold was a signal to ease monetary and credit controls, a net outflow was a signal to tighten controls. Response to both of these signals involved immediate use of the discount rate, the chief instrument of monetary policy. It is a fair generalization that monetary policy under the gold standard was primarily expressed through the discount activities of central banks.

Popular Basis of the Gold Standard System

The popularity of the gold standard system, in theory and in practice, was due to several factors. The impersonal and automatic fashion in which the gold standard mechanism was supposed to operate had an appealing elegance to the nineteenth century mind. It seemed to place the mysteries of money matters in Olympian hands and to protect them from erring mortals. Also, it fitted well into the mechanistic view of organized society which dominated scientific thought in the nineteenth century.

The emphasis placed on the stability of international exchanges attracted support from all those who were especially impressed with the advantages of an expanding volume of international trade. Economists in particular supported the gold standard because they saw in the development of world markets the possibility of greater specialization in the use of resources than would be possible within the limits of a national economy. Active support also came from the commercially minded enterprisers who were so influential in the nineteenth century, particularly in England. This group clearly saw the connection between national and individual prosperity and the unhampered flow of international trade at stable exchange values.

Still another reason for the popularity of the gold standard was a widespread fear of inflation. By the nineteenth century, as you know, the civilized world had had many, many sad experiences with inflation. There was comfort in the idea that fiat money could be avoided by maintaining a constant relationship between the currency unit and a fixed quantity of the scarce metal.

Finally, the wide acceptance of the gold standard theory reflected the assumption of a high degree of flexibility in domestic prices and wages. Whether such flexibility obtained in practice was little questioned. The real fact was that people quite generally thought that prices and wages were flexible and they regarded price and wage flexibility as a good thing.

Changing Role of Monetary Policy

The operation of the gold standard mechanism was not without its hardships. Gold standard countries experiencing a contraction in gold stocks found themselves confronted with deflationary pressures. These harsh effects necessarily put the rules of the game to severe test. After a succession of such tests, it was inevitable that a more flexible concept of monetary policy would emerge. It eventually became the practice of the monetary authorities--that is, the central bankers, who after all had to come into direct contact with the human problems of adjustment--to act in a way that would mitigate some of the harsher effects of the gold flow mechanism.

Little by little, such practices became the rationale of modern central banking. By 1914 when the Federal Reserve System was established, the special contribution of central banking was conceived to be that of preventing undesirable monetary and credit stringency during periods of transient emergency, such as might arise from a temporary drain of gold or from seasonal swings in commerce, industry, and agriculture. As a result, the originally narrow concept of monetary or central banking policy under the gold standard theory had to be broadened to take more account of internal consequences.

After the disruptive effects of World War I, the gold standard never regained the form it had had in the prewar era. In those countries where its suspension had been considered only a wartime measure, its reestablishment was on substantially modified lines. In the new environment, monetary authorities were acknowledged to have even more extensive and flexible responsibilities. As a matter of fact, they were assigned the double role of functioning as an overt buffer against the upsetting consequences of

gold flows and as the means of continuously adjusting monetary and credit conditions to the needs of domestic trade and industry. The Federal Reserve Board's Annual Report for 1923 is a classic example of the newer thinking with regard to monetary or central banking policy. At that time, when gold was flowing to the United States, the Board indicated that the increasing gold ratio of the System was not a signal for an automatic easing of Reserve Bank credit. The report stated: "It is its (i.e., the Federal Reserve's) responsibility to regulate the flows of new and additional credit from its reservoirs in accordance with solid indications of the economic needs of trade and industry."

In this climate of thought, stability of the international exchanges as a primary preoccupation of monetary policy became definitely subordinate to domestic economic stability. Accordingly, during the Twenties, major gold movements were interpreted as calling for deliberate measures to counteract rather than to reinforce their effects. And to fulfill the broader responsibilities of monetary policy more effectively, new policy techniques were developed--including, in our country, open-market operations, a more systematic bank supervisory policy, formally issued policy statements for public information, and the publicizing of relevant statistical facts.

With this background of developing ideas about monetary management, it was only to be expected that the great financial collapse of the late Twenties and early Thirties would further change the character of monetary policy. The breakdown of the gold standard internationally, involving widespread depreciation and devaluation of currencies in relation to gold put monetary policy in many countries into direct control over foreign exchange transactions, particularly over capital movements. Subsequent monetary reorganization brought about a position of more positive influence over the activities of banks and other financial institutions.

You are acquainted with developments during this period in our own country. We devalued the dollar and undertook a comprehensive overhauling of our monetary machinery. Time does not permit a review of these fundamental reorganization measures. I want only to remind you that two new techniques of continuing monetary policy were introduced at that time-- authority to vary the level of reserve requirements of member banks and control over the margins required on stock market loans. The reserve requirement authority provided a powerful new method of general monetary policy, while the regulation of margins afforded a selective instrument to influence credit conditions in a particular but important area. The importance of these innovations, as well as of the inclusive reform of our monetary structure with which they were associated, is that they meant a still more explicit commitment to active monetary policy focused on national economic stability.

During the Thirties, sheer necessity of depressed economic conditions and widespread unemployment made reattainment of a satisfactorily high level of business and consumption activity the principal preoccupation of monetary and other public policy. You will recall the upsetting, though not altogether novel, experience we had of reaching a cyclical peak in business activity without approaching full levels of output and employment. You will also recall that previously accepted notions as to the potency of monetary policy, fostered particularly in the Twenties, were seen to be

grossly exaggerated. To combat the powerful forces of maladjustment during this period, reliance had to be placed on other measures--notably fiscal policy. Even with the extensive use of other policy measures, large-scale unemployment persisted until the outbreak of World War II.

Postwar Conception of Monetary Policy

The huge demands generated by war soon eliminated unemployment. But the experience of the depressed Thirties had a lasting impact. How to prevent the recurrence of large-scale unemployment was a dominant question in all discussions of postwar policies. From these discussions it became clear that public economic policy would have to assume a great postwar responsibility for the maintenance of continuously high levels of employment. There is no better testimony as to how intense was the concern over this issue than the Employment Act of 1946, which was passed, incidentally, by a conservative Congress.

But the goal of high level employment was not to be pursued at all costs. For example, "full employment" through inflation, was recognized as an undesirable long-run solution. Resort to wasteful, "make-work" projects was considered unacceptable. And, of course, all policy measures were expected to meet the general requirement of consistency with a "free private enterprise" system.

Not high employment alone, but stability at high levels of employment and output, achieved within the framework of a free private enterprise economy, became the emerging conception of the primary purpose of all public economic policy, including monetary or central banking policy. The part which monetary policy was to play in realizing this conception was not entirely clear. But that its responsibility was to be a large one, there can be no doubt.

I want to state at this point that wartime and early postwar thought regarding the future role of monetary policy was not neglectful of the international aspects of the money problem. It was recognized that some mechanism had to be devised as a substitute, internationally, for the former gold standard mechanism. The fruit of this thinking, as you are aware, was the international agreement reached at Bretton Woods providing for the establishment of an International Monetary Fund and an International Bank. It was felt that the first of these co-operative institutions--the Monetary Fund--could adequately assure relative stability of international exchange values, and that the second agency--the Bank--could contribute to the progressive expansion and balanced growth of world trade.

Both of these institutions were projected to function in a peaceful world in which member countries pursued national economic and monetary policies designed to promote high levels of employment and real income and to develop as fully as possible the productivity of their resources. The new agencies were not expected to be final answers to the international monetary problem. On the other hand, there was a conviction that success in the experiment of continuous international consultation and cooperation through these organized channels would give the world a better monetary mechanism internationally than had been provided by any former gold standard system. A stable expansion of international trade, if a favorable environment for such expansion could be established, would

progressively strengthen the new international financial institutions and permit them to perform their respective functions with increasing effectiveness.

Such then is the postwar conception of the objectives of policy in the management of money, and, as I have said, the goal of a stable but progressive private enterprise economy puts a very heavy responsibility on monetary management.

Complex Structure of the Money Supply

For monetary policy to do its part, it must provide the economy at all times with a supply of money consistent with the needs of a stable and expanding economy. This is easier said than done, for the term "money supply", at least in our own country, is a highly complex concept. Our particular money supply is not a quantity of readily identifiable and additive items. Rather, it is an amorphous mass.

We have currency money issued by the Treasury and the Federal Reserve Banks. We have the demand deposit money created by the commercial banks. We have a large amount of other liquid assets in the form of time deposits and savings accounts, building and loan shares, and the cash value of readily convertible insurance policies. We have an even larger volume of other liquid assets in the form of Government securities, exchangeable into money at par, by redemption or sale. We have still other assets--e.g., corporate bonds and obligations of State and local governments--that are very high in liquidity, and therefore by 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. These bank reserves have correctly been called high-pressure dollars.

The significance, from the standpoint of monetary policy, of this complex money structure becomes even greater when we realize that the ultimate concern of monetary policy is not with the money supply itself, but with the flow of money through the economy. The active money flow in the economy bears the impact of changes in the money supply and of the activation or deactivation of existing money stocks. In our complex money system, both of these types of monetary change reflect the independent decisions of many individuals and institutions, as well as the decisions of the monetary authorities.

In view of this complexity of monetary problems it is not surprising that the total monetary flow will at times reveal a tendency to become excessive, producing the symptoms of a general price rise, or that at other times it will show an opposite tendency, producing price declines and unemployment.

Ideally, monetary policy should completely forestall either tendency and maintain a total monetary flow that is at all times perfectly adjusted to the stability needs of the community. But the limitations on our ability to forecast economic behavior is itself sufficient reason to suppose that such an ideal is impossible of attainment in the near future. At present the most that we can feasibly aim for is to achieve and approximation to this ideal.

Need for Flexibility in Formulating Policies

Such an approximation is by no means an unambitious goal. It inevitably requires all the foresight, knowledge, and judgment that we can muster. One cardinal virtue to be cultivated is flexibility both in thought and in action. No rigid policy, no matter how well thought out in advance, will enable us to cope adequately with the problems of an uncertain future. Nor can monetary authorities expect to avoid mistakes that will require remedial action. Improvisation and reversibility should be included in a proper concept of flexibility.

We must not overlook the risks of flexibility in the making of public policy, not the least of which is that flexibility can itself become a source of economic instability. A well functioning private economy requires stability in certain areas of public policy as much as it requires flexibility in others. An important part of wise policy making, as I see it, is to recognize and adhere to the boundaries of each of these areas. The importance of this aspect of policy making is reflected, I think, in the considerable recent popularity of what has been termed built-in, or automatic, flexibility--a concept to which I shall refer again in a few minutes. Essentially, this concept undertakes to compromise the advantages of flexibility and stability in economic policy.

Strategic Factors in the Money Flow

The major changes that do occur in the economy's money flow are heavily dependent on certain strategic forces such as capital formation by private business, consumer expenditures for durable goods and housing, and international trade. To a greater or less degree each of these forces is subject to influence by the monetary authorities through the terms and conditions on which new money is available to borrowers. However, their susceptibility to such influence is qualified by the fact that these forces are in turn heavily dependent on non-monetary factors.

The volume of business capital formation, for instance, is affected by current expectations of future business activity, and investment plans are subject to expansion, modification, postponement, or withdrawal as the economic outlook changes. Demands for consumer durable goods stem from wants that are now deeply imbedded in the American standard of life. The state of international trade is a reflection of world political tensions as well as the product of reciprocal needs among nations for goods and services. In general, policies operating through the cost and availability of money--the major ways in which the monetary authorities can influence developments--are apt to meet with greater success when it is a matter of restraining rather than stimulating monetary expansion.

I might add at this juncture that the complexity of the money flow process is the basic justification for such instruments of monetary policy as margin requirements and consumer instalment credit regulation. By influencing credit conditions in selected areas, these instruments help to keep the use of credit in balance as well as to maintain sound credit conditions in the sectors affected. They thus afford a means of keeping certain strategic non-monetary forces from having an undue influence on the money supply and on the monetary flow through the economy. While they are relatively new techniques of monetary policy, in the brief period they have been available they have had a helpful supplementary effect. The

extent to which they may be forerunners of a broader development of selective credit technique cannot be judged at this stage of monetary development. Much more experience than we have had to date will be necessary before the desirability of such a development can be judged.

Timing of Treasury Surpluses and Deficits

The monetary flow through the economy is also affected strategically by Treasury surpluses and deficits. Whether considered within the scope of monetary policy proper or viewed as a separate area of public policy, the fiscal operations of Government play a significant role in monetary affairs. They cannot be ignored in any consideration of contemporary problems.

A current surplus on a cash basis means that the Government's outlays are running less than its income, and it is therefore having a contractive effect on the total money flow in the economy. A current cash deficit means that outlays are running in excess of income, and that the net effect of the Government's fiscal operations is to have an expansive effect on the current monetary flow. Consequently, under a stabilizing economic policy, surpluses should be accumulated whenever there is a tendency for the monetary flow to become excessive, and deficits ought never to arise except when it is desirable to expand the monetary flow.

This principle of fiscal policy is, or ought to be by now, a thoroughly elementary notion. Though I cannot speak with the authority of one who is directly concerned with making fiscal policy, it seems to me that a much more relevant and difficult problem is how to provide for Government surpluses and deficits of the right amount at the right time. In other words, to me, the really crucial problem in developing an adequately stabilizing economic policy is that of providing proper flexibility in Government finance.

Flexible Fiscal Policy

A certain amount of flexibility in Government fiscal policy can be provided on an automatic basis, that is, without requiring deliberate and specific action by either the Congress or the Executive. If the structure of tax rates remains unchanged, revenues will rise as the monetary flow expands, tending to reduce a deficit or increase a surplus. As the monetary flow contracts, revenues will fall, tending to reduce the surplus or create a deficit. With no opposing changes in expenditures, this automatic ebb and flow of revenues will itself exercise a stabilizing influence on the monetary flow. Such stabilizing influence may be supplemented, of course, by equally automatic fluctuation in the volume of outlays made on behalf of such items as unemployment compensation.

A stabilizing fiscal policy achieved through automatic devices is an undeniably appealing approach to the problem, and its potentialities are well worth stressing. But I suspect that its potentialities can never be great enough to preclude entirely the need for specific tax or expenditure adjustments as well. Just what tax or expenditure adjustments ought to be a part of a program of fiscal stability, I am not prepared to discuss in detail. In general, my preference is for relying on the tax rather than the expenditure side of the budget. It is my impression that

most expenditure items do not lend themselves readily to rapid expansion or contraction; but such rapid changes would be necessary if expenditure adjustments are to be heavily relied on to promote economic stability. Aside from the problem of workability, I am not sure that we ought to rely on changes in the volume of Government expenditures as a major means for ironing out fluctuations in the economy. For the scope of the Government's direct role in the market place is related primarily to the size and nature of its expenditures on goods and services. I think the scope of this role is one of the elements that, in a free private enterprise economy, ought itself to be kept as stable as possible.

Long-Run "Neutrality" of Fiscal Policy

The problem of stability at high levels of employment, insofar as it depends on fiscal policy, may involve resort to deficit financing, but only on a temporary and not on a permanent basis. A belief in the need for a chronic Government deficit to attain stability reflects, it seems to me, a lack of confidence in the viability of our economy. The long-run fiscal objective of budget neutrality--i.e., of a balanced budget--is, in my outlook, entirely consistent with the achievement of stable and high levels of employment and output.

From the point of view of stabilization needs, our real danger may be that we will lapse into an excessive use of deficit finance. If tension in the international situation persists, no retrenchment from a huge military budget will be possible. At the same time a considerable expansion in the welfare activities of the Government is probable. This combination of a welfare and garrison state means a large and growing volume of Government expenditures, implying in turn an average volume of Government revenues equally large if in the long run we are to maintain a balanced budget. In this situation, the temptation--and the danger--is to slip into a policy of chronic deficit financing. Should we default on our fiscal-monetary obligations in this way, the result may be to create a demand for comprehensive direct controls in order to combat a chronic condition of inflationary pressures.

Management of Surpluses and Deficits

The implications for monetary policy of a stabilizing program of Government finance are not confined alone to the timing of surpluses and deficits. They extend also to the way in which a surplus is disposed of or a deficit is financed. Differences in disposing of a surplus and in financing a deficit will be reflected in different effects on the money supply. Broadly speaking, their significance will depend on such factors as the nature and strength of the demand for investable funds and the reserve position of commercial banks.

To illustrate my point, a surplus might be used to retire debt held by the nonbank public. In this case, the process of accumulating and disposing of a surplus would not in itself result in any reduction in the money supply; it would only shift the ownership of money from taxpayer to security owner. On the other hand, if a surplus is used to reduce debt held by the commercial banks, a portion of the money supply will be extinguished, while the immediately available supply of bank reserves for new money creation will be increased. If a surplus is used to retire Federal Reserve held debt,

bank reserves as well as the money supply will thereby be reduced. Clearly, this last disposition of a budget surplus is the one that will make a maximum contribution to a policy of monetary restraint.

A similar type of analysis applies to the financing of a deficit--leading to a similar conclusion, namely, that if the deficit is to make a maximum contribution to monetary expansion it should be financed to the extent that it is feasible to do so through borrowning from the central banks--in our own country the Federal Reserve Banks.

Other Aspects of Government Finance

In addition to the management of budget surpluses and deficits, Government finance affects monetary policy through its management of outstanding public debt. Aspects of debt management, such as methods of refinancing, maturity, distribution, and of course the pattern and level of rates, must all be comprehended in, or related to, modern monetary policy. The principal objective of debt management from the point of view of monetary stability is easy enough to state: during inflationary periods when the monetary flow is excessive, it is desirable to attract investors' funds into public debt holdings and away from private investment expenditures, thereby reducing the active money supply. During deflationary periods, it is desirable to induce an exchange of public debt holdings for cash, thereby increasing the active money supply.

In this area of debt management more than anywhere else in the monetary and fiscal field, it seems to me, we are limited in the development of stabilizing policies by the incompleteness of our knowledge. With a debt of the magnitude of 250 billion dollars, with a stable level of long-term interest rates held long enough to permeate the entire asset and liability structure, and with a tense international situation, we do know that monetary policy must maintain orderly conditions at all times in the Government securities market.

But within this limitation, how much can be done? Are there changes to be made, through refinancing operations, in the maturity and ownership distribution of the debt that would improve it from the point of view of monetary stabilization? During inflationary periods, is some flexibility in the prices of Government securities compatible with maintenance of orderly market conditions? What would be the sure effects of such flexibility? Would these effects compensate for the known advantages of certain confidence in the orderliness and stability of the Government securities market?

Firm answers to questions such as these are prerequisite to development of debt management policies. Yet, even with much more intensive thought than this matter has thus far been given, the answer will be slow in coming. We have, after all, only acquired our present huge public debt within the past decade. We will need to proceed cautiously in building up our experience in improving methods for its management.

Concluding Comment

In the present lecture, I have endeavored to sketch the evolving role of monetary or central banking policy in relation to economic

stability. You will see that over the years it has undergone a profound change. If I have read the trend of history correctly, the change has been consistently in the direction of a broader and more flexible role, but with more definite responsibilities toward facilitating the maintenance of high levels of employment, stable values, and a rising standard of living--in short, towards facilitating greater over-all economic stability.

If we agree that this reading of history is a proper one, then we must conclude, I think, that the contemporary role of monetary policy is indeed a matter of crucial importance to all of us. We must also ask ourselves a very basic question: do we know enough about economic behavior and organization to stabilize a progressive private enterprise economy by the application of monetary and other public economic policies?

You are all familiar with the wide range of answers given to this basic question. They extend from a doctrinaire affirmative to an agnostic negative. My own position, as you might deduce, is towards the middle of these extremes. I do not believe that any one possesses the ultimate truth on the question. Nor do I think that we know too little and can never know enough to have a rational basis for action that will advance us along the road of stability. I do believe our knowledge and understanding is great enough so that we can proceed with some confidence of ultimate success. In going forward, we must recognize that monetary policy can carry only its share of the responsibility, that many other public policies--particularly fiscal policy--will have to do their part. We must recognize, too, that if the responsibilities are to be carried effectively, the public agencies charged with carrying them out will need to be adequately equipped with appropriate authority to perform their proper functions.