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## THE PHILOSOPHY OF CURRENT MONETARY AND CREDIT POLICY

The subject of this paper is as vast as it is interesting and it is particularly important in this national emergency. I shall approach it as one who has had some experience with money and credit, and is being confronted continuously with basic problems of monetary and credit policy. I wish to tell you of some of these experiences which relate to the "why" and "wherefore" of central banking.

I have to meet my policy responsibilities in my appointed place, so to speak, and at the proper time, and you will understand that I cannot talk about matters of current interest as freely as you could. Nor can I air my personal views on policy decisions that are now pending or that may arise in the near future.

This distinguished audience can aid our monetary and credit authorities in formulating basic solutions of the current problems that I shall outline. I consider it a great privilege to present this paper to an audience so well qualified to discuss the principles of our policy at this most critical time of our history.

### Basic Problems of Money and Credit; Financial Stability

In any philosophical study of social relations we have to start with the final purpose of man himself. We assume that man, in order to fulfill his final purpose, must strive for the moral, intellectual, and physical development of the individual, his family, and his entire community. Economic progress is one of the means that, rightly used, assists in that development. In the course of history we may one day reach a point where further economic progress may hinder rather than promote man's advancement because it would encourage, say, excessive idleness or luxury. At present, however, this danger seems remote. Many members of our own nation, as well as vast numbers of people all over the world, are still living in extreme poverty, lacking sufficient food, clothing, and shelter, as well as sufficient opportunity to devote themselves to the spiritual problems of life. Crime and vice are at present more closely associated with extreme poverty than with wealth. As long as that is the case, economic progress, aimed at reducing extreme poverty as much and as rapidly as possible, seems a worthy goal of human activity.

The use of money and credit has been designed to aid economic progress. In a meeting of professional economists I need not dwell upon the role played by these instruments in our economy. Money and credit are obviously necessary for the best use of the division of labor among individuals, among nations, and even among generations. In particular, they are obviously necessary for economic progress. They enable the pioneering entrepreneur to make better or cheaper products available to the economic community, and they enable the consumer to raise his standard of living by purchasing these new products.

The use of money and credit has, however, a drawback which has alarmed observers since the times of Aristotle. The very fact that these instruments make possible the exchange of present and future goods and services, may result in temporary irregularities in the flow of money and credit, and these irregularities may deeply disturb the economy in general. Hoarding of cash and contraction of credit may bring economic activity to a virtual standstill while dishoarding of cash and expansion of credit may produce furious overactivity. The more important the role of money and credit, the greater the danger and the graver the consequences of those disturbances, of a constant succession of booms and depressions. Not that money and credit are necessarily the only villains in the piece; an economy without money and credit would probably also show cyclical fluctuations, but it is the influence of variations in money and credit which makes cyclical fluctuations so violent and often disastrous. Two hundred years ago, an otherwise forgotten economist, Joseph Harris, wrote: "The greatest effect of money is in its fluctuations, and this if it be sudden, will be generally pernicious in its consequences." These words are still true today.

Monetary fluctuations are not only pernicious, but also fundamentally unjust. They lead to a violation of individual, commutative justice: a sudden and violent decline in the purchasing power of money enriches the debtor at the expense of the creditor; a sudden and violent increase enriches the creditor at the expense of the debtor. In addition, these fluctuations lead to a violation of social, distributive justice: they deeply affect in particular the demand for employment and thus the reward of labor. In times of inflationary booms they promote unproductive specul tion at the expense of productive work; for example, in postwar Germany prior to the currency reform of 1948 a worker had to engage in black market dealings to supplement his wages, and a girl could earn substantially more by dancing for half an hour with an American soldier in return for a package of cigarettes than by working the whole week in a factory or a store in return for wages paid in depreciated currency. In times of deflationary depressions these fluctuations lead to widespread unemployment; they burden many workers not only with extreme poverty and the accompanying temptations of vice and crime, but also with feelings of frustration which destroy their faith in the social order.

For these reasons, the monetary authorities have always considered it their main duty to stabilize the financial system, so as to create -- in the words of Father Dempsey --"the conditions in which the citizens can readily recognize and fulfill their obligations in justice." The monetary authorities are, however, confronted with two basic problems: first, exactly what kind of stabilization would serve that purpose; and second, what means would bring about the desired stabilization in conformity with the principles of social ethics, and expecially the principles of justice and individual liberty.

Types of Financial Stabilization

At first glance, the simplest kind of stabilization would seem to be that of the total volume of money and credit. In fact, an economy that shows little if any change from year to year, may be best served by a constant level of money and credit. In a rapidly progressing economy, however, such a stabilization obviously leads to an ever growing disparity between the supply of goods and the supply of money and credit, and may hinder growth and progress. It has been proposed to avoid this drawback by providing for a constant rate of increase in the volume of money and

credit. I wonder, however, whether we could forecast the rate at which the economy is likely to expand, and more important, whether we could expect the economy to expand at a constant rate, even if we eliminate financial instability. Would not a constant rate of increase in the volume of money and credit be at times too high and at other times too low, and thus lead to alternating inflationary and deflationary pressures rather than to stability?

Let us remember that in this country the volume of currency and adjusted deposits, apart from seasonal variations, remained virtually constant in 1948 and 1949. Despite that stability, the economy experienced a distinct inflationary pressure in 1948, and a moderate contraction in 1949. Another example is provided by the German economy in the period between the fall of 1948 and the spring of 1950, when both the volume of money and the volume of bank credit expanded quarter by quarter at a virtually constant rate, but the economy experiences quite violent fluctuations.

Many eminent economists favor stabilization of the price level. Indeed, if all prices could be stabilized, such a result might remove individual injustice as between debtors and creditors since neither would be in danger of suffering losses due to the time difference between payment and repayment. Such stabilization, however, would also eliminate an esential element of adjustment from our economic system. It would be impossible as well as undesirable in a dynamic economy to keep all prices constant; the goal of proponents of price stabilization is therefore stability of some price index.

I wonder, however, about the implications of stabilization of the price index. Unless all prices included in the index are held constant, a rise in prices of some goods would require a corresponding decline in prices of some other goods in order to keep the average of all prices stable. To the extent that lower prices reflect lower costs of production arising out of improved efficienty or reflect diminished demand for the products affected, declines in some prices would be desirable and in the public interest. To the extent, however, that reductions in specific prices represent arbitrary actions taken merely for the purpose of general price stability, such reductions would be undesirable because they would discourage production of wanted goods and be unjust to the producers of the goods.

Moreover, I wonder whether a stable price level always implies economic stability at large. Is it not possible that under certain conditions a rise in the price level may be necessary, say, in order to provide added incentives for investment required by economic stability. Or that a fall in the price level may be needed in order to bring prices and wages into a more stable relation? For example, at the beginning of 1948, our price level dropped, owing to a recession in agricultural prices, from their record level reached as the result of abnormal war and postwar demands. At that time our economy as a whole was still subject to inflationary tendencies; would it really have been just or sensible at that time to inject more money into our economy in order to keep the price level from falling?

All these methods of stabilizing primarily either the supply of money and credit, or the price level seem, therefore, open to serious

objections. The avoidance of violent price fluctuations is certainly an important goal of monetary policies; but is it not preferable while promoting growth and progress to try to stabilize economic activity as a whole, rather than any segment? Such a policy conforms to the Employment Act of 1946, which directs all government agencies to promote "maximum employment, production, and purchasing power." Does it not also conform to the principles of individual and social justice, by creating conditions equitable for all members of the economic community rather than for any special group?

It is true that the level of economic activity as a whole is difficult to define and to calculate; I wonder, however, whether these difficulties are much greater than those of defining and calculating the rate of expansion of the economy or a serviceable price index. I believe with Ricardo that "no plan can possibly be devised which will maintain money at an absolutely uniform value". The difficulties of exact measurement are, therefore, not decisive; the concept of stable economic activity remains fundamentally an "objective and calculable criterion" and thus fulfills, in the words of Father Dempsey, the "necessary condition to a meaningful just price of money."

Critics of monetary policy have charged, however, that the generality and vagueness of the concept of overall economic stability makes possible essentially arbitrary actions of the monetary authorities. I am fully aware of that danger, but I believe that the danger is due to the character of economic policy as such rather than to any particular concept. It is true that the members of the community cannot exactly forecast the measures which the monetary authorities will take in any particular situation; but neither can the monetary authorities exactly forecast what effects their measures will have. Identical measures may have very different effects even under apparently identical economic circumstances, because of differences in the psychology of business, in expectations, or in political conditions. It would, therefore, be a hopeless task, in my opinion, to devise immutable rules covering all possible contingencies and combinations, and to force the monetary authorities to follow those rules without any discretion whatsoever. These rules would become so complicated as to make our entire system of money and credit one huge bureaucracy. As long as we do not choose that way--and I shall have more to say about the choice in a moment--we must concede a large measure of discretion to the monetary authorities. Central banking in a free economy will always remain a matter of skill and experience, and hence as much an art as an exact science.

Methods of Achieving Financial Stability

The choice of the proper way toward financial stability is beset by problems even more difficult than those created by the choice of the goal. The instruments of monetary policy deeply affect the character of our economy. We can use either direct or indirect controls, or both. Direct controls force the members of the economic community to behave in a certain manner. Indirect controls influence economic conditions in such a way that the members of the community are induced to behave in a certain manner of their own free will.

The choice between these two methods, or a combination of both, touches upon the most burning issue of our day, the relation between the State and the Individual. The follower of totalitarian philosophies and the follower

of radical laissez-faire each takes a simple and uncompromising stand. Those of us who believe that the State is one of the institutions designed to assist man in his struggle to increase his welfare and fulfill his final purpose, have to avoid both the dangers of State tyranny and of anarchy. I wonder, however, whether in our times the first danger is not the greater, whether it is not more difficult and more urgent to preserve individual liberty than to guard against an excess of individual license.

There are two traditional means of monetary policy that conform most closely to the principles of individual self-determination in that they are completely self-enforcing and need neither detection nor punishment of contraventions. They are changes in the discount rate and Open Market operations. In recent years, however, both instruments have lost much of their effectiveness, and have, therefore, to be supplemented by other means.

Let us take the case of changes in the discount rate. A change as such does not forbid anybody to charge any interest rate he likes. However, it raises or lowers the costs of any lender who has to borrow funds from the central banking system, and therefore makes it less or more profitable for him to expand credit. The lender will thus be compelled by his own self-interest to adjust his credit policies in the manner envisaged by the monetary authorities. A change in discount rates also signalizes a shift in monetary policy and has, therefore, a wide effect on bankers' attitudes.

Open Market operations likewise do not force anybody to do anything. However, by making funds available to the market, or by withdrawing funds from the market, or by refusing to supply funds through the purchase of securities, the monetary authorities influence the availability of reserves to lending institutions and make it therefore more or less easy or advisable for them to expand credit. The lenders will again be compelled by their own self-interest to adjust their credit policies in the manner envisaged by the monetary authorities.

I need hardly tell you that in reality changes in the discount rate and Open Market operations, at present and in our country, do not seem to work according to those simple models. Ever since the second World War, the banks and other financial institutions have been holding very large amounts of marketable government securities. So long as the Federal Reserve purchases these securities at relatively constant prices, all those holders are able to sell them without much penalty and to make other loans or investments. In particular, the banks are able to replenish their reserves at will by selling marketable government securities to the Federal Reserve and thus avoid the penalty of borrowing from the Federal Reserve. Likewise, other holders of marketable government securities wanting to obtain cash can readily sell them and thus cause an increase in bank reserves. As long as the Federal Reserve follows the policy of maintaining relatively stable market prices of government securities, it cannot refuse to buy these securities, and cannot withdraw funds from the market by selling marketable government securities, if to do so would bring down their price.

The Federal Reserve is, therefore, confronted with a problem, which has obvious philosophical implications. Even a small decline in the price

of marketable government bonds, which are primarily held by institutional investors, might be considered unjust to those holders. On the other hand, to buy all securities offered by anyone in order to prevent a drop in prices might permit an inflationary expansion of credit. In that case, the support of the price of government securities would be unjust to the holders of money and money claims--including the holders of securities—and to the recipients of fixed incomes. I do not want to enlarge upon my own ideas as to the solution of that problem and I hope instead that the discussion will acquaint me with the views held by the members of this distinguished audience.

Since changes in the discount rate and Open Market operations have become less available for use, two other instruments of monetary policy have become more important. One of them is the use of reserve requirements. By raising these requirements, the Federal Reserve can require member banks to deposit a larger part of their funds with the Federal Reserve and therefore prevent them from using that part of their funds for lending operations. Conversely, a lowering of reserve requirements makes funds available for lending. When it is used, this instrument restricts the liberty of action of the banks somewhat more than changes in the discount rate or Open Market operations. Moreover, it affects all banks in a given category and not merely the banks that are expanding credit. The effectiveness of this instrument is also somewhat blunted as long as the banks can readily shift government security holdings to the Federal Reserve to meet an increase in requirements.

Under existing legislation the Federal Reserve can vary the requirements only within narrow limits. The problem arises, therefore, whether it would be advisable to ask for a change in legislation. And if such a request is deemed advisable, the further problem arises what type of additional reserve requirements should be recommended under present circumstances. We could recommend that banks be permitted to use either cash or short-term government securities as additional reserves, or we could propose reserve requirements dependent upon the volume of certain types of bank credit, rather than of bank deposits. Or we could request that additional reserve requirements be based upon increments of deposits or credits rather than upon their absolute volume. Each of these proposals has its advantages and shortcomings, both from the point of view of efficiency and of justice.

The second tool, which is being more and more widely recommended and used is that of selective credit controls. At present we have margin requirements for stock exchange transactions and regulations of down-payments and maturities for consumers' instalment credits and for home construction mortgages. These controls affect demand rather than the supply of credit; they often prevent credit transactions which both the lender and the borrower would be willing to make if left to their own decisions, and thus approach the character of non-monetary controls such as price or wage fixing and rationing. The main difference seems to be the fact that selective credit controls do not directly limit the price or quantity of goods or properties that might be bought by the parties concerned: these parties are still at liberty to buy or sell securities, to purchase automobiles or television sets, or to construct new homes, and they are only limited in their credit transactions. Many people, however, cannot in fact buy securities, automobiles, or new homes if their credit facitilies are restricted.

At present, hardly anybody doubts that selective credit controls are necessary in particular areas, especially since the existing controls affect mainly goods which use great quantities of scarce strategic materials and for which demand must be reduced in any case. The problem arises, however, whether monetary policy should, in the future, lay greater stress on the extension of selective controls or on wider use of general monetary and credit policies, such as discount rates, Open Market operations and reserve requirements. Some economists would scrap general policies altogether and rely exclusively on selective controls; in that case, those controls would presumably have to be extended to a qualitative regulation of the entire credit and capital market. Selective and qualitative credit controls are, however, difficult to administer, and can be applied only in areas in which collateral for credit is directly related to the purpose of credit and determine its amount. I wonder, moreover, whether even complete control of all credit transactions would make general monetary policy unnecessary. Selective credit controls would promise little success if the total volume of potential credit were permitted to grow without limits. Selective and qualitative controls are, therefore, supplements to, rather than substitutes for, general monetary policies.

Financial Stability and Social Justice

My preceding remarks have been mainly concerned with the relation of money and credit to the principles of individual justice and liberty. Monetary policy alone, however, cannot be relied upon to assure economic stability with growth. It is, therefore, intimately connected with economic policy as a whole, and thus with all the problems of social justice, concerning the role of the State in the economy.

There is a particularly close tie between monetary and fiscal policy: fiscal policy, by determining the credit needs of the Treasury, is often the decisive factor that makes monetary policy effective or ineffective. We have already seen how the problem of price support, the maintenance of an orderly market in U. S. government securities, affects our Open Market operations. On the other hand, the Treasury, as the country's largest debtor, would be directly affected by any decision of the monetary authorities that might lead to a rise in interest rates. Social justice certainly requires that this effect be taken into consideration, but the difficulty of the problem lies in the application of this principle to specific measures. I shall be gratified, indeed, if the discussion sheds some light on that matter, which, as you know, is of great practical importance.

In ordinary times, monetary and fiscal measures will generally suffice to achieve the goals of economic policy in the field of finance. In times of national emergency, when economic progress and economic incentives must give way to the requirements of defense, the use of non-monetary direct controls, such as price and wage ceilings and rationing, usually becomes unavoidable. It would be a grave mistake, however, to believe that these direct controls make monetary measures superfluous. Just as selective credit controls can work only as supplements of general monetary policies, so non-monetary direct controls can be successfully applied only in conjunction with proper monetary and fiscal measures. Price and wage ceilings and rationing, for instance, can be effectively administered only as long as total purchasing power is kept within bounds; and total purchasing power can be limited only by policies affecting the volume of money incomes and credit expansion. The present emergency, far

from relegating monetary and credit policies into the background, makes these policies more important than ever.

This problem is not merely a matter of efficiency and administrative convenience. Even in the present emergency, and in fact, just because of this emergency, we must not forget that our economic and non-economic policies are designed to serve the individual. For this reason alone we should strive to employ as much as possible those controls that do not require a vast apparatus of enforcement, of inquiry into the daily life of the members of our community, of prosecution and punishment. We have seen that monetary policies keep those requirements to a minimum, and they are, therefore, best adapted to the needs of our society.

These remarks lead me back to the starting point of our inquiry. Even a question, which at first glance seems to be purely practical, such as the relation of monetary and non-monetary controls, cannot be answered correctly unless we go back to the very basis of social philosophy. For this reason, everyone of us, and especially those who -- like myself -- are constantly in danger of being overwhelmed by their daily routine, must as often as possible take time out to think of the true significance of their actions. We shall be able to fulfill the daily duties of our office only if we constantly keep in mind our solemn obligation to conform to the tenets of justice, to protect the liberty of our Nation, and to respect the dignity of men.

This paper will achieve its purpose if it stimulates a discussion on the way in which monetary and credit policies can be carried out in conformity with these principles.