A REVIEW
OF
MONETARY POLICY

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I can think of no better time for a review of monetary policy than now, and I can think of no one more interested than you.

Over many years monetary policy has received more or less public attention. Its instruments, techniques and their use and application have changed and have been modified by changing attitudes and by time, experience and conditions.

In the past few years not only here, but throughout the world, we have witnessed the use of a variety of techniques for influencing the flow of credit. If there is one thing about monetary policy that is everlastingly true it is that to put it to use requires constant vigilance, constant study, and delicate adaptation to the peculiar circumstances of each change in the economic situation. We should, therefore, welcome all opportunities to survey and reappraise our experience with the use of the various means of influencing the supply of credit. I want to emphasize, however, over and over again, that monetary policy alone cannot achieve economic stability at high employment levels. It is only one essential part of a much broader program -- involving both government and business -- all aspects of which must be wisely pursued if we are to realize our goal.

Looking back to the establishment of the Federal Reserve System and the developments in the objectives of monetary policy over the intervening years, an interesting shift in emphasis as to these objectives may be observed. The Federal Reserve Act, in addition to establishing basic Federal Reserve functions of holding bank reserves, offering discount privileges to member banks, and providing an elastic currency, speaks of preventing injurious credit expansion and contraction,

and it goes without saying that Federal Reserve policy has at all times been based upon an awareness of the high economic cost of violent and excessive credit expansion and contraction. Long after the Federal Reserve System had begun to be directly cognizant of its functions in the prevention of injurious credit developments, the Employment Act of 1946 gave the System, along with agencies of the Federal Government in general, a new charge, that of pursuing policies and programs which would contribute to high and stable employment. Needless to say, this is not inconsistent with the earlier admonition, although it does broaden the objectives of monetary policy.

More recently, as the economic problems of the postwar period have received study and attention, the emphasis of monetary policy has shifted slightly again. In recent years we have become more and more conscious of the fact that Federal Reserve policy, like all aspects of government policy, must seek two objectives which, although intertwined and closely related to each other, from time to time need separate consideration; namely, the objective of economic stability and the objective of economic growth. Specifically, these twin objectives mean that policies which might foster economic growth for a time but which would create an increasing tendency toward instability are clearly self-defeating; conversely, policies or programs which might tend to insure stability at the expense of stifling growth would be equally unacceptable.

The question then is, what does the program of economic growth with stability mean in practical terms so far as Federal Reserve policy is concerned? I am sure that I do not have to stress before this group the basic fact that the Federal Reserve System is in a position to exercise a degree of influence upon the volume of credit supplied through the banking

system. In periods of tendency toward recession or depression the System seeks, by making bank reserves generously available, to create conditions favorable to an expansion of bank credit. The basic criterion for the appropriateness of a policy of all-out encouragement toward expansion (this has often been called a policy of "active ease") is the development in the economy of unemployed resources. Under such circumstances it may be reasonably presumed that greater availability of credit at incentive rates would assist the economy in increasing output without having an inflationary impact upon prices. This situation is aptly illustrated by the year 1954, during which unemployment rose in the United States and during which the Federal Reserve System followed a policy which facilitated an expansion of credit and an increase in the money supply.

The corollary of an effective policy during recession is that during periods of high employment, when inflationary pressures are evident, the System seeks to impose restraints upon credit expansion. As you are well aware, there are two related reasons why such action is necessary. First, when resources are already fully employed, the creation of more purchasing power through expansion of credit cannot mean higher employment or output, but is likely to take the form of increased prices. Secondly, if the experience of the past teaches us one thing, it is that excessive credit expansion and price rises not only create inequities in all sectors of our economy but also breed later trouble in the form of credit difficulties, price collapses and reduction in levels of economic activity as the economy deflates. Hence, to avoid paralyzing recession and depression, it is clearly necessary to avoid the excesses that have characterized most prolonged booms in the past. Further, the experience of those countries that have endeavored to bolster their economies by continued monetary creation,

whether by issuance of currency or by bank credit expansion, shows that this course leads to deterioration of living standards, the penalizing of saving, and cruel inequities in the distribution of income and wealth.

Superimposed on the responsibility which the Federal Reserve System has for helping to prevent or mitigate cyclical "ups" and "downs" in economic activity is the objective of maintaining a flexible money supply that will permit and encourage the growth over time of both investment and consumption to match our population growth and to provide for ever-increasing efficiency in our productive processes. This means over time that the money supply cannot be static; it must grow with general economic growth. It does not mean, however, that growth in the supply or availability of money must be at some constant or unchanging rate; allowance must be made for variations in the rate of use of existing money by the public. These variations can be and are very wide as economic conditions change.

Now let us examine more particularly the character of the problems of monetary policy which were faced in 1956. The year 1955 had witnessed a surprisingly rapid recovery from the 1954 recession. The slack in employment and unused physical resources was quickly taken up during 1955, and the Federal Reserve System accordingly modified its monetary policy early in that year from one of active ease to a policy of neutrality and still later during the year to a policy of mild restraint, growing more positive as the year wore on and inflationary developments became more manifest.

The pressure of demand upon economic resources continued to be great during 1956. The high level of economic activity, together with favorable expectations regarding the future, resulted in heavy demands for credit. Real estate mortgage and consumer credit demands continued to grow during the year, although at a slower rate, reflecting in part a smaller

number of new housing starts and a substantial reduction in the sale of automobiles. The business sector of the economy greatly increased its demands for credit, and was supplied more credit, as evidenced by a rise of around $5 billion in commercial bank loans to business borrowers and a flotation of over $10 billion in securities issues for new capital during the year. This demand arose in part from a higher rate of production and sales of most goods, necessitating higher inventory and higher working capital generally. One of the most significant developments of the year was a sharp increase in business expenditures (actual and planned) for new plant and equipment. Total expenditures for these purposes in 1956 reached approximately $35 billion compared with something under $29 billion for 1955 and in the last quarter of 1956 was at an annual rate of close to $38 billion with further growth anticipated.

As you know so well, in an economy of high employment levels -- and employment reached new peaks in 1956 while unemployment declined to the lowest level in 3 years (probably at a minimum) -- the only way in which further credit demands can be met without inflationary risks is out of savings. Some increased savings were made available in 1956 by a rise in both personal and corporate savings. Also, the cash position of the Federal Government moved during 1956 from a deficit to a surplus position; the cash surplus for the calendar year was about $6 billion. In spite of these developments making more funds available to borrowers, the demand for borrowings on balance greatly exceeded the supply of savings. The substantial increase in interest rates (and drop in prices of outstanding debt-securities) that took place during the year was a clear manifestation of this imbalance in the credit markets.

In the face of credit demands outrunning the funds available from savings and of an increase in the rate of "turnover" of money, the

Federal Reserve System followed a general policy of restraint on further credit expansion. This does not mean in the literal sense that the Federal Reserve decided to "make" credit scarce. Fundamentally, the scarcity of credit was a product of the market forces of supply and demand. What the Federal Reserve System did do was to refrain from making new Federal Reserve credit available in amounts that would have been necessary to meet all demands at current rates, since to do so would obviously have resulted in more price inflation as holders of the new credit bid against one another for the limited economic resources available.

Our statistics show that industrial production is now at a new record level of 148 per cent of the 1947-49 average. The rise from the year-ago high has been about 3 per cent, and most of the increase has occurred since summer. Production of a number of key industrial materials had reached capacity levels by late 1955, and capacity expansion over the past 12 months has resulted in only moderate further output increases. Thus, production of a combination of 8 major industrial materials -- including aluminum, steel, cement, paper, and petroleum products -- increased 3 per cent from November 1955 to November 1956, or at just about the rate their combined capacity was expanded. Meanwhile, the Mid-Eastern development has directed new demands in this materials area, notably for petroleum and steel.

Thus in 1956 a restrictive monetary policy meant in essence that the net amount of reserves supplied to and withdrawn from the banks by the Federal Reserve System was essentially unchanged. As would be expected, the System bought and sold Treasury bills in the open market to cushion seasonal and other temporary influences on credit markets; but contrary to the belief of many, it did not take money out of the market on balance during the year. Federal Reserve holdings of U. S. Government

securities were slightly larger toward the end of 1956 (as this is being written), than a year earlier, but member bank borrowings were somewhat lower. A moderate increase in gold stock and a generally higher level of Reserve Bank float supplied most of the additional reserves to cover increased needs of the public for hand-to-hand money (currency in circulation -- withdrawn from banks) as well as reserves required against the small growth in deposits.

In spite of the decisions of the Federal Reserve System to refrain from creating net new reserves, commercial banks were able, as I have mentioned, to increase loans by very substantial amounts during the year. As you are well aware, this was accomplished largely by sale of Government securities, total bank holdings of these securities falling by around $3½ billion during the year. Nonbank lenders, such as life insurance companies, also disposed of Government securities to a limited extent as a means of increasing loans to private borrowers. The decreases in these holdings of Government securities were absorbed in part by a reduction in the public debt and in part by increased holdings of other savers, including public and private pension funds and individuals. Meanwhile, however, the total money supply -- that is, demand deposits and currency held by the public -- is estimated (at this writing) to have increased about one billion or about one per cent during the year. The "turnover of deposits" or rate of use of money, however, increased by around 8 per cent. These increases in the supply and turnover of money provided the monetary basis for increase in various forms of financial activity, as well as for a growth of about 5 per cent in the gross national product, of which more than half reflected price rises.

Use of the traditional instruments of credit influence by the Federal Reserve System in 1956 reflects again the adaptation of these

instruments to current problems. As I have indicated, open market operations, primarily in the purchase and sale of Treasury bills, were used to provide for seasonal and other short-term variations in the reserve needs of member banks, but since purchases and sales were practically in balance over the year, there was little net impact from such operations. On the other hand, in line with rising market rates of interest, rediscount rates were increased in 1956, after having been raised four times in 1955.

Here again I may point out, that while changes in rediscount rates are one of the instruments of credit influence, as generally used in our economy they do not by themselves "make" the market or fix the level of interest rates. Although rediscount rate changes may have some real and psychological impact upon the market, they are to a degree only recognition of money market conditions created by the demand and supply forces in the market itself. The rediscount rate is one of the ways in which the Federal Reserve System can influence to some extent member bank borrowing; continuation of the rediscount rate well below market rates for an extended period would in most circumstances be an encouragement to borrowing by member banks at the Federal Reserve Banks. Rediscount rate changes also serve to indicate the direction of monetary policy.

Margin requirements -- credit extended to purchase or hold stock -- were increased from 50 to 60 per cent in January 1955 and from 60 to 70 per cent in April of that year. In other words, throughout 1956 30 per cent of the price of the stock could be borrowed.

The year 1956, as it unfolded, was clearly a year in which continued restraint on overall credit expansion was called for. High employment, low unemployment, growing demands for both investment and consumption, and rising prices (the consumer price index went up 2.8 per cent from January through November and the wholesale price index went up 3.6 per cent from January through November), confirmed such a diagnosis. Under these circumstances

it was inevitable that potential borrowers at some points should feel the pinch of unavailability of credit and higher cost for credit. The scarcity of credit thus merely reflected a scarcity of economic resources relative to demand in a free market economy.

Monetary policy everywhere is necessarily influenced not only by domestic but also by international considerations. For obvious reasons, international factors play a particularly important role in countries in which international trade and investment represent a large part of total economic activity.

Last summer, we witnessed two major instances of the influence of international considerations on monetary policy. In the United Kingdom, the restrictive monetary and fiscal policies pursued by the authorities had pretty well succeeded in stabilizing the domestic economy. However, mainly because of the disturbances in the Mid-East even before the most recent crisis, the United Kingdom gold and dollar reserves, and the exchange rate of the pound sterling, continued to be subject to severe pressure. This pressure made it impossible for the United Kingdom authorities to relax their restrictive policies in spite of the fact that the purely domestic situation could have permitted some relaxation.

The second example: last spring, the German monetary authorities decided that the domestic situation of the German economy required restrictive action, including a sizeable rise in the discount rate. However, after the discount rate had been raised, it appeared that the new rate level was attracting foreign funds to Germany in such volume as to pour more liquidity into the German banking system than the restrictive policies were taking out. Mainly for this reason, the German central bank had to undo at least part of the discount rate increase.

While our economy is less dependent on international factors than the economies of the United Kingdom and Germany, we cannot disregard these factors in our monetary decisions. At present, the international situation is too complex to permit here and now a review of all relevant circumstances. On balance, however, developments abroad seem likely to exert further short-term and long-term influences on our domestic economy, and in considering the domestic aspects of our monetary and credit problems and policies, you and we must keep these influences constantly in mind.

In the long run, the effectiveness of monetary policy depends not only upon proper use of the interrelated instruments of that policy, but also upon a degree of public understanding and acceptance of the program. It is human nature, especially in a dynamic competitive economy, to deplore restraint, and the reaction of many people to credit restraint is no exception. Yet I believe we all recognize not only that there is need for restraint from time to time, but also that of all instruments of restraint the instruments of general monetary policy, being broad and impersonal, bring the least interference and disruption in economic life. The basic aim of monetary policy during the months past has been to exercise such restraint as would avoid further inflation while disrupting the processes of the free economy as little as possible.

Various people have suggested from time to time that Congress give the Federal Reserve System the power to use selective instruments of credit control such as consumer instalment credit and real estate credit controls, in addition to its present power to change margin requirements. Others have suggested direct credit controls -- both quantitative and qualitative. This, as is evident, would be a departure from the Federal Reserve System's broad, impersonal and indirect general monetary instruments described in this review.

I have appreciated this opportunity to review with you what are essentially our common problems -- the creation of a monetary and banking system that will operate smoothly to facilitate growth in our economy and that will at the same time avoid the heavy cost and dangers of recurrent cycles of expansion and contraction, with theirresultant periods of unemployment and partial stagnation. The creation of such a monetary system is our common objective. We at the Federal Reserve welcome the understanding and assistance of all, and particularly the banking community, in the achievement of our goal.

We do know that a sound monetary policy is not achieved by formulas, by automatic mechanical devices or by taking certain prescribed steps at predetermined intervals. While we have learned much about the various instruments of monetary policy and their effective use we have much yet to learn. We are keenly aware that timing is of the essence but timing is not always clearly indicated in economic charts and graphs. One thing is certain: too much or too little money and credit are hurtful to our economy.

Exactly how much credit can most effectively be used at any particular time requires constant study and review of all relevant data, but let me suggest two points for your consideration: (1) Sound growth over time will require facilitating growth in the money supply. (2) The exact character and timing of that growth will have to be determined as conditions develop.

Let me close by emphasizing that we all need continually to learn more about the workings of our economic institutions in order to do our jobs effectively. Let us approach that task in a spirit of frankness and sincerity and with a firm desire to cooperate with each other in the solution of our common problems.

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