For release on delivery

(Approximately 9:30 a.m., CDT,
Wednesday, June 3, 1959)

THE ROLE OF MONETARY POLICY IN AN EXPANDING ECONOMY

by

M. S. Szymczak

Member of the Board of Governors

of the

Federal Reserve System

before the

1959 Seminar

Fraternal Investment Association

at the French Lick-Sheraton Hotel

French Lick, Indiana

June 3, 1959

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We keep hearing about cycles--weather cycles, business cycles, even sun spot cycles. Let me suggest that there has been another cycle of particular interest to those of us who are concerned with monetary policy. This is the cycle in the degree of faith that economists, governments, and the public generally have had in the efficacy of monetary and credit policy as a means of achieving economic stability with economic progress.

In the early part of this century, especially prior to 1914, there was widespread belief in the importance and effectiveness of monetary policy, particularly in connection with the preservation of stable international monetary relationships. It is probably correct to say that the Bank of England--the "Old Lady of Threadneedle Street"--was the very personification of that belief. By judicious manipulation of the discount rate, and by the purchase and sale of bills of exchange, the Bank of England saw to it that not too much gold flowed into or out of the country, that her exchange rates were kept stable, and that Great Britain remained the prosperous banker to the world that she was. I find it interesting, too, that in those days the activities of the central bank were carried out without public notice and perhaps without very much interest on the part of the public. No explanations were asked or given.

After the establishment of the Federal Reserve System in the United States, and particularly after the Federal Reserve had played an important part in connection with the financing of World War I, the belief and faith in the effectiveness of central bank action in the field of monetary policy continued high. This faith was strengthened by what appeared to be effective use of monetary policy during the 1920's, particularly in the recessions of 1924 and 1927.

The events of 1929-1933 were of course sobering. I doubt that anyone has seriously suggested that monetary policy actions or shortcomings were responsible for the Great Depression; nevertheless, the high unemployment and general economic stagnation of the early 1930's cast grave doubts upon the effectiveness of monetary policy in dealing with a major depression. Federal Reserve action could and did make credit freely available to the economy, and interest rates in financial markets declined to very low levels. However, the mere availability of credit at low interest rates was not, and probably never can be, in and of itself effective in stimulating economic recovery from a major depression. In these conditions, ready availability of credit at low rates is only one of the essential steps necessary to recovery. The other requirement is effective use of this credit by businesses and individuals.

During this period, therefore, the cycle I am describing--the cycle of faith and belief in the effectiveness of monetary policy--reached its low point. Economists, and the public generally, shifted from faith in monetary policy to a greater and greater dependence on fiscal policy--that is, government taxes and expenditures--as the major program to pull the economy out of the depression.

World War II, of course, sharply changed the focus of economic policy, but there was no revival of the belief in the importance of monetary policy during or immediately after the war. During the war, monetary policy was primarily concerned with the maintenance of low and stable interest rates that would facilitate the orderly financing of the large war-time budgetary deficits and the refunding of the public debt. While this was a success, Federal Reserve support of government securities provided banks with large amounts of new re-

serves, and therefore a potential and actual inflationary expansion of credit. After the war we entered upon a period during which, primarily as a result of the refinancing problems connected with the very large national debt that had been created during the war, the Federal Reserve continued a policy of market support of government bond prices, thus in effect not only giving up the proper use of its traditional instruments of monetary and credit policy but also, and in addition, further expanding the reserves of banks and thus the inflationary expansion of credit.

The so-called Treasury-Federal Reserve "accord" of 1951 marked an important milestone in the field of monetary policy. This accord was in effect a recognition that monetary policy cannot successfully do its job under conditions where the Federal Reserve is committed to the support of government bond prices at any designated level, and under its terms the Federal Reserve System gradually regained flexibility in the implementation of monetary and credit policy.

As a result of this accord, and of the events that followed, there has been a sharp upswing in what I have referred to as the cycle of faith in and reliance upon monetary policy as a leading means of achieving economic stability. It is generally recognized that monetary and credit policy instruments played an important part in our over-all efforts to mitigate the economic impact of the recession of 1954, the inflationary movement of 1955-57, and again the recession of 1958. In fact, I believe there is some reason to say that in the minds of some people there has been a tendency to conclude, during the past eight years, that monetary policy alone can achieve economic

stability, and that therefore if economic stability is not achieved, it must be the fault of monetary policy. The epitome of this point of view is reflected in the somewhat paradoxical position of those who say that monetary policy proved powerless to stop the inflation of 1956-57, and yet hold that the restrictive monetary policy was the prime cause of the 1958 recession. Now this over-emphasis upon monetary policy in the minds of some people has, I believe, had the unfortunate effect of tending toward a neglect of appropriate fiscal policy, government expenditures and taxes, and other policies and practices, public and private, which are of great importance to our success in achieving economic stability and in providing for sound economic growth.

We have thus come the full circle since 1914, the date of the enactment of the Federal Reserve Act. Like many cycles, this cycle has tended toward extremes, with the result that early in the period I have discussed, too much was expected of monetary policy; then for a time too little was looked for from monetary policy; and finally, in the more recent period, it seems to me that some people have again expected perhaps too much from it.

No longer does monetary policy escape public notice or public interest. Today, it is interesting to note that the world over monetary policy operates, as it were, in a "fish bowl". Explanations are asked for and given.

On the basis of a review of these developments, it would seem opportune (even at the risk of repeating the known) for us to review how monetary policy goes about accomplishing what it can hope to do, and to discuss briefly what it cannot do.

First, how does monetary and credit policy actually work in practice? Basically, monetary policy has its impact on the quantity of money in the economy, and less directly upon the rate of use of that money. As you all know, in our economy the most important type of money is not hand-to-hand currency, of which we use only such quantity as is convenient, but bank deposits subject to check. Thus, the creation of money is synonymous with the creation of credit by the commercial banking system.

In a period of expanding economic activity, for example, the demand for borrowed funds on the part of both consumers and businessmen wishing to spend tends to exceed the supply of savings available through the capital markets, through savings banks, savings and loan associations, and the like. Under these circumstances prospective borrowers go to commercial banks to borrow money, and as new credit is extended, new deposits are simultaneously created, with a resultant increase in the money supply. If bank credit, and therefore the money supply, is permitted to expand faster than the output of goods and services in the economy can be expanded, the inevitable result is a tendency toward inflation. Under such circumstances we have the classic example of too much money chasing too few goods, thus driving up prices. The function of monetary and credit policy at such a time is to impose restraints on the growth of commercial bank credit and therefore on the growth of the money supply.

The Federal Reserve System has three basic instruments which it may use to implement a policy of credit restraint: open market operations, discount rate changes, and changes in reserve requirements of member banks.

The most used and perhaps the least understood of these instruments is open market operations, by which I mean the purchase or sale of government securities in the open market. The impact of such open market operations is upon the reserve levels of member banks, and through these reserve levels upon the ability and willingness of commercial banks to extend credit to prospective borrowers. In a period of credit restraint, the Federal Reserve System may sell government securities, forcing member banks to draw down their balances at Federal Reserve Banks in order to make payment for these securities, either for themselves or for their deposit customers, and thus reducing their reserves and their ability to lend.

This is not, however, the way things typically happen. It is more usual, in a period of expanding economic activity and in furtherance of a policy of credit restraint, for the Federal Reserve System not to make sales in the open market, but merely to refrain from purchasing enough securities in the market to give member banks all the reserves they want in order to meet loan demands. What I am saying--and I think this is important--is that a policy of credit restraint is not typically a policy that results in an actual reduction of bank credit and money supply, but simply an unwillingness on the part of the Federal Reserve to provide enough new bank reserves to meet the total credit demands. The scarcity of bank reserves relative to the strong demand for credit creates a condition of credit tightness or credit restraint.

The fact that member banks in need of reserves may borrow from Federal Reserve Banks through the "discount window", as we term it, brings

into play the second instrument of credit policy; namely changes in the discount rate. This is the interest rate at which member banks may borrow from Federal Reserve Banks for short periods to tide themselves over temporary reserve shortages. It is fixed by the directors of each of the Federal Reserve Banks subject to the approval of the Board of Governors in Washington. In a period of credit restraint, it may be necessary to raise the discount rate in order that this rate may act as a deterrent to excessive borrowing by member banks. Discount rate increases at such times are partly in response to increasing market rates of interest, and partly a way of influencing market rates of interest.

The third basic instrument of credit and monetary policy is a change in the minimum legal reserve requirements for member banks. A policy of credit restraint may call for increases in reserve requirements, in order to reduce the ability of commercial banks to lend on the basis of their current reserve level. Typically, reserve requirements changes are used when the Federal Reserve wishes to have a major impact upon the credit situation, since even a small change in the percentage of reserve requirements will have a substantial effect upon the lending and investing power of commercial banks. An increase in reserve requirements, for example, not only allows banks to extend less credit on the basis of their existing reserves, but as the percentage reserve requirement is increased, each new dollar in reserves that banks may acquire can serve as the basis for a smaller number of dollars of new bank deposits. In other words, (to give both restraint and expansion) the multiple of deposit expansion decreases or increases as reserve requirements are increased or decreased. For

these reasons, reserve requirement changes are sometimes referred to as the bluntest of the three policy instruments.

The possible actions just described illustrate what might be done by the Federal Reserve System to implement a policy of credit restraint during a period of inflationary or potentially inflationary developments. If the demand for credit is strong, a situation of so-called "tight money" will result, unless the Federal Reserve adopts a policy of supplying reserves adequate to meet all demands. It is not strictly accurate to say that under these circumstances the Federal Reserve has established or decreed a tight money condition. Strictly speaking, the tight money condition has been created by the very strong demand for credit on the part of an expanding economy. Even if the Federal Reserve did not restrain credit expansion at such time, it is highly likely that the various demands for credit would reinforce each other in such a way that we would eventually have tight money in any case. The resulting inflationary price movements would stimulate additional demands for credit and cause interest rates to rise. The inevitable consequence would eventually be a reversal of the economic trend--probably a disastrous collapse.

In an economic recession, of course, the use of Federal Reserve instruments tends to be just the opposite of those we have described. As we all know, Federal Reserve policy, while it can encourage an increase in money, cannot force the economy to utilize this money in spending for increased production and employment. It can only make credit freely available, with a resultant lowering of the interest rate

structure, thus encouraging banks to lend or purchase securities and borrowers to borrow, not only at banks, but through all credit markets. Such free availability of credit may have a greater or lesser degree of success in increasing the spending level and in stimulating recovery from a recession; however, it is worth pointing out that the policy of credit ease followed by the Federal Reserve System in the 1958 recession resulted in an actual rise in the money supply during that year, thus creating in part the basis for the following recovery and economic expansion.

I should perhaps emphasize that the direct and principal impact of monetary and credit policy is upon the credit-granting activities of banks and are designed to influence the amount of cash that the public holds on deposit at banks or in the form of currency. Nevertheless, Federal Reserve actions also have some supplementary effect on nonbanking institutions, such as insurance companies, savings and loan associations, and the like, because all markets for credit tend to be closely interrelated. In general, the funds available to such nonbank institutions arise from savings which the public wants to invest and not hold in cash form, and their lending activities are larger in the aggregate than those of banks, but the ability of banks to lend or invest affects other credit markets and the availability of savings. Bank credit, however, cannot be a substitute for savings without creating an inflationary threat. In the long run economic growth and stability depend upon the volume of genuine savings and the uses made of them.

In summary, monetary and credit policy influences can be extremely useful in creating an economic atmosphere which is conducive to

economic growth with a minimum of instability. The Federal Reserve System, in the use of these instruments, acts regularly to permit the monetary system to accommodate itself to such seasonal changes as a varying demand for currency, credit needed for crop marketing, and other developments of this nature. In fact, in dollar volume the bulk of its operations is for these temporary purposes. Also, Federal Reserve actions may be important in insulating the economy from such potentially unstabilizing developments as gold flow, either into the country or out of the country. But more importantly, the instruments of monetary policy are highly useful in ameliorating the swings of the business cycle and in preventing the excesses that would ordinarily flow from unregulated credit growth, while at the same time furnishing the basis for the longer run credit expansion so necessary to sound economic growth.

We have now described the main things that we can reasonably expect monetary policy to do. Let us now ask the question, what are some of the things monetary policy cannot do or does not do?

In the first place, the Federal Reserve System, in the normal use of its instruments of monetary policy, does not "fix" interest rates. In a market economy such as ours interest rates are fixed by the interaction between the demand for, and the supply of, loanable funds in particular markets, and the function of the interest rate in each market is to equate the demand and supply at that rate of interest. In other words, if we examine any particular market, such as that for new corporation bonds, we see on the one side banks, insurance companies, pension funds and all others who may have money to lend, and on the other side the various corporations

who wish to borrow. These borrowers and lenders compete freely among themselves in the market, and the interest rate that emerges is simply the result of this free market competition. Thus, while central bank action does affect the supply of credit available from the banking system, the far more volatile element in credit markets is likely to be the variation in the demand for funds that normally takes place over the business cycle. This being the case, it is erroneous to conclude that interest rates are subject to determination by administrative decisions of the monetary authorities. As I pointed out, even the fixing of the discount rate must in some degree reflect, rather than determine, what is happening to interest rates in credit markets generally.

In the second place, the monetary authorities are not in a position to exercise any direct or close control over changes in the general price level. Monetary policy does have some impact on the expansion and contraction of the total money supply, although even this is indirect and imprecise. One of the problems of monetary policy administration is that changes in the total rate of spending in the economy may take place without commensurate changes in the money supply, as the existing money supply turns over at a higher or lower rate. These changes in the velocity of money constitute a variable which the Federal Reserve System seeks to take into account and at times to offset by the use of its instruments of credit policy. It is therefore evident that the impact of monetary policy upon the general price level is quite indirect and far from precise.

Nor does Federal Reserve policy have any direct control over the uses to which credit is put (except for margin requirements that affect

stock market credit). It can only keep a careful watch on all of the relevant economic developments as they become apparent, and act accordingly to attempt to restrain credit growth or to ease credit, as the case may be, to secure sound economic growth without the extremes of inflation or deflation. Basically, the objective of monetary policy is thus to assist in maintaining the fundamental balance between the flow of savings on the one hand and the demand of borrowers for funds on the other hand, a balance which is the *sine qua non* of stability.

There is a third thing that monetary policy cannot do--it cannot alone do the whole job of economic stabilization. The most obvious complement of monetary policy is appropriate fiscal policy. The importance of fiscal policy in the maintenance of stability flows in part from the sheer size of Government activities in economic affairs, and in part from the fact that tax and expenditure policies of Governments directly affect private investment and private saving decisions. Further, there are other policies and practices apart from monetary and fiscal policy which, in my opinion, have an important bearing on our success in achieving economic stability. For example, the price and work policies followed by business and labor organizations should be recognized as being important to stability. When, during a period of slack demand and unused productive capacity, prices fail to come down or even are raised, as was true in some cases last year, there is concrete evidence of the failure of basic economic adjustments to operate in a normal way. Similarly, I think we all recognize the necessity for wage rate adjustments over time to be kept in step with the need for maintaining a balanced distribution

of the benefits of productivity, so that demands for potential increases in output are stimulated and capital is available to provide essential equipment and technological advances. These examples illustrate the plain fact that the task of economic stabilization is far too complex to expect monetary policy alone, or even monetary policy and fiscal policy in concert, to achieve our over-all objectives.

In summary, then, I have attempted today to place monetary policy in proper perspective. Monetary and credit policies play a part--I believe a vital part--in the maintenance of stability and in creating an atmosphere conducive to orderly economic growth. But, like all other instruments of economic policy, monetary policy instruments have their limitations. Monetary and credit policy is only one of a whole set of policies, attitudes, and objectives, the successful implementation of all of which is required if we are to realize to the full our potential for economic growth and development, which is of such vital importance in the world struggle now going on.