FEDERAL RESERVE DECISION MAKING

(Remarks of C. Canby Balderston, Vice Chairman, Board of Governors of the Federal Reserve System, before the Financial Analysts of Philadelphia, on Friday, April 12, 1957.)

Tight money, so-called, has moved the Federal Reserve from the financial page to the front page. Since the Fed works full-time to do its share to protect the purchasing power of the dollar, it is important that the nature of the System and of its decision making should be understood.

My first point is that the central bank in this country is a system, not a single bank. It is a system whose structure or design balances decentralization and centralization. It is a Federal system with a basic structure and checks and balances akin to those of our Federal Government.

My second point is that its monetary policy decisions are not made suddenly or arbitrarily, but are the result of long consideration and discussion to which many minds contribute. Federal Reserve decisions evolve as one phase of the economy fades into another. They do not spring full-grown like Athena from the brow of Zeus.

It is especially appropriate to be discussing the Federal nature of our central banking system in the city which was the home of the First and Second Banks of the United States. The First Bank was chartered by the Government to issue paper currency. Essentially it was a private central bank though its ownership was divided: one-fifth governmental, four-fifths private.

The charter of the First Bank lapsed during the administration of President Madison; the function of issuing currency was returned to state banks exclusively. These state bank notes lacked 100 per cent metallic backing and many of them declined in value substantially.

Five years after the First Bank expired, Congress gave birth to the Second Bank of the United States. Five of the directors were appointed by the President of the United States and 20 by private stockholders. Its main office was here in Philadelphia, but it had over two dozen branches scattered from Maine to Louisiana. Through these branches Nicholas Biddle could contract and expand the currency. Bray Hammond indicates that its power to regulate came from the fact that it held the deposits of the U. S. Treasury, the largest depositor in the country. When checks of the local banks were deposited with it, Biddle gave the Treasury immediate availability and then pressed the local banks to make settlement in specie. As they lost specie, their power to lend was reduced. The Second Bank exerted strong influence upon both industry and agriculture. But once again the central bank came under political attack because it was looked upon as the tool of the money power. And so, President Jackson vetoed the renewal of its charter after Congress had voted its renewal. Once more the control of the issuance of currency was returned to the state banks. And this country continued to rely upon state banks for the issuance of notes until the establishment of the National Banking System in 1863. Both credit and currency inflation were again without restraint even though Nicholas Biddle had been demonstrating real insight into the methods by which a central bank could keep the money supply attuned to the needs of the economy. Subsequent to the demise of the Second Bank, the currencies were neither dependable nor elastic.

In the long decades that intervened before the Federal Reserve System was created, this country suffered a series of monetary afflictions. Chief among them was the Civil War inflation that culminated in the politically attractive greenback movement. This destruction of values was followed by the free silver agitation. The silver purchase legislation in effect from 1878 to 1893 resulted in increased currency issues and a gold outflow which endangered the maintenance of the gold standard, but the free silver group wanted to go still further and substitute free coinage of silver at its old price. So much for a currency that was unreliable both as a medium of exchange and as a store of value.

But the panics of the 1870's and 1890's and 1907 demonstrated the other weakness of our currency: its inelasticity not only seasonally, but also for secular growth. There was no central bank to provide for an elastic currency and to serve as a bank of last resort when individual commercial banks suffered from "runs" against them or to supply the expanding monetary base essential for a growing economy.

While gold discoveries around the turn of the century supplied the basis for monetary growth--perhaps too rapid expansion--provision for adjusting money supply flexibly to the varying needs of the economy waited until 1913 when Congress determined upon a central bank in the form of a truly federal system. Its structure consisted of a central Board with 12 regional banks, to which there have since been added 24 branches. Each of the 12 banks has 9 directors of which 3 represent lenders, borrowers and the public at large, respectively. The first 6 are elected by the commercial banks that hold Federal Reserve stock. Of these 3 are bankers and 3 are businessmen or farmers who are not bankers. The remaining 3 public representatives are appointed by the Federal Reserve Board. Altogether the Federal Reserve Banks and their branches have 260 directors who represent a cross-section of American businessmen.

At the hub of this Federal Reserve wheel are the Federal Reserve Board and the Open Market Committee. The first, consisting of 7 members appointed by the President for staggered terms of 14 years each and confirmed by the Senate, may be described as a coordinating body, with the general oversight of the several Banks and branches, and the authority to administer margin requirements, and to review and determine discount rates. It has the responsibility also for examining the Federal Reserve Banks and Branches, and through these Banks to examine the member banks.

The Open Market Committee consists of the 7 members of the Board of Governors plus 5 Presidents in rotation and has the responsibility for managing the System's portfolio of United States Government securities, the largest portfolio in the world. This Committee is the clearing house for the System. Its direct responsibility is to control the use of the most delicate of the monetary instruments, namely, open market operations. It can increase or decrease bank reserves by buying or selling securities. Recently, however, the Committee has come to be a forum for corralling the knowledge and thinking of the entire System, and for exchanging views as to the shifts in our dynamic economy. Not only is it the focal point of the System's intelligence activities, it is a mechanism for determining the consensus of System thinking. Each individual member is responsible for judging the trend of events independently and for reaching his own conclusions; he is also responsible, as a member of the Committee, for making his contribution to its joint product. Over a period of time it is a fair assumption that the consensus of a number of informed opinions is a safer guide to policy making than that of a single individual, however correct he may be at a particular moment. To accomplish these ends, the Open Market Committee now meets about every three weeks. The 7 Presidents who at a given time are not members under the system of rotation also attend; except for voting, they participate in all other respects as if they were members.

What I am suggesting is that it is a mistake to think of shifts in Federal Reserve policy as being the result of abrupt or arbitrary actions. The general monetary policy for which the Federal Reserve is responsible is featured by flexibility. It shifts with the ebb and flow of the economic tides. Just as businessmen seek to determine business trends by observing the signs and portents that have been found historically to have some meaning, so monetary authorities appraise business tendencies by the same signs and act accordingly.

The problem of judging the state of business, as you have discovered, is two-fold. One is the time-lag before business data become available. The other is the low visibility during certain phases of the cycle.

For monetary authorities, the most fundamental problem of timing is to forecast changes in the business climate in order to take compensatory action before the figures actually prove its necessity. Promptness of action is imperative if the anticipated results are not to be reduced unduly by the time-lag between changes in monetary policy and their effect on business activity. If the authorities wait until the figures demonstrate beyond question that further credit restraint or stimulation is needed, the action may lose its effectiveness, in whole or in part. But the perils of action based on judgments in advance of confirmatory information are obvious!

Another timing difficulty stems from the integration of monetary and fiscal policy. Actions by either the Fed or the Treasury may create difficulties for the other one, however firmly these two agencies resolve to work in concert. For instance, take the problem posed for both the Treasury and the Federal Reserve at the time the discount rate was raised in November 1955. For some months, business confidence had been mounting. It was evidenced by the rise of industrial orders and of loans, by rising stock prices, by business plant expansion, by a scarcity of steel, cement, and glass, and by increasing prices of many important industrial materials and products. The discount action that such a situation might have indicated was delayed by the economic uncertainties stemming from President Eisenhower's illness in late September. That these uncertainties dissolved in the sober reflections of businessmen was indicated by the McGraw-Hill survey of capital additions which forecast an overall increase in 1956 plans over 1955 of 13 per cent. The return of ebullience plus high seasonal demand for loans caused the Federal Reserve Banks, with the approval of the Board of Governors, to raise their rediscount rates in November even though the Treasury faced a refunding in December of over $12 billion. The Federal Reserve action, necessary as it was, increased the Treasury's difficulties in refinancing its maturing obligations the following month. The action had to be taken at the proper time despite some risk of unsettling the market for both Government and private securities.

Monetary policy should be adapted to future contours that can be discerned only dimly and for a short distance ahead. Consequently, shifts in business outlook are rarely so definite and clear-cut that monetary authorities can decide abruptly to shift credit policy from restraint to ease, or vice versa. Nor is a shift in policy emphasis usually decided suddenly without extended consideration. Just as a paddler guides his canoe through the ever-changing currents of a swift-flowing river, so must monetary authorities use as much foresight as possible in adapting their policies to changes in direction and condition.

Sometimes, of course, crises develop suddenly. In the spring of 1953, ebullience was high, plant expansion was rapid, inventory accumulation was large, and credit demands were strong with prospects for large Treasury borrowing ahead. The monetary authorities met this situation by maintaining restraint on bank credit expansion. Suddenly, in a matter of days, as heavy borrowing demand hit the market, money became tighter than it had been for 20 years. There developed fears that this tightness might endanger the smooth conduct of business, particularly in view of the usual seasonal expansion in demands then beginning, and the restraints were eased. In retrospect, it appears that the subsequent decline in activity is to be attributed in part to curtailment of governmental defense expenditures—a curtailment that had not been scheduled when the monetary restraints were imposed.

However, typical changes in the use of open market operations, changes in discount rate and reserve requirements evolve gradually from a whole sequence of developments in manufacturing, in commerce, in finance, and in the markets of the world. A striking example happened in the middle of 1956 when the Minneapolis and San Francisco Banks used discount rates different from the rest of the Reserve Banks. The commercial banks in those districts were experiencing such loan demand as to cause them to borrow heavily from their respective Federal Reserve Banks. The Federal Reserve directors of those two districts felt that the business sentiment reflected by this loan demand was sufficiently exuberant to require curbing. Accordingly, they decided to increase their discount rates, subject to review and determination by the Federal Reserve Board. The Federal Reserve Board, likewise, was watching with concern the expansionist tendencies of that period, and it approved the changes in these two districts even though the other ten districts did not all follow suit for over four months.

There is ample evidence to indicate that neither monetary policy nor fiscal policy, nor the two in concert, can provide growth and economic equilibrium in the face of either general despair or speculative exuberance. Of these two products of group psychology, despair and ebullience, there is also evidence in the history of previous booms and busts to demonstrate their power. Take the impact of the widespread destruction of equities in the 1930's upon the initiative of executives and their willingness to venture even if they were credit-worthy. At the other end of the spectrum observe the speculative fever that has so often weakened the economy during boom periods. There was the inventory expansion culminating in 1920, the Florida real estate boom culminating in 1926, and the inflation of security prices ending in 1929 that was inspired by the belief in a "new era" and was supported by an abnormal flow of credit into the stock market.

Dr. Riefler has observed that "a business situation is no sounder than the quality of its business decisions." Their quality, however, has two aspects. One aspect is the soundness of the decision itself. To base a decision upon an objective appraisal of such facts as are available does not, of course, insure that it will subsequently prove to be correct. But is the decision not more likely to prove imprudent if it is based upon the desire to chase the "fast buck" or upon sales projections that are inflated by price advances? The second aspect is that there are times in the business cycle when business decisions may cause aggregate demand to outrun supply even though most of the decisions may have been made prudently. Even if all of the demand arising from speculative and imprudent decisions were eliminated, it is conceivable that the remaining ones might create so much demand for scarce materials, labor and credit as to prove inflationary. Hence, it is not realistic to assume that prudent decisions alone are a solution without the overall control exerted by the central bank over the total supply of credit.

The question is frequently raised as to whether monetary and fiscal controls can prevent creeping inflation. Professor Sumner Slichter has frequently written upon this subject. He has recently observed that points of view concerning it fall into three categories. First, there are the pessimists who argue that no government dares to resist the demand for more and more credit because of the popularity of inflation with employers, trade unionists and the growing number of debtors. The second group he describes as cautious optimists, typified by Dr. Arthur F. Burns, who argue that the goals of stable prices and of high and rising employment are broadly compatible. The third group he describes as optimistic skeptics who hold that the long-run price movement is determined largely by influences over which men have only very incomplete control. These skeptics feel that there is not much that any one can do about the rapidly growing need for metals and oil unless one can halt industrialization and check population growth. Moreover, they hold that the country is not prepared to accept either of the two known methods of control—sufficient credit restraint to create enough unemployment to halt the rise in labor cost or drastic government controls of wages and prices.

There is no evidence from the experience of any country, even Russia, that <u>direct</u> controls over prices and wages, however drastic, can contain inflation. It is my own belief, however, that with <u>general</u> monetary control and sound fiscal policies orderly economic growth and reasonably stable prices <u>are</u> compatible. I decline to accept the doctrine that we can not have price stability without heavy unemployment. My principal argument is that excess capacity tends to depress prices and to curb price rises. As capacity catches up with demand, prices recede. Witness the record in cotton spinning, the production of rayon and acetate, and the weaving of cotton and synthetic fabrics. In the last of these, the data suggest that both productivity and wage rates have increased about one-third since 1947 while fabric prices have fallen.

My second observation is that the belief that creeping inflation is inevitable is both self-defeating and dangerous. It is self-defeating because one group after another seeks to protect itself by devices such as escalator clauses that tend to bring on the very malady it dreads; dangerous because it has an insidious effect upon the quality of decision making by businessmen who feel (perhaps unconsciously) that if they err on the side of imprudence in plant expansion and inventory building, the anticipated rise of costs and prices will validate their blunders. Such a belief threatens the continuance of the orderly rolling adjustment that seems now to be in progress. The wide belief that inflation is not only inevitable, but in fact desirable to sustain high employment, would accentuate the ebullience that has already caused investment demand to outrun savings. It leads to the effort of too many people to buy too much too fast.

If the value of money is to be stable and to assist the economy to move steadily upward, its supply must be harmonized with the flow of goods and with market competition. The impact of the general money supply upon the economy is so great as to make it of prime concern to citizens generally. Thus, supervision and control by governmental authority is required. As far as the total supply of money and credit is concerned, we have a managed currency. The apportionment of this supply among individual borrowers, however, is not primarily a matter for Government but for private lenders operating through free markets. The selection of the particular customer to whom loans are to be made is and should be left to the discretion of commercial institutions. Only if the allocation is the result of the operation of a free market will it be as impersonal as is desirable. This is not to say that it is inappropriate to intervene to further the general public welfare. Our public school system is a classic example of the social gains from such intervention. In war or other extreme emergencies involving severe social hardship, or when there is undue restraint of trade, the Government should interfere with the allocative function of prices and markets.

But when the Government does intervene in the process of allocation to take care of especially sheltered groups through subsidies, guarantees, or direct loans, it should remember that it is increasing the difficulties of those not so sheltered. Under the free enterprise system it is axiomatic that not all groups can be thus protected.

Currently, with the widespread feeling that continued inflation is inevitable, consideration of the public welfare calls primarily for measures to bring savings into balance with investment demand. Confidence that we possess and will pass on to our children a stable dollar is more important to <u>all</u> groups in the country than further attempts to shelter some of these groups from inflation.

I turn now to the philosophy that pervades the Federal Reserve System and guides its methods. The point has been made by Chairman Martin that the philosophy of the System may be likened to the concept of trusteeship. Trusteeship involves obligations that extend beyond mere legality. It involves the highest ethical and moral standards in the carrying out of the mandate issued to the trustee. While that mandate is in force, it implies the courage to take actions, however unpopular they may be at the moment, that the trustee believes to be best for the country and its economy. Naturally, the "trust indenture" of which we are speaking, that is the Federal Reserve Act, is not irrevocable because it may be changed at the will of the Congress.

In bringing about this trustee arrangement to deal with the highly complex problems faced by a central banking system, the Congress is to be credited with foresight in the degree of independence with which it has surrounded the System. The nuances of independence are not easily spelled out. They involve an opportunity, like that of the judiciary, to act objectively without favor and without fear, free of private pressures on the one side and partisan political pressures on the other. Such objective action requires full recognition of the real needs and interests of all concerned, along with recognition of their important roles in a properly functioning economy.