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MONETARY POLICY DECISION-MAKING

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# MONETARY POLICY DECISION-MAKING

The quality of monetary policy and business policy decisions is important at all times but especially so during prosperity. It will influence the duration and soundness of the current expansion. Steady, consistent economic progress calls for decisions of high quality if orderly growth is not to be interrupted by the violent dips that follow extreme booms. As Dr. Winfield Riefler has remarked "A business situation is no better than the quality of decisions that businessmen make," and as Chairman William McC. Martin has observed, "The state of the Nation tomorrow--its progress and prosperity--rests with the decisions of today."

This discussion does not deal with the decisions of entrepreneurs, important as these are, but with the monetary-policy decisions of the Federal Reserve System.

The decisions made by the Board of Governors and by the Open Market Committee of the System may be grouped into three categories. One of these consists of personnel and other decisions having to do with the internal operations of the Federal Reserve Banks and of the Board's staff. A second class consists of supervisory decisions made by the Board of Governors in carrying out its duties of examining member banks, of seeing that they remain sound and adequately capitalized, and of enforcing such statutory requirements as the Congress has determined upon. These supervisory responsibilities encompass admission to membership, the granting of trust powers, the restriction upon the payment of interest, the authority of member banks to merge in case either the capital or the surplus is diminished thereby, the authorization of branches for state member banks, and the enforcement of the Bank Holding Company Act. The third and most important group has to do with monetary policy, which involves decisions as to the extent and timing of open market operations, and of changes in discount rates, in reserve requirements and in margin requirements.

These policy decisions stem from the goals toward which monetary policy is directed. As long as these objectives are stated in general terms, there is little dispute. Everyone wants the country's standard of living to continue to rise. Strong economic activity and adequate job opportunities are goals that all agree upon, and so sustainable growth without inflation is high among accepted objectives. Political and economic freedom are American hallmarks.

Monetary policy actions, however, must be specific and decisions on such actions must be made in relation to definite policy objectives. Accordingly, from these generally accepted goals one may distil four objectives which flow from the mandates that are implicit in the Federal Reserve Act and the Full Employment Act. These are: to foster orderly economic growth; to sustain maximum employment; to protect the purchasing power of the monetary unit; and to keep international payments in balance (a main purpose of monetary policy for most countries even more than for our own.)

Although these specific goals might receive general acceptance it must be recognized that they represent plural objectives that may seem incompatible. For instance, certain nations have been forced to slacken their rate of domestic growth in order to balance their international payments. Moreover, there is considerable debate in this country whether the goals of full employment and stable prices are completely reconcilable.

Most of the day-to-day problems in economic policy making, however, arise not out of differences as to objectives, but out of the choice of specific policies which will promote those objectives.

Decision-making process

In any board of seven members judgments as to what ought to be done are likely to differ on occasion even when the pertinent facts are agreed to. This is sometimes true of the Board of Governors. In most cases, however, analysis of the facts does lead to agreement. Where it does not and the differences in point of view lead to different value judgments, a formal vote is required. Such instances, however, are relatively rare, as will be noted from a perusal of the Annual Reports. If a member dissents, his vote is of course recorded, either with or without a supporting statement.

The great majority of the Board decisions are arrived at by the general agreement of those present and voting. Since staff memoranda setting forth the facts and legal opinions concerning the supervisory and other matters coming before the Board for determination are circulated to Board Members in advance of their formal consideration, the usual procedure in Board meeting is to decide each instance promptly. Members of the staff who have knowledge of a case are present, however, so that a Board Member wishing clarification of the issue, elaboration of the facts, or elucidation of the law may ask questions before the decision is made.

The policy determination for which the Open Market Committee is responsible is of a somewhat different nature. As you know, this Committee, consisting of the seven Board Members and five of the Reserve Bank

Presidents, has statutory responsibility for open market operations. Because the use of this instrument is so closely related to the use of discount rates and reserve requirements, the discussions of this Committee encompass all three even though its directives are confined to open market operations alone. What is involved in its decisions is to determine the direction and degree of change in open market policy; whether to move in the direction of restraint or of ease, and how fast.

It is usually not possible for the Chairman to state open market issues in such form that the members can vote "yes" or "no". On the contrary, he has to determine as best he can what is the "sense of the meeting" when he summarizes the general instruction of the Committee to the Manager of the Open Market Account at the end of the meeting. The Manager of the Account has available to him both this resumé, to which any member may object if he feels it does not reflect the majority opinion, and also the minutes stating the position of each individual member. This consensus reflects any policy change that the Open Market Committee wishes to have made and is an important supplement to the written directive that is adopted formally at each meeting. Guided by this consensus, the Manager of the Account deals with day-to-day changes much as a chauffeur keeps his vehicle on the road by adjusting to bumps, dips, and obstacles. But changes in destination and pace are guided by the formal directives of the Committee.

Decision-making problems

The interpretation of the economic facts put before the Open Market Committee might be comparatively simple if the facts always gave a clear and consistent picture. Actually, however, conflicts often appear among them. Income and prices may seem to point in one direction; production in another. The monetary facts may not square with the presumed measures of real economic activity. For instance, interest rates in short-term money markets may seem to show more demand for funds than can be explained by the monetary position, or by inventory growth or other sources of demand for credit. Finally, conflicts in economic developments may be puzzling. As usual in a recovery period, the growth in physical output from factories has not been accompanied by a corresponding increase in employment. This reflects a rapid improvement in productivity that is, in part, the fruition of earlier capital outlays and of management steps to increase efficiency. Such developments are of long-run importance since they reflect increased capacity to improve our standard of living. Nevertheless, the short-run problems of absorbing all of the individuals who are still unemployed are of social and economic significance.

Moreover, even if there is basic agreement as to the facts, they are not interpreted alike by all individuals. On occasions an increase in business inventories may appear to some as voluntary adjustment by businessmen in anticipation of rising production and sales, while to others it may appear to be an involuntary adjustment resulting from a failure of sales to keep pace with businessmen's expectations. In the early phase of the present recovery, the slow growth of bank loans to business might have signaled to some that monetary policy was too restrictive while to others it seemed a signal of high business liquidity and ample availability of funds from internal sources.

Another problem in policy-making is that many of the economic facts needed for policy formation are frequently unavailable, or become available so late as to be of little use in current policy formation. In the interim, it is necessary to rely upon "straws in the wind" obtained by word-of-mouth. Decision-making within the Federal Reserve System faces the same difficulties as decision-making in other areas, including the necessity of having to make decisions before the evidence is complete.

For monetary authorities, the most fundamental problem of timing is to foresee changes in the business climate in order to take compensatory action before the figures actually prove the 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 effects on business activity. If action is delayed until figures demonstrate the need beyond question, the action may lose its effectiveness in whole or in part. But the perils of action that anticipates the figures are obvious!

Finally there are problems arising out of the need for monetary policy to be coordinated with Treasury financing. If we had the kind of fiscal policy sometimes hopefully and idealistically outlined in the textbooks there would be no need to finance Government deficits except in periods of low business activity. During such periods the financing of deficits creates no real problem for the monetary authority. Unfortunately, Government deficits often have to be financed in periods of expansion—an unhappy fact that the Federal Reserve cannot ignore. In addition, the Treasury faces a continuing problem of refinancing the vast volume of securities maturing in the course of a year and of engaging in large borrowing and debt retirement operations to compensate for the uneven flow of tax receipts.

Monetary policy must take heavy Treasury financing operations into account so that the success of those operations will not be placed in jeopardy. On the other hand, monetary policy must not be subordinated to fiscal policy. They must work as a team. A well-known example of the lack of such teamwork was the inflationary "pegging" of government bond prices after World War II.

Occasionally, the coordination of monetary and fiscal policies encounters difficulties of timing. For example, consider the problem posed for both the Treasury and the Federal Reserve when the state of the economy called for raising the discount rate in the Spring of 1957. For some months business confidence had been mounting. It was evidenced by a rise of industrial orders and of loans, by buoyant stock prices, by plant expansion, by a scarcity of steel, cement and glass, and by increasing material prices. The indicated discount change was delayed by Treasury financing activities in February, March, May and July 1957. The Federal Reserve Banks, with the approval of the Board of Governors, finally raised their discount rates in August. This action that was needed for technical as well as economic reasons was delayed by these financing operations so that it came nearer the cyclical peak than would have been desirable. It is noteworthy that the Treasury has made much progress in the structuring and spacing of its floating debt to the end of minimizing the market impact of financing in the short-term area.

Additional complications stem from the so-called administrative lag in the use of fiscal policy. Since it is necessarily long in the making and in the execution, it may exert an impact on business at just the wrong time to improve the stability. In fact, governmental buying that was originally intended to be compensatory might actually be superimposed on a boom in a private sector, and further accentuate demand that is distorting the economy.

Influence on monetary policy of free markets and freedom of choice

The problems of monetary policy are the problems of a society organized around the principles of free markets and freedom of choice. In an economy where freedom is exercised by individuals and by business units, effective regulation of the money system is of prime importance. In fact, the major concern of monetary policy in such an economy is to minimize the unstabilizing effects of changes in the use of money and credit which businesses and individuals generate in the exercise of freedom. But freedom, even though it entails flaws, is the wellspring of social and economic advance. It spurs the creative process and permits experimentation leading to change. The resultant economic hazards are small prices to pay for the rewards.

In the field of credit, the Government cannot compel any man to lend his money against his will--even to the Government itself--in circumstances or upon terms not acceptable to him. This important freedom of the lender--matched of course by the freedom of the borrower to reject unacceptable terms--can have embarrassing results for the Government, as happens when many investors abstain from purchasing Government bonds. But the freedom nevertheless serves the public interest, for it imposes upon the nation's elected representatives and upon all other branches of the Government the necessity of following sound fiscal policies.

Another freedom of concern in monetary policy determination is in the use of money itself. Those who hold cash balances may allow idle cash reserves to accumulate when interest rates are only moderately attractive. However, when short-term interest rates are high there is an incentive to economize in the use of cash balances. Increases occur in the transaction and income velocity of money. Sometimes such increases are reasonably predictable on the basis of interest rates; at other times, other influences make them unpredictable. An increase in velocity represents a legitimate exercise of economic freedom, but it complicates decisions as to what money supply is appropriate to sustain economic growth.

Still another economic freedom that has repercussions on the monetary system is the choice among inventory policies. The recession that began in the fall of 1957 was accompanied by rapid inventory liquidation. Indeed it continued after the bottom of the cycle was reached, but manufacturing inventories are now increasing rather briskly. The choice of inventory policy requires business judgment that is usually best exercised by private citizens. Nevertheless, the great buying or liquidating waves that flow from changes in inventory policy create a real challenge not only for those concerned with monetary policy but ultimately for individual businessmen themselves.

The problems which are the concern of monetary policy in a free society are those which flow from the exercise of freedom in the use of money. These problems are ever changing and no mortal can predict with certainty where they will lead. Accordingly, monetary policy can never be reduced to formulas or the application of routine adjustments to standard situations. It must continuously be modified to fit a changing economic environment. It is my belief that the Congress, in creating the Federal Reserve System, has designed an institution eminently suited to formulate monetary policy that is flexible. It is suited to the variety of our economy and to its changing moods. It recognizes that central banking is an art and not a science.